

EMCLAIRE FINANCIAL CORP

Form 10-Q

August 11, 2014

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended **June 30, 2014**

or

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

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

Commission File Number: **001-34527**

**EMCLAIRE FINANCIAL CORP**

(Exact name of registrant as specified in its charter)

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

612 Main Street, Emlenton, Pennsylvania 16373  
(Address of principal executive offices) (Zip Code)

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

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

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

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

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

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

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

The number of shares outstanding of the Registrant's common stock was 1,771,158 at August 11, 2014.

**EMCLAIRE FINANCIAL CORP**

**INDEX TO QUARTERLY REPORT ON FORM 10-Q**

**PART I – FINANCIAL INFORMATION**

|         |                                                                                                                             |    |
|---------|-----------------------------------------------------------------------------------------------------------------------------|----|
| Item 1. | <u>Interim Financial Statements (Unaudited)</u>                                                                             |    |
|         | <u>Consolidated Balance Sheets as of June 30, 2014 and December 31, 2013</u>                                                | 1  |
|         | <u>Consolidated Statements of Net Income for the three and six months ended June 30, 2014 and 2013</u>                      | 2  |
|         | <u>Consolidated Statements of Comprehensive Income (Loss) for the three and six months ended June 30, 2014 and 2013</u>     | 3  |
|         | <u>Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2014 and 2013</u>                      | 4  |
|         | <u>Consolidated Statements of Changes in Stockholders' Equity for the three and six months ended June 30, 2014 and 2013</u> | 5  |
|         | <u>Notes to Consolidated Financial Statements</u>                                                                           | 6  |
| Item 2. | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                                | 28 |
| Item 3. | <u>Quantitative and Qualitative Disclosures About Market Risk</u>                                                           | 41 |
| Item 4. | <u>Controls and Procedures</u>                                                                                              | 42 |

**PART II – OTHER INFORMATION**

|          |                                                                    |    |
|----------|--------------------------------------------------------------------|----|
| Item 1.  | <u>Legal Proceedings</u>                                           | 42 |
| Item 1A. | <u>Risk Factors</u>                                                | 42 |
| Item 2.  | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 42 |
| Item 3.  | <u>Defaults Upon Senior Securities</u>                             | 42 |
| Item 4.  | <u>Mine Safety Disclosures</u>                                     | 43 |
| Item 5.  | <u>Other Information</u>                                           | 43 |
| Item 6.  | <u>Exhibits</u>                                                    | 43 |

Signatures

44

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

Emclaire Financial Corp

Consolidated Balance Sheets

As of June 30, 2014 (Unaudited) and December 31, 2013

(Dollar amounts in thousands, except per share data)

|                                                                           | June 30,<br>2014 | December 31,<br>2013 |
|---------------------------------------------------------------------------|------------------|----------------------|
| Assets                                                                    |                  |                      |
| Cash and due from banks                                                   | \$2,426          | \$ 2,485             |
| Interest earning deposits with banks                                      | 35,068           | 14,173               |
| Cash and cash equivalents                                                 | 37,494           | 16,658               |
| Securities available for sale                                             | 146,527          | 117,304              |
| Loans receivable, net of allowance for loan losses of \$5,046 and \$4,869 | 360,469          | 352,430              |
| Federal bank stocks, at cost                                              | 2,791            | 3,977                |
| Bank-owned life insurance                                                 | 10,562           | 10,401               |
| Accrued interest receivable                                               | 1,530            | 1,466                |
| Premises and equipment, net                                               | 14,114           | 12,310               |
| Goodwill                                                                  | 3,664            | 3,664                |
| Core deposit intangible, net                                              | 852              | 965                  |
| Prepaid expenses and other assets                                         | 5,699            | 6,667                |
| Total Assets                                                              | \$583,702        | \$ 525,842           |
| Liabilities and Stockholders' Equity                                      |                  |                      |
| Liabilities:                                                              |                  |                      |
| Deposits:                                                                 |                  |                      |
| Non-interest bearing                                                      | \$115,362        | \$ 104,269           |
| Interest bearing                                                          | 399,041          | 327,737              |
| Total deposits                                                            | 514,403          | 432,006              |
| Short-term borrowed funds                                                 | 2,150            | 24,150               |
| Long-term borrowed funds                                                  | 15,000           | 20,000               |
| Accrued interest payable                                                  | 253              | 292                  |

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|                                                                                                                                                                                |           |            |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------|------------|
| Accrued expenses and other liabilities                                                                                                                                         | 4,439     | 4,322      |
| Total Liabilities                                                                                                                                                              | 536,245   | 480,770    |
| Commitments and Contingent Liabilities                                                                                                                                         | -         | -          |
| Stockholders' Equity:                                                                                                                                                          |           |            |
| Preferred stock, \$1.00 par value, 3,000,000 shares authorized;<br>Series B, non-cumulative preferred stock, \$5,000 liquidation value, 5,000 shares issued<br>and outstanding | 5,000     | 5,000      |
| Common stock, \$1.25 par value, 12,000,000 shares authorized; 1,872,175 and 1,870,675<br>shares issued; 1,770,158 and 1,768,658 shares outstanding, respectively               | 2,340     | 2,338      |
| Additional paid-in capital                                                                                                                                                     | 19,586    | 19,478     |
| Treasury stock, at cost; 102,017 shares                                                                                                                                        | (2,114 )  | (2,114 )   |
| Retained earnings                                                                                                                                                              | 24,541    | 23,650     |
| Accumulated other comprehensive loss                                                                                                                                           | (1,896 )  | (3,280 )   |
| Total Stockholders' Equity                                                                                                                                                     | 47,457    | 45,072     |
| Total Liabilities and Stockholders' Equity                                                                                                                                     | \$583,702 | \$ 525,842 |

See accompanying notes to consolidated financial statements.

## Emclaire Financial Corp

## Consolidated Statements of Net Income (Unaudited)

For the three and six months ended June 30, 2014 and 2013

(Dollar amounts in thousands, except per share data)

|                                                     | For the three months ended<br>June 30, |          | For the six months ended<br>June 30, |          |
|-----------------------------------------------------|----------------------------------------|----------|--------------------------------------|----------|
|                                                     | 2014                                   | 2013     | 2014                                 | 2013     |
| Interest and dividend income:                       |                                        |          |                                      |          |
| Loans receivable, including fees                    | \$ 4,089                               | \$ 4,098 | \$ 8,119                             | \$ 8,297 |
| Securities:                                         |                                        |          |                                      |          |
| Taxable                                             | 493                                    | 470      | 897                                  | 887      |
| Exempt from federal income tax                      | 253                                    | 295      | 518                                  | 562      |
| Federal bank stocks                                 | 44                                     | 17       | 79                                   | 35       |
| Interest earning deposits with banks                | 27                                     | 18       | 38                                   | 31       |
| Total interest and dividend income                  | 4,906                                  | 4,898    | 9,651                                | 9,812    |
| Interest expense:                                   |                                        |          |                                      |          |
| Deposits                                            | 607                                    | 805      | 1,169                                | 1,643    |
| Borrowed funds                                      | 149                                    | 194      | 329                                  | 392      |
| Total interest expense                              | 756                                    | 999      | 1,498                                | 2,035    |
| Net interest income                                 | 4,150                                  | 3,899    | 8,153                                | 7,777    |
| Provision for loan losses                           | 183                                    | 153      | 345                                  | 295      |
| Net interest income after provision for loan losses | 3,967                                  | 3,746    | 7,808                                | 7,482    |
| Noninterest income:                                 |                                        |          |                                      |          |
| Fees and service charges                            | 394                                    | 428      | 771                                  | 826      |
| Commissions on financial services                   | 13                                     | 76       | 22                                   | 139      |
| Title premiums                                      | 15                                     | 27       | 24                                   | 49       |
| Net gain on sales of available for sale securities  | -                                      | 99       | 658                                  | 184      |
| Earnings on bank-owned life insurance               | 93                                     | 96       | 192                                  | 192      |
| Other                                               | 318                                    | 305      | 605                                  | 571      |
| Total noninterest income                            | 833                                    | 1,031    | 2,272                                | 1,961    |
| Noninterest expense:                                |                                        |          |                                      |          |
| Compensation and employee benefits                  | 1,832                                  | 1,932    | 3,774                                | 3,837    |
| Premises and equipment                              | 604                                    | 527      | 1,204                                | 1,069    |
| Intangible asset amortization                       | 57                                     | 73       | 113                                  | 145      |
| Professional fees                                   | 183                                    | 178      | 346                                  | 355      |
| Federal deposit insurance                           | 88                                     | 102      | 176                                  | 208      |

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|                                             |           |           |           |           |
|---------------------------------------------|-----------|-----------|-----------|-----------|
| Other                                       | 942       | 820       | 2,314     | 1,593     |
| Total noninterest expense                   | 3,706     | 3,632     | 7,927     | 7,207     |
| Income before provision for income taxes    | 1,094     | 1,145     | 2,153     | 2,236     |
| Provision for income taxes                  | 216       | 206       | 433       | 439       |
| Net income                                  | 878       | 939       | 1,720     | 1,797     |
| Preferred stock dividends                   | 25        | 125       | 50        | 250       |
| Net income available to common stockholders | \$ 853    | \$ 814    | \$ 1,670  | \$ 1,547  |
| Basic and diluted earnings per common share | \$ 0.48   | \$ 0.46   | \$ 0.94   | \$ 0.88   |
| Diluted earnings per common share           | 0.48      | 0.46      | 0.94      | 0.87      |
| Average common shares outstanding           | 1,770,158 | 1,762,158 | 1,769,775 | 1,761,546 |

See accompanying notes to consolidated financial statements.

**Emclaire Financial Corp**

Consolidated Statements of Comprehensive Income (Loss) (Unaudited)

For the three and six months ended June 30, 2014 and 2013

(Dollar amounts in thousands)

|                                                              | For the three months ended<br>June 30,<br>2014 |             | For the six months ended<br>June 30,<br>2014 |             | For the six months ended<br>June 30,<br>2013 |          |
|--------------------------------------------------------------|------------------------------------------------|-------------|----------------------------------------------|-------------|----------------------------------------------|----------|
| Net income                                                   | \$ 878                                         |             | \$ 939                                       |             | \$ 1,720                                     | \$ 1,797 |
| Other comprehensive income (loss)                            |                                                |             |                                              |             |                                              |          |
| Unrealized gains (losses) on securities:                     |                                                |             |                                              |             |                                              |          |
| Unrealized holding gain (loss) arising during the period     | 1,525                                          | (4,110 )    | 2,755                                        | (4,471 )    |                                              |          |
| Reclassification adjustment for gains included in net income | -                                              | (99 )       | (658 )                                       | (184 )      |                                              |          |
|                                                              | 1,525                                          | (4,209 )    | 2,097                                        | (4,655 )    |                                              |          |
| Tax effect                                                   | (519 )                                         | 1,431       | (713 )                                       | 1,583       |                                              |          |
| Net of tax                                                   | 1,006                                          | (2,778 )    | 1,384                                        | (3,072 )    |                                              |          |
| Comprehensive income (loss)                                  | \$ 1,884                                       | \$ (1,839 ) | \$ 3,104                                     | \$ (1,275 ) |                                              |          |

See accompanying notes to consolidated financial statements.

**Emclaire Financial Corp**

## Condensed Consolidated Statements of Cash Flows (Unaudited)

For the six months ended June 30, 2014 and 2013

(Dollar amounts in thousands)

|                                                                                             | For the six months ended<br>June 30,<br>2014 |       | 2013 |       |
|---------------------------------------------------------------------------------------------|----------------------------------------------|-------|------|-------|
| Cash flows from operating activities                                                        |                                              |       |      |       |
| Net income                                                                                  | \$                                           | 1,720 | \$   | 1,797 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |                                              |       |      |       |
| Depreciation and amortization                                                               |                                              | 386   |      | 336   |
| Provision for loan losses                                                                   |                                              | 345   |      | 295   |
| Amortization of premiums, net                                                               |                                              | 127   |      | 90    |
| Amortization of intangible assets and mortgage servicing rights                             |                                              | 113   |      | 145   |
| Realized gains on sales of available for sale securities, net                               |                                              | (658) |      | (184) |
| Net gains on foreclosed real estate                                                         |                                              | (14)  |      | (12)  |
| Restricted stock and stock option compensation                                              |                                              | 84    |      | 98    |
| Increase in bank-owned life insurance, net                                                  |                                              | (161) |      | (164) |
| Increase in accrued interest receivable                                                     |                                              | (64)  |      | (49)  |
| Decrease in prepaid expenses and other assets                                               |                                              | 169   |      | 1,111 |

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|                                                                |          |   |          |   |
|----------------------------------------------------------------|----------|---|----------|---|
| Decrease in accrued interest payable                           | (39)     | ) | (65)     | ) |
| Increase in accrued expenses and other liabilities             | 117      |   | 250      |   |
| Net cash provided by operating activities                      | 2,125    |   | 3,648    |   |
| Cash flows from investing activities                           |          |   |          |   |
| Loan originations and principal collections, net               | (8,531)  | ) | (1,055)  | ) |
| Available for sale securities:                                 |          |   |          |   |
| Sales                                                          | 21,559   |   | 3,314    |   |
| Maturities, repayments and calls                               | 5,227    |   | 26,304   |   |
| Purchases                                                      | (53,255) | ) | (60,116) | ) |
| Redemption (purchase) of federal bank stocks                   | 1,186    |   | (555)    | ) |
| Proceeds from the sale of foreclosed real estate               | 121      |   | 70       |   |
| Write-down of foreclosed real estate                           | -        |   | 19       |   |
| Additions to premises and equipment                            | (2,190)  | ) | (2,251)  | ) |
| Net cash used in investing activities                          | (35,883) | ) | (34,270) | ) |
| Cash flows from financing activities                           |          |   |          |   |
| Net increase in deposits                                       | 82,397   |   | 17,038   |   |
| Repayments on Federal Home Loan Bank advances                  | (5,000)  | ) | -        |   |
| Net change in short-term borrowings                            | (22,000) | ) | 5,500    |   |
| Proceeds from exercise of stock options, including tax benefit | 26       |   | 20       |   |
| Dividends paid                                                 | (829)    | ) | (955)    | ) |
| Net cash provided by financing activities                      | 54,594   |   | 21,603   |   |
| Increase (decrease) in cash and cash                           | 20,836   |   | (9,019)  | ) |

|                       |    |        |    |        |
|-----------------------|----|--------|----|--------|
| equivalents           |    |        |    |        |
| Cash and cash         |    |        |    |        |
| equivalents at        |    | 16,658 |    | 20,424 |
| beginning of period   |    |        |    |        |
| Cash and cash         |    |        |    |        |
| equivalents at end of | \$ | 37,494 | \$ | 11,405 |
| period                |    |        |    |        |
| Supplemental          |    |        |    |        |
| information:          |    |        |    |        |
| Interest paid         | \$ | 1,537  | \$ | 2,100  |
| Income taxes paid     |    | -      |    | 140    |
| Supplemental noncash  |    |        |    |        |
| disclosure:           |    |        |    |        |
| Transfers from loans  |    |        |    |        |
| to foreclosed real    |    | 20     |    | 92     |
| estate                |    |        |    |        |

See accompanying notes to consolidated financial statements.

## Emclaire Financial Corp

## Consolidated Statements of Changes in Stockholders' Equity (Unaudited)

For the three and six months ended June 30, 2014 and 2013

(Dollar amounts in thousands, except per share data)

|                                                  | For the three months ended<br>June 30, |           | For the six months ended<br>June 30, |           |
|--------------------------------------------------|----------------------------------------|-----------|--------------------------------------|-----------|
|                                                  | 2014                                   | 2013      | 2014                                 | 2013      |
| Balance at beginning of period                   | \$ 45,945                              | \$ 51,866 | \$ 45,072                            | \$ 51,725 |
| Net income                                       | 878                                    | 939       | 1,720                                | 1,797     |
| Other comprehensive income (loss)                | 1,006                                  | (2,778 )  | 1,384                                | (3,072 )  |
| Stock compensation expense                       | 42                                     | 63        | 84                                   | 98        |
| Dividends declared on preferred stock            | (25 )                                  | (125 )    | (50 )                                | (250 )    |
| Dividends declared on common stock               | (389 )                                 | (352 )    | (779 )                               | (705 )    |
| Exercise of stock options, including tax benefit | -                                      | -         | 26                                   | 20        |
| Balance at end of period                         | \$ 47,457                              | \$ 49,613 | \$ 47,457                            | \$ 49,613 |
| Common cash dividend per share                   | \$ 0.22                                | \$ 0.20   | \$ 0.44                              | \$ 0.40   |

See accompanying notes to consolidated financial statements.

## **Emclaire Financial Corp**

### Notes to Consolidated Financial Statements (Unaudited)

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

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

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

The accompanying unaudited consolidated financial statements for the interim periods include all adjustments, consisting of normal recurring accruals, which are necessary, in the opinion of management, to fairly reflect the Corporation's consolidated financial position and results of operations. Additionally, these consolidated financial statements for the interim periods have been prepared in accordance with instructions for the Securities and Exchange Commission's (SEC's) Form 10-Q and Article 10 of Regulation S-X and therefore do not include all information or footnotes necessary for a complete presentation of financial condition, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America (GAAP). For further information, refer to the audited consolidated financial statements and footnotes thereto for the year ended December 31, 2013, as contained in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2013 filed with the SEC.

The balance sheet at December 31, 2013 has been derived from the audited financial statements at that date but does not include all the information and footnotes required by GAAP for complete financial statements.

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

conform to the current year's financial statement presentation.

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

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

The Series B Preferred Stock is entitled to receive non-cumulative dividends payable quarterly on each January 1, April 1, July 1 and October 1, beginning October 1, 2011. The dividend rate, which is calculated on the aggregate liquidation amount, was initially set at 5% per annum based upon the current level of Qualified Small Business Lending (QSBL) by the Bank at that time. The dividend rate in the subsequent periods for the first two and one-half years through the quarter ending December 31, 2013 was based upon the percentage change in qualified lending between each dividend period and the baseline QSBL level established at the time the Agreement was entered into. Such dividend rate varied from 1% to 5% per annum. For the two year period beginning January 1, 2014, the dividend rate is fixed at a rate of 2% per annum. If the Series B Preferred Stock remains outstanding for more than four-and-one-half years, beginning January 1, 2016, the dividend rate will be fixed at 9%. The dividend rate was 2.0% and 5.0%, respectively, for the quarters ended June 30, 2014 and 2013. Such dividends are not cumulative, but the Corporation may only declare and pay dividends on its common stock (or any other equity securities junior to the Series B Preferred Stock) if it has declared and paid dividends for the current dividend period on the Series B Preferred Stock, and will be subject to other restrictions on its ability to repurchase or redeem other securities.

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

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

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

Basic earnings per common share (EPS) excludes dilution and is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted EPS

includes the dilutive effect of additional potential common shares for assumed issuance of restricted stock and shares issued under stock options.

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

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

| (Dollar amounts in thousands, except for per share amounts)                                                                     | For the three months ended |           | For the six months ended |           |
|---------------------------------------------------------------------------------------------------------------------------------|----------------------------|-----------|--------------------------|-----------|
|                                                                                                                                 | June 30,<br>2014           | 2013      | June 30,<br>2014         | 2013      |
| <u>Earnings per common share - basic</u>                                                                                        |                            |           |                          |           |
| Net income                                                                                                                      | \$ 878                     | \$ 939    | \$ 1,720                 | \$ 1,797  |
| Less: Preferred stock dividends                                                                                                 | 25                         | 125       | 50                       | 250       |
| Net income available to common stockholders                                                                                     | \$ 853                     | \$ 814    | \$ 1,670                 | \$ 1,547  |
| Average common shares outstanding                                                                                               | 1,770,158                  | 1,762,158 | 1,769,775                | 1,761,546 |
| Basic earnings per common share                                                                                                 | \$ 0.48                    | \$ 0.46   | \$ 0.94                  | \$ 0.88   |
| <u>Earnings per common share - diluted</u>                                                                                      |                            |           |                          |           |
| Net income available to common stockholders                                                                                     | \$ 853                     | \$ 814    | \$ 1,670                 | \$ 1,547  |
| Average common shares outstanding                                                                                               | 1,770,158                  | 1,762,158 | 1,769,775                | 1,761,546 |
| Add: Dilutive effects of assumed issuance of restricted stock and exercise of stock options                                     | 14,691                     | 14,223    | 13,893                   | 13,350    |
| Average shares and dilutive potential common shares                                                                             | 1,784,849                  | 1,776,381 | 1,783,668                | 1,774,896 |
| Diluted earnings per common share                                                                                               | \$ 0.48                    | \$ 0.46   | \$ 0.94                  | \$ 0.87   |
| Stock options and restricted stock awards not considered in computing diluted earnings per share because they were antidilutive | 67,000                     | 67,000    | 67,000                   | 67,000    |

**4. Securities**

The following table summarizes the Corporation's securities as of June 30, 2014 and December 31, 2013:

| (Dollar amounts in thousands) | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|-------------------------------|-------------------|------------------------------|-------------------------------|---------------|
|-------------------------------|-------------------|------------------------------|-------------------------------|---------------|

Available for sale:

June 30, 2014:

|                                                              |            |          |           |             |
|--------------------------------------------------------------|------------|----------|-----------|-------------|
| U.S. Treasury and federal agency                             | \$ 3,469   | \$ -     | \$ (135   | ) \$3,334   |
| U.S. government sponsored entities and agencies              | 32,445     | 16       | (282      | ) 32,179    |
| U.S. agency mortgage-backed securities: residential          | 34,533     | 481      | -         | 35,014      |
| U.S. agency collateralized mortgage obligations: residential | 38,910     | -        | (1,310    | ) 37,600    |
| State and political subdivisions                             | 34,545     | 786      | (345      | ) 34,986    |
| Corporate debt securities                                    | 1,004      | -        | (2        | ) 1,002     |
| Equity securities                                            | 2,356      | 87       | (31       | ) 2,412     |
|                                                              | \$ 147,262 | \$ 1,370 | \$ (2,105 | ) \$146,527 |

December 31, 2013:

|                                                              |            |          |           |             |
|--------------------------------------------------------------|------------|----------|-----------|-------------|
| U.S. Treasury and federal agency                             | \$ 4,466   | \$ -     | \$ (298   | ) \$4,168   |
| U.S. government sponsored entities and agencies              | 23,637     | -        | (745      | ) 22,892    |
| U.S. agency mortgage-backed securities: residential          | 11,020     | 341      | -         | 11,361      |
| U.S. agency collateralized mortgage obligations: residential | 41,751     | 2        | (2,031    | ) 39,722    |
| State and political subdivisions                             | 36,657     | 830      | (988      | ) 36,499    |
| Corporate debt securities                                    | 250        | -        | (9        | ) 241       |
| Equity securities                                            | 2,356      | 131      | (66       | ) 2,421     |
|                                                              | \$ 120,137 | \$ 1,304 | \$ (4,137 | ) \$117,304 |

**4. Securities (continued)**

The following table summarizes scheduled maturities of the Corporation's debt securities as of June 30, 2014. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities and collateralized mortgage obligations are not due at a single maturity and are shown separately.

| (Dollar amounts in thousands)                    | Available for sale |            |
|--------------------------------------------------|--------------------|------------|
|                                                  | Amortized Cost     | Fair Value |
| Due in one year or less                          | \$55               | \$56       |
| Due after one year through five years            | 36,461             | 36,499     |
| Due after five through ten years                 | 31,526             | 31,564     |
| Due after ten years                              | 3,421              | 3,382      |
| Mortgage-backed securities: residential          | 34,533             | 35,014     |
| Collateralized mortgage obligations: residential | 38,910             | 37,600     |
|                                                  | \$144,906          | \$144,115  |

Information pertaining to securities with gross unrealized losses at June 30, 2014 and December 31, 2013, aggregated by investment category and length of time that individual securities have been in a continuous loss position are included in the table below:

| (Dollar amounts in thousands)                                | Less than 12 Months |                 | 12 Months or More |                 | Total      |                 |
|--------------------------------------------------------------|---------------------|-----------------|-------------------|-----------------|------------|-----------------|
|                                                              | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value | Unrealized Loss |
| Description of Securities                                    |                     |                 |                   |                 |            |                 |
| June 30, 2014:                                               |                     |                 |                   |                 |            |                 |
| U.S. Treasury and federal agency                             | \$ -                | \$ -            | \$ 3,334          | \$ (135 )       | \$ 3,334   | \$ (135 )       |
| U.S. government sponsored entities and agencies              | 4,245               | (19 )           | 18,728            | (263 )          | 22,973     | (282 )          |
| U.S. agency collateralized mortgage obligations: residential | 8,556               | (135 )          | 29,044            | (1,175 )        | 37,600     | (1,310 )        |
| State and political subdivisions                             | 1,192               | (8 )            | 12,767            | (337 )          | 13,959     | (345 )          |
| Corporate debt securities                                    | 1,002               | (2 )            | -                 | -               | 1,002      | (2 )            |
| Equity securities                                            | 1,161               | (31 )           | -                 | -               | 1,161      | (31 )           |
|                                                              | \$ 16,156           | \$ (195 )       | \$ 63,873         | \$ (1,910 )     | \$ 80,029  | \$ (2,105 )     |
| December 31, 2013:                                           |                     |                 |                   |                 |            |                 |
| U.S. Treasury and federal agency                             | \$ 4,168            | \$ (298 )       | \$ -              | \$ -            | \$ 4,168   | \$ (298 )       |
| U.S. government sponsored entities and agencies              | 22,891              | (745 )          | -                 | -               | 22,891     | (745 )          |
| U.S. agency mortgage-backed securities: residential          | 33,805              | (1,729 )        | 4,982             | (302 )          | 38,787     | (2,031 )        |

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|                                  |           |           |   |          |         |        |           |           |   |
|----------------------------------|-----------|-----------|---|----------|---------|--------|-----------|-----------|---|
| State and political subdivisions | 13,262    | (988      | ) | -        | -       | 13,262 | (988      | )         |   |
| Corporate debt securities        | 242       | (9        | ) | -        | -       | 242    | (9        | )         |   |
| Equity securities                | 1,142     | (66       | ) | -        | -       | 1,142  | (66       | )         |   |
|                                  | \$ 75,510 | \$ (3,835 | ) | \$ 4,982 | \$ (302 | )      | \$ 80,492 | \$ (4,137 | ) |

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

| (Dollar amounts in thousands)  | For the three months<br>ended June 30, |          | For the six months<br>ended June 30, |         |
|--------------------------------|----------------------------------------|----------|--------------------------------------|---------|
|                                | 2014                                   | 2013     | 2014                                 | 2013    |
| Proceeds                       | \$ -                                   | \$ 1,539 | \$21,559                             | \$3,314 |
| Gains                          | -                                      | 99       | 658                                  | 184     |
| Tax provision related to gains | -                                      | 34       | 224                                  | 63      |

**4. Securities (continued)**

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

There were two equity securities in an unrealized loss position as of June 30, 2014, none of which were in an unrealized loss position for more than 12 months. Equity securities owned by the Corporation consist of common stock of various financial service providers. The investment securities are in an unrealized loss position as a result of recent market volatility. The Corporation does not invest in these securities with the intent to sell them for a profit in the near term. For investments in equity securities, in addition to the general factors mentioned above for determining whether the decline in market value is other-than-temporary, the analysis of whether an equity security is other-than-temporarily impaired includes a review of the profitability, capital adequacy and other relevant information available to determine the financial position and near term prospects of each issuer. The results of analyzing the aforementioned metrics and financial fundamentals suggest recovery of amortized cost as the sector improves. Based on that evaluation, and given that the Corporation's current intention is not to sell any impaired security and it is more likely than not it will not be required to sell these securities before the recovery of their amortized cost basis, the Corporation does not consider the equity securities with unrealized losses as of June 30, 2014 to be other-than-temporarily impaired.

There were 105 debt securities in an unrealized loss position as of June 30, 2014, of which 89 were in an unrealized loss position for more than 12 months. Of these 105 securities, 6 were U.S. Treasury securities, 18 were U.S. government sponsored entity and agency securities, 26 were government-backed collateralized mortgage obligations, 53 were state and political subdivision securities and 2 were corporate debt securities. The unrealized losses associated with these securities were not due to the deterioration in the credit quality of the issuer that would likely result in the non-collection of contractual principal and interest, but rather have been caused by a rise in interest rates from the time the securities were purchased. Based on that evaluation and other general considerations, and given that the Corporation's current intention is not to sell any impaired securities and it is more likely than not it will not be required to sell these securities before the recovery of its amortized cost basis, the Corporation does not consider the debt securities with unrealized losses as of June 30, 2014 to be other-than-temporarily impaired.

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

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

| (Dollar amounts in thousands)         | June 30,<br>2014 | December 31,<br>2013 |
|---------------------------------------|------------------|----------------------|
| Mortgage loans on real estate:        |                  |                      |
| Residential first mortgages           | \$104,618        | \$ 105,541           |
| Home equity loans and lines of credit | 88,374           | 87,928               |
| Commercial real estate                | 106,273          | 101,499              |
|                                       | 299,265          | 294,968              |
| Other loans:                          |                  |                      |
| Commercial business                   | 56,770           | 53,214               |
| Consumer                              | 9,480            | 9,117                |
|                                       | 66,250           | 62,331               |
| Total loans, gross                    | 365,515          | 357,299              |
| Less allowance for loan losses        | 5,046            | 4,869                |
| Total loans, net                      | \$360,469        | \$ 352,430           |

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

The following table presents impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not necessary as of June 30, 2014:

(Dollar amounts in thousands)

|                                 | Impaired Loans with Specific Allowance |                     |                   | For the three months ended June 30, 2014 |                                      |                                          |
|---------------------------------|----------------------------------------|---------------------|-------------------|------------------------------------------|--------------------------------------|------------------------------------------|
|                                 | As of June 30, 2014                    |                     |                   |                                          |                                      |                                          |
|                                 | Unpaid Principal Balance               | Recorded Investment | Related Allowance | Average Recorded Investment              | Interest Income Recognized in Period | Cash Basis Interest Recognized in Period |
| Residential first mortgages     | \$ 172                                 | \$ 172              | \$ 28             | \$ 127                                   | \$ 8                                 | \$ 2                                     |
| Home equity and lines of credit | -                                      | -                   | -                 | -                                        | -                                    | -                                        |
| Commercial real estate          | 3,649                                  | 2,708               | 227               | 2,715                                    | 10                                   | 10                                       |
| Commercial business             | 2,210                                  | 2,210               | 540               | 1,314                                    | 51                                   | 4                                        |
| Consumer                        | -                                      | -                   | -                 | -                                        | -                                    | -                                        |
| Total                           | \$6,031                                | \$ 5,090            | \$ 795            | \$4,156                                  | \$ 69                                | \$ 16                                    |

|                                 | For the six months ended June 30, 2014 |                                      |                                          | For the six months ended June 30, 2014 |  |  |
|---------------------------------|----------------------------------------|--------------------------------------|------------------------------------------|----------------------------------------|--|--|
|                                 |                                        |                                      |                                          |                                        |  |  |
|                                 | Average Recorded Investment            | Interest Income Recognized in Period | Cash Basis Interest Recognized in Period |                                        |  |  |
| Residential first mortgages     | \$ 112                                 | \$ 9                                 | \$ 3                                     |                                        |  |  |
| Home equity and lines of credit | -                                      | -                                    | -                                        |                                        |  |  |
| Commercial real estate          | 2,650                                  | 17                                   | 12                                       |                                        |  |  |
| Commercial business             | 876                                    | 56                                   | 4                                        |                                        |  |  |
| Consumer                        | -                                      | -                                    | -                                        |                                        |  |  |
| Total                           | \$3,638                                | \$ 82                                | \$ 19                                    |                                        |  |  |

**Impaired Loans with No Specific Allowance**

|  | For the three months ended June 30, 2014 |                     |                   | For the three months ended June 30, 2014 |                                      |                                          |
|--|------------------------------------------|---------------------|-------------------|------------------------------------------|--------------------------------------|------------------------------------------|
|  | As of June 30, 2014                      |                     |                   |                                          |                                      |                                          |
|  | Unpaid Principal                         | Recorded Investment | Related Allowance | Average Recorded Investment              | Interest Income Recognized in Period | Cash Basis Interest Recognized in Period |

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|                                 | Balance  | Investment | Investment | in Period | in Period |
|---------------------------------|----------|------------|------------|-----------|-----------|
| Residential first mortgages     | \$ 118   | \$ 118     | \$ 59      | \$ 2      | \$ -      |
| Home equity and lines of credit | -        | -          | -          | -         | -         |
| Commercial real estate          | 1,488    | 1,089      | 896        | 12        | 1         |
| Commercial business             | 430      | 428        | 407        | 1         | 1         |
| Consumer                        | 1,348    | 1,348      | 1,348      | -         | -         |
| Total                           | \$ 3,384 | \$ 2,983   | \$ 2,710   | \$ 15     | \$ 2      |

For the six months  
ended June 30, 2014

|                                 | Average<br>Recorded<br>Investment | Interest Income<br>Recognized<br>in Period | Cash Basis<br>Interest<br>Recognized<br>in Period |
|---------------------------------|-----------------------------------|--------------------------------------------|---------------------------------------------------|
| Residential first mortgages     | \$ 46                             | \$ 2                                       | \$ -                                              |
| Home equity and lines of credit | -                                 | -                                          | -                                                 |
| Commercial real estate          | 823                               | 14                                         | 3                                                 |
| Commercial business             | 383                               | 1                                          | 1                                                 |
| Consumer                        | 1,348                             | -                                          | -                                                 |
| Total                           | \$ 2,600                          | \$ 17                                      | \$ 4                                              |

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

The following table presents impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not necessary as of December 31, 2013:

(Dollar amounts in thousands)

|                                 | Impaired Loans with Specific Allowance |                        |                      |                                         |                                            |                                                   |
|---------------------------------|----------------------------------------|------------------------|----------------------|-----------------------------------------|--------------------------------------------|---------------------------------------------------|
|                                 | As of December 31, 2013                |                        |                      | For the year ended<br>December 31, 2013 |                                            |                                                   |
|                                 | Unpaid<br>Principal<br>Balance         | Recorded<br>Investment | Related<br>Allowance | Average<br>Recorded<br>Investment       | Interest Income<br>Recognized<br>in Period | Cash Basis<br>Interest<br>Recognized<br>in Period |
| Residential first mortgages     | \$82                                   | \$ 82                  | \$ 21                | \$49                                    | \$ 5                                       | \$ 4                                              |
| Home equity and lines of credit | -                                      | -                      | -                    | -                                       | -                                          | -                                                 |
| Commercial real estate          | 3,462                                  | 2,521                  | 181                  | 3,202                                   | 13                                         | 13                                                |
| Commercial business             | -                                      | -                      | -                    | -                                       | -                                          | -                                                 |
| Consumer                        | -                                      | -                      | -                    | -                                       | -                                          | -                                                 |
| Total                           | \$3,544                                | \$ 2,603               | \$ 202               | \$3,251                                 | \$ 18                                      | \$ 17                                             |

|                                 | Impaired Loans with No Specific Allowance |                        |                                   |                                            |                                                   |
|---------------------------------|-------------------------------------------|------------------------|-----------------------------------|--------------------------------------------|---------------------------------------------------|
|                                 | For the year ended                        |                        |                                   |                                            |                                                   |
|                                 | As of December 31, 2013                   |                        | December 31, 2013                 |                                            |                                                   |
|                                 | Unpaid<br>Principal<br>Balance            | Recorded<br>Investment | Average<br>Recorded<br>Investment | Interest Income<br>Recognized<br>in Period | Cash Basis<br>Interest<br>Recognized<br>in Period |
| Residential first mortgages     | \$ 20                                     | \$ 20                  | \$ 4                              | \$ 1                                       | \$ -                                              |
| Home equity and lines of credit | -                                         | -                      | -                                 | -                                          | -                                                 |
| Commercial real estate          | 1,074                                     | 675                    | 584                               | 5                                          | 5                                                 |
| Commercial business             | 336                                       | 336                    | 354                               | -                                          | -                                                 |
| Consumer                        | 1,348                                     | 1,348                  | 1,457                             | -                                          | -                                                 |
| Total                           | \$ 2,778                                  | \$ 2,379               | \$ 2,399                          | \$ 6                                       | \$ 5                                              |

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

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

(Dollar amounts in thousands)

|                                 | Impaired Loans with Specific Allowance |                        |                      | For the three months              |                                            |                                                   |
|---------------------------------|----------------------------------------|------------------------|----------------------|-----------------------------------|--------------------------------------------|---------------------------------------------------|
|                                 | As of June 30, 2013                    |                        |                      | ended June 30, 2013               |                                            |                                                   |
|                                 | Unpaid<br>Principal<br>Balance         | Recorded<br>Investment | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest Income<br>Recognized<br>in Period | Cash Basis<br>Interest<br>Recognized<br>in Period |
| Residential first mortgages     | \$81                                   | \$ 81                  | \$ 20                | \$ 40                             | \$ 2                                       | \$ 2                                              |
| Home equity and lines of credit | -                                      | -                      | -                    | -                                 | -                                          | -                                                 |
| Commercial real estate          | 3,665                                  | 2,724                  | 214                  | 3,364                             | 5                                          | 5                                                 |
| Commercial business             | -                                      | -                      | -                    | -                                 | -                                          | -                                                 |
| Consumer                        | -                                      | -                      | -                    | -                                 | -                                          | -                                                 |
| Total                           | \$3,746                                | \$ 2,805               | \$ 234               | \$ 3,404                          | \$ 7                                       | \$ 7                                              |

|                                 | For the six months<br>ended June 30, 2013 |                                            |                                                   |
|---------------------------------|-------------------------------------------|--------------------------------------------|---------------------------------------------------|
|                                 | Average<br>Recorded<br>Investment         | Interest Income<br>Recognized<br>in Period | Cash Basis<br>Interest<br>Recognized<br>in Period |
| Residential first mortgages     | \$ 27                                     | \$ 2                                       | \$ 2                                              |
| Home equity and lines of credit | -                                         | -                                          | -                                                 |
| Commercial real estate          | 3,599                                     | 9                                          | 9                                                 |
| Commercial business             | -                                         | -                                          | -                                                 |
| Consumer                        | -                                         | -                                          | -                                                 |
| Total                           | \$ 3,626                                  | \$ 11                                      | \$ 11                                             |

|  | Impaired Loans with No Specific Allowance |                                             |
|--|-------------------------------------------|---------------------------------------------|
|  | As of June 30, 2013                       | For the three months<br>ended June 30, 2013 |

Cash Basis

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|                                 | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Average<br>Recorded<br>Investment | Interest Income<br>Recognized<br>in Period | Interest<br>Recognized<br>in Period |
|---------------------------------|--------------------------------|------------------------|-----------------------------------|--------------------------------------------|-------------------------------------|
| Residential first mortgages     | \$ -                           | \$ -                   | \$ -                              | \$ -                                       | \$ -                                |
| Home equity and lines of credit | -                              | -                      | -                                 | -                                          | -                                   |
| Commercial real estate          | 1,061                          | 662                    | 563                               | 2                                          | 2                                   |
| Commercial business             | 356                            | 356                    | 360                               | -                                          | -                                   |
| Consumer                        | 1,348                          | 1,348                  | 1,469                             | -                                          | -                                   |
| Total                           | \$ 2,765                       | \$ 2,366               | \$ 2,392                          | \$ 2                                       | \$ 2                                |

For the six months  
ended June 30, 2013

|                                 | Average<br>Recorded<br>Investment | Interest Income<br>Recognized<br>in Period | Cash Basis<br>Interest<br>Recognized<br>in Period |
|---------------------------------|-----------------------------------|--------------------------------------------|---------------------------------------------------|
| Residential first mortgages     | \$ -                              | \$ -                                       | \$ -                                              |
| Home equity and lines of credit | -                                 | -                                          | -                                                 |
| Commercial real estate          | 544                               | 3                                          | 3                                                 |
| Commercial business             | 363                               | -                                          | -                                                 |
| Consumer                        | 1,529                             | -                                          | -                                                 |
| Total                           | \$ 2,436                          | \$ 3                                       | \$ 3                                              |

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

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

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

At June 30, 2014 and December 31, 2013, the Corporation had \$7.1 million and \$2.5 million, respectively, of loans classified as TDRs, which are included in impaired loans above. At June 30, 2014 and December 31, 2013, the Corporation had \$588,000 and \$56,000 of the allowance for loan losses allocated to these specific loans. At June 30, 2013, the Corporation had \$2.1 million of loans classified as TDRs with \$55,000 of the allowance for loan losses allocated to these specific loans.

During the three and six month periods ended June 30, 2014, the Corporation modified eleven additional loans to be identified as TDRs. One commercial relationship consisting of eight loans totaling \$2.4 million was modified as the Bank granted repayment concessions due to financial difficulties experienced by the borrower. Concessions on these eight loans included reduced monthly payments through the notes' maturities. An additional commercial real estate relationship consisting of two loans totaling \$2.1 million was modified as the Bank granted a payment concession on one loan and interest rate concessions on both loans due to cash flow considerations caused by vacancy rates. In addition, the Corporation modified a residential mortgage loan with pre- and post-modification recorded investments of \$76,000 and \$93,000, respectively, due to a bankruptcy court order. The modifications included capitalization of \$5,000 of accrued and unpaid interest and \$13,000 of legal expenses, a reduction in the interest rate from 6.25% to 5.00% and a 15 year extension of the original term. Because these loans were previously impaired with specific reserves allocated to them, there was no impact to the provision for loan losses for the three and six month periods ended June 30, 2014 as a result of the modifications.

During the six month period ended June 30, 2013, the Corporation modified a residential mortgage loan with a pre- and post-modification recorded investment of \$83,000 as a TDR due to financial difficulties experienced by the borrower. The modification included a reduction in the interest rate from 6.75% to 4.00% and a 65 month extension of the original term. During the three month period ended June 30, 2013, the Corporation did not modify any additional loans as TDRs.

A loan is considered to be in payment default once it is 30 days contractually past due under the modified terms. During the three and six month periods ended June 30, 2014, there were defaults on three loans classified as TDRs which totaled \$426,000 at June 30, 2014. Of these loans, two were not past due and one was 30-59 days delinquent at June 30, 2014. During the three and six month periods ended June 30, 2013, the Corporation did not have any loans

which were modified as TDRs for which there was a payment default within twelve months following the modification.

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

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

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

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

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

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

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

Management uses the following definitions for risk ratings:

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

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

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

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

The following table presents the classes of the loan portfolio summarized by the aggregate pass and the criticized categories of special mention, substandard and doubtful within the Corporation's internal risk rating system as of June 30, 2014 and December 31, 2013:

(Dollar amounts in thousands)

|                                 | Not Rated  | Pass       | Special<br>Mention | Substandard | Doubtful | Total      |
|---------------------------------|------------|------------|--------------------|-------------|----------|------------|
| June 30, 2014:                  |            |            |                    |             |          |            |
| Residential first mortgages     | \$ 103,939 | \$-        | \$ -               | \$ 679      | \$ -     | \$ 104,618 |
| Home equity and lines of credit | 88,277     | -          | -                  | 97          | -        | 88,374     |
| Commercial real estate          | -          | 99,380     | 238                | 6,655       | -        | 106,273    |
| Commercial business             | -          | 52,388     | 1,485              | 2,897       | -        | 56,770     |
| Consumer                        | 8,132      | -          | -                  | 1,348       | -        | 9,480      |
| Total                           | \$ 200,348 | \$ 151,768 | \$ 1,723           | \$ 11,676   | \$ -     | \$ 365,515 |
| December 31, 2013:              |            |            |                    |             |          |            |
| Residential first mortgages     | \$ 104,983 | \$-        | \$ -               | \$ 558      | \$ -     | \$ 105,541 |
| Home equity and lines of credit | 87,868     | -          | -                  | 60          | -        | 87,928     |
| Commercial real estate          | -          | 93,973     | 256                | 7,270       | -        | 101,499    |
| Commercial business             | -          | 50,008     | 674                | 2,532       | -        | 53,214     |
| Consumer                        | 7,769      | -          | -                  | 1,348       | -        | 9,117      |
| Total                           | \$ 200,620 | \$ 143,981 | \$ 930             | \$ 11,768   | \$ -     | \$ 357,299 |

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

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and nonperforming loans as of June 30, 2014 and December 31, 2013:

(Dollar amounts in thousands)

|                                 | Performing<br>Accruing<br>Loans<br>Not<br>Past Due | Accruing<br>30-59 Days<br>Past Due | Accruing<br>60-89 Days<br>Past Due | Nonperforming<br>Accruing<br>90<br>Days<br>+<br>Past<br>Due | Nonaccrual | Total<br>Loans |
|---------------------------------|----------------------------------------------------|------------------------------------|------------------------------------|-------------------------------------------------------------|------------|----------------|
| June 30, 2014:                  |                                                    |                                    |                                    |                                                             |            |                |
| Residential first mortgages     | \$ 101,915                                         | \$ 1,910                           | \$ 114                             | \$ -                                                        | \$ 679     | \$ 104,618     |
| Home equity and lines of credit | 87,743                                             | 431                                | 103                                | -                                                           | 97         | 88,374         |
| Commercial real estate          | 102,910                                            | 80                                 | -                                  | -                                                           | 3,283      | 106,273        |
| Commercial business             | 54,274                                             | 211                                | -                                  | -                                                           | 2,285      | 56,770         |
| Consumer                        | 8,104                                              | 27                                 | 1                                  | -                                                           | 1,348      | 9,480          |
| Total loans                     | \$ 354,946                                         | \$ 2,659                           | \$ 218                             | \$ -                                                        | \$ 7,692   | \$ 365,515     |
| December 31, 2013:              |                                                    |                                    |                                    |                                                             |            |                |
| Residential first mortgages     | \$ 103,821                                         | \$ 884                             | \$ 278                             | \$ 38                                                       | \$ 520     | \$ 105,541     |
| Home equity and lines of credit | 87,302                                             | 394                                | 172                                | -                                                           | 60         | 87,928         |
| Commercial real estate          | 98,095                                             | 516                                | 22                                 | -                                                           | 2,866      | 101,499        |
| Commercial business             | 52,581                                             | 258                                | -                                  | 24                                                          | 351        | 53,214         |
| Consumer                        | 7,682                                              | 61                                 | 26                                 | -                                                           | 1,348      | 9,117          |
| Total loans                     | \$ 349,481                                         | \$ 2,113                           | \$ 498                             | \$ 62                                                       | \$ 5,145   | \$ 357,299     |

The following table presents the Corporation's nonaccrual loans by aging category as of June 30, 2014 and December 31, 2013:

(Dollar amounts in thousands)

| Not<br>Past Due | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days +<br>Past Due | Total<br>Loans |
|-----------------|------------------------|------------------------|-----------------------|----------------|
|-----------------|------------------------|------------------------|-----------------------|----------------|

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June 30, 2014:

|                                 |          |        |       |        |         |
|---------------------------------|----------|--------|-------|--------|---------|
| Residential first mortgages     | \$ 289   | \$ 81  | \$ 19 | \$ 290 | \$679   |
| Home equity and lines of credit | -        | -      | 20    | 77     | 97      |
| Commercial real estate          | 3,016    | 60     | 13    | 194    | 3,283   |
| Commercial business             | 2,223    | 39     | -     | 23     | 2,285   |
| Consumer                        | 1,348    | -      | -     | -      | 1,348   |
| Total loans                     | \$ 6,876 | \$ 180 | \$ 52 | \$ 584 | \$7,692 |

December 31, 2013:

|                                 |          |          |       |          |         |
|---------------------------------|----------|----------|-------|----------|---------|
| Residential first mortgages     | \$ 88    | \$ -     | \$ 82 | \$ 350   | \$520   |
| Home equity and lines of credit | -        | -        | -     | 60       | 60      |
| Commercial real estate          | 412      | 2,148    | -     | 306      | 2,866   |
| Commercial business             | 65       | -        | -     | 286      | 351     |
| Consumer                        | 1,348    | -        | -     | -        | 1,348   |
| Total loans                     | \$ 1,913 | \$ 2,148 | \$ 82 | \$ 1,002 | \$5,145 |

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

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

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

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

(Dollar amounts in thousands)

|                                           | Residential<br>Mortgages | Home<br>Equity<br>& Lines<br>of Credit | Commercial<br>Real Estate | Commercial<br>Business | Consumer | Total   |
|-------------------------------------------|--------------------------|----------------------------------------|---------------------------|------------------------|----------|---------|
| Three months ended June 30, 2014:         |                          |                                        |                           |                        |          |         |
| Allowance for loan losses:                |                          |                                        |                           |                        |          |         |
| Beginning Balance                         | \$ 936                   | \$ 619                                 | \$ 2,221                  | \$ 1,094               | \$ 51    | \$4,921 |
| Charge-offs                               | (19)                     | (14)                                   | -                         | -                      | (33)     | (66)    |
| Recoveries                                | -                        | -                                      | 4                         | -                      | 4        | 8       |
| Provision                                 | -                        | (137)                                  | 150                       | 139                    | 31       | 183     |
| Ending Balance                            | \$ 917                   | \$ 468                                 | \$ 2,375                  | \$ 1,233               | \$ 53    | \$5,046 |
| Six months ended June 30, 2014:           |                          |                                        |                           |                        |          |         |
| Allowance for loan losses:                |                          |                                        |                           |                        |          |         |
| Beginning Balance                         | \$ 923                   | \$ 625                                 | \$ 2,450                  | \$ 822                 | \$ 49    | \$4,869 |
| Charge-offs                               | (97)                     | (14)                                   | (2)                       | (17)                   | (67)     | (197)   |
| Recoveries                                | -                        | -                                      | 9                         | 7                      | 13       | 29      |
| Provision                                 | 91                       | (143)                                  | (82)                      | 421                    | 58       | 345     |
| Ending Balance                            | \$ 917                   | \$ 468                                 | \$ 2,375                  | \$ 1,233               | \$ 53    | \$5,046 |
| At June 30, 2014:                         |                          |                                        |                           |                        |          |         |
| Ending ALL balance attributable to loans: |                          |                                        |                           |                        |          |         |
| Individually evaluated for impairment     | 28                       | -                                      | 227                       | 540                    | -        | 795     |
| Collectively evaluated for impairment     | 889                      | 468                                    | 2,148                     | 693                    | 53       | 4,251   |
| Total loans:                              |                          |                                        |                           |                        |          |         |
| Individually evaluated for impairment     | 290                      | -                                      | 3,797                     | 2,638                  | 1,348    | 8,073   |
| Collectively evaluated for impairment     | 104,328                  | 88,374                                 | 102,476                   | 54,132                 | 8,132    | 357,442 |

At December 31, 2013:

Ending ALL balance attributable to loans:

|                                       |     |     |       |     |    |       |
|---------------------------------------|-----|-----|-------|-----|----|-------|
| Individually evaluated for impairment | 21  | -   | 181   | -   | -  | 202   |
| Collectively evaluated for impairment | 902 | 625 | 2,269 | 822 | 49 | 4,667 |

Total loans:

|                                       |         |        |        |        |       |         |
|---------------------------------------|---------|--------|--------|--------|-------|---------|
| Individually evaluated for impairment | 102     | -      | 3,196  | 336    | 1,348 | 4,982   |
| Collectively evaluated for impairment | 105,439 | 87,928 | 98,303 | 52,878 | 7,769 | 352,317 |

Three months ended June 30, 2013:

Allowance for loan losses:

|                   |        |        |          |        |       |          |
|-------------------|--------|--------|----------|--------|-------|----------|
| Beginning Balance | \$ 807 | \$ 727 | \$ 3,189 | \$ 702 | \$ 63 | \$ 5,488 |
| Charge-offs       | (12 )  | -      | (941 )   | -      | (25 ) | (978 )   |
| Recoveries        | -      | -      | 2        | -      | 5     | 7        |
| Provision         | (23 )  | (106 ) | 297      | (25 )  | 10    | 153      |
| Ending Balance    | \$ 772 | \$ 621 | \$ 2,547 | \$ 677 | \$ 53 | \$ 4,670 |

Six months ended June 30, 2013:

Allowance for loan losses:

|                   |        |        |          |        |       |          |
|-------------------|--------|--------|----------|--------|-------|----------|
| Beginning Balance | \$ 828 | \$ 730 | \$ 3,090 | \$ 636 | \$ 66 | \$ 5,350 |
| Charge-offs       | (17 )  | -      | (941 )   | -      | (56 ) | (1,014 ) |
| Recoveries        | 1      | -      | 4        | -      | 34    | 39       |
| Provision         | (40 )  | (109 ) | 394      | 41     | 9     | 295      |
| Ending Balance    | \$ 772 | \$ 621 | \$ 2,547 | \$ 677 | \$ 53 | \$ 4,670 |

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

## 6. Goodwill and Intangible Assets

The following table summarizes the Corporation's acquired goodwill and intangible assets as of June 30, 2014 and December 31, 2013:

| (Dollar amounts in thousands) | June 30, 2014         |                          | December 31, 2013     |                          |
|-------------------------------|-----------------------|--------------------------|-----------------------|--------------------------|
|                               | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Goodwill                      | \$3,664               | \$ -                     | \$ 3,664              | \$ -                     |
| Core deposit intangibles      | 4,027                 | 3,175                    | 4,027                 | 3,062                    |
| Total                         | \$7,691               | \$ 3,175                 | \$ 7,691              | \$ 3,062                 |

Goodwill resulted from three previous branch acquisitions. Goodwill represents the excess of the total purchase price paid for the branch acquisitions over the fair value of the assets acquired, net of the fair value of the liabilities assumed. Goodwill is not amortized but is evaluated for impairment on an annual basis or whenever events or changes in circumstances indicate the carrying value may not be recoverable. Impairment exists when a reporting unit's carrying value of goodwill exceeds its fair value. The Corporation has selected November 30 as the date to perform the annual impairment test. No goodwill impairment charges were recorded during 2013 or in the first six months of 2014. The core deposit intangible asset is amortized using the double declining balance method over a weighted average estimated life of nine years and is not estimated to have a significant residual value. During the three and six month period ending June 30, 2014, the Corporation recorded intangible amortization expense totaling \$57,000 and \$113,000, respectively, compared to \$73,000 and \$145,000, respectively, for the same periods in 2013.

## 7. Stock Compensation Plans

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

In addition, the Corporation's 2007 Stock Incentive Plan and Trust (the Plan), which is shareholder approved, permits the grant of restricted stock awards and options to its directors, officers and employees for up to 177,496 shares of common stock, of which 5,913 shares of restricted stock and 45,283 stock options remain available for issuance under the Plan.

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

A summary of option activity under the Plans as of June 30, 2014, and changes during the period then ended is presented below:

|                                   | Options  | Weighted-Average<br>Exercise Price | Aggregate<br>Intrinsic Value<br>(in thousands) | Weighted-Average<br>Remaining Term<br>(in years) |
|-----------------------------------|----------|------------------------------------|------------------------------------------------|--------------------------------------------------|
| Outstanding as of January 1, 2014 | 79,250   | \$ 24.97                           | \$ -                                           | 3.8                                              |
| Granted                           | -        | -                                  | -                                              | -                                                |
| Exercised                         | (1,500 ) | 17.00                              | 14,835                                         | -                                                |
| Forfeited                         | -        | -                                  | -                                              | -                                                |
| Outstanding as of June 30, 2014   | 77,750   | \$ 25.12                           | \$ 137,268                                     | 3.3                                              |
| Exercisable as of June 30, 2014   | 77,250   | \$ 25.19                           | \$ 131,268                                     | 3.2                                              |

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

A summary of the status of the Corporation's nonvested option shares as of June 30, 2014, and changes during the period then ended is presented below:

|                               | Options | Weighted-Average<br>Grant-date Fair Value |
|-------------------------------|---------|-------------------------------------------|
| Nonvested at January 1, 2014  | 500     | \$ 1.44                                   |
| Granted                       | -       | -                                         |
| Vested                        | -       | -                                         |
| Forfeited                     | -       | -                                         |
| Nonvested as of June 30, 2014 | 500     | \$ 1.44                                   |

A summary of the status of the Corporation's nonvested restricted stock awards as of June 30, 2014, and changes during the period then ended is presented below:

|                               | Shares | Weighted-Average<br>Grant-date Fair Value |
|-------------------------------|--------|-------------------------------------------|
| Nonvested at January 1, 2014  | 25,800 | \$ 20.11                                  |
| Granted                       | -      | -                                         |
| Vested                        | -      | -                                         |
| Forfeited                     | 100    | 25.50                                     |
| Nonvested as of June 30, 2014 | 25,700 | \$ 20.08                                  |

For the three and six month periods ended June 30, 2014, the Corporation recognized \$42,000 and \$84,000, respectively, in stock compensation expense, compared to \$63,000 and \$98,000, respectively, for the same periods in 2013. As of June 30, 2014, there was \$266,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plans. That cost is expected to be recognized over a weighted-average period of 1.4 years. It is the Corporation's policy to issue shares on the vesting date for restricted stock awards. Unvested restricted stock awards do not receive dividends declared by the Corporation.

**8. Employee Benefit Plans**

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

The Corporation provided the requisite notice to plan participants on March 12, 2013 of the determination to freeze the plan (curtailment). While the freeze was not effective until April 30, 2013, management determined that participants would not satisfy, within the provisions of the plan, 2013 eligibility requirements based on minimum hours worked for 2013. Therefore, employees ceased to earn benefits as of January 1, 2013. This amendment to the plan will not affect benefits earned by the participants prior to the date of the freeze. The expense associated with the plan was immaterial for the three and six month periods ended June 30, 2014 and 2013.

## **9. Fair Value**

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

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

**9. Fair Value (continued)**

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

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

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

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

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

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

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

*Impaired loans* – At the time a loan is considered impaired, it is valued at the lower of cost or fair value. Impaired loans carried at fair value generally receive a specific allowance for loan losses. For collateral dependent loans, fair value is commonly based on real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business, resulting in a Level 3 classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly. As of June 30, 2014, the fair value of impaired loans consists of loan balances of \$2.9 million, net of a valuation allowance of \$627,000, compared to loan balances of \$2.5 million, net of a valuation allowance of \$181,000, at December 31, 2013. There was \$393,000 and \$665,000 of additional provision for loan losses recorded for impaired loans during the three and six month period ended June 30, 2014, respectively. There was \$20,000 of additional provision recorded for impaired loans for the same periods in 2013.

## 9. Fair Value (continued)

*Other Real estate owned (OREO)* – Assets acquired through or instead of foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals. Management's ongoing review of appraisal information may result in additional discounts or adjustments to the valuation based upon more recent market sales activity or more current appraisal information derived from properties of similar type and/or locale. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. At June 30, 2014, the Corporation had no OREO measured at fair value. As of December 31, 2013, OREO measured at fair value less costs to sell had a net carrying amount of \$80,000, which was made up of the outstanding balance of \$104,000 and write-downs of \$24,000. There was no expense recorded during the three and six months ended June 30, 2014 associated with the write-down of OREO, compared to \$0 and \$19,000 for the same periods in 2013.

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

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

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

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

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

**9. Fair Value (continued)**

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

| (Dollar amounts in thousands)                                |           | (Level 1)                                                     | (Level 2)                                    | (Level 3)                             |
|--------------------------------------------------------------|-----------|---------------------------------------------------------------|----------------------------------------------|---------------------------------------|
| Description                                                  | Total     | Quoted Prices in<br>Active Markets<br>for Identical<br>Assets | Significant<br>Other<br>Observable<br>Inputs | Significant<br>Unobservable<br>Inputs |
| June 30, 2014:                                               |           |                                                               |                                              |                                       |
| U.S. Treasury and federal agency                             | \$3,334   | \$ 3,334                                                      | \$ -                                         | \$ -                                  |
| U.S. government sponsored entities and agencies              | 32,179    | -                                                             | 32,179                                       | -                                     |
| Mortgage-backed securities: residential                      | 35,014    | -                                                             | 35,014                                       | -                                     |
| Collateralized mortgage obligations: residential             | 37,600    | -                                                             | 37,600                                       | -                                     |
| State and political subdivision                              | 34,986    | -                                                             | 34,986                                       | -                                     |
| Corporate debt securities                                    | 1,002     | -                                                             | 1,002                                        | -                                     |
| Equity securities                                            | 2,412     | 1,759                                                         | -                                            | 653                                   |
|                                                              | \$146,527 | \$ 5,093                                                      | \$ 140,781                                   | \$ 653                                |
| December 31, 2013:                                           |           |                                                               |                                              |                                       |
| U.S. Treasury and federal agency                             | \$4,168   | \$ 4,168                                                      | \$ -                                         | \$ -                                  |
| U.S. government sponsored entities and agencies              | 22,892    | -                                                             | 22,892                                       | -                                     |
| U.S. agency mortgage-backed securities: residential          | 11,361    | -                                                             | 11,361                                       | -                                     |
| U.S. agency collateralized mortgage obligations: residential | 39,722    | -                                                             | 39,722                                       | -                                     |
| State and political subdivisions                             | 36,499    | -                                                             | 36,499                                       | -                                     |
| Corporate debt securities                                    | 241       | 241                                                           | -                                            | -                                     |
| Equity securities                                            | 2,421     | 1,768                                                         | -                                            | 653                                   |
|                                                              | \$117,304 | \$ 6,177                                                      | \$ 110,474                                   | \$ 653                                |

The Corporation's policy is to transfer assets or liabilities from one level to another when the methodology to obtain the fair value changes such that there are more or fewer unobservable inputs as of the end of the reporting period. During the three and six month periods ended June 30, 2014, the Corporation had no transfers between levels. The following table presents changes in Level 3 assets measured on a recurring basis for the three and six month periods ended June 30, 2014 and 2013:

| (Dollar amounts in thousands)          |  | Three months ended |          | Six months ended |          |
|----------------------------------------|--|--------------------|----------|------------------|----------|
|                                        |  | June 30,           | June 30, | June 30,         | June 30, |
|                                        |  | 2014               | 2013     | 2014             | 2013     |
| Balance at the beginning of the period |  | \$ 653             | \$ 653   | \$ 653           | \$ 653   |

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|                                              |        |        |        |        |
|----------------------------------------------|--------|--------|--------|--------|
| Total gains or losses (realized/unrealized): | -      | -      | -      | -      |
| Included in earnings                         | -      | -      | -      | -      |
| Included in other comprehensive income       | -      | -      | -      | -      |
| Issuances                                    | -      | -      | -      | -      |
| Transfers in and/or out of Level 3           | -      | -      | -      | -      |
| Balance at the end of the period             | \$ 653 | \$ 653 | \$ 653 | \$ 653 |

**9. Fair Value (continued)**

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

| (Dollar amounts in thousands)         |         | (Level 1)<br>Quoted Prices in<br>Active Markets<br>for Identical<br>Assets | (Level 2)<br>Significant<br>Other<br>Observable<br>Inputs | (Level 3)<br>Significant<br>Unobservable<br>Inputs |
|---------------------------------------|---------|----------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
| Description                           | Total   |                                                                            |                                                           |                                                    |
| June 30, 2014:                        |         |                                                                            |                                                           |                                                    |
| Impaired commercial real estate loans | \$558   | \$ -                                                                       | \$ -                                                      | \$ 558                                             |
| Impaired commercial business loans    | 1,670   | -                                                                          | -                                                         | 1,670                                              |
|                                       | \$2,228 | \$ -                                                                       | \$ -                                                      | \$ 2,228                                           |
| December 31, 2013:                    |         |                                                                            |                                                           |                                                    |
| Impaired commercial real estate loans | \$2,340 | \$ -                                                                       | \$ -                                                      | \$ 2,340                                           |
| Other residential real estate owned   | 80      | -                                                                          | -                                                         | 80                                                 |
|                                       | \$2,420 | \$ -                                                                       | \$ -                                                      | \$ 2,420                                           |

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

| (Dollar amounts in thousands)         |       | Valuation<br>Techniques(s)                                          | Unobservable<br>Input (s)                                           | Range        |
|---------------------------------------|-------|---------------------------------------------------------------------|---------------------------------------------------------------------|--------------|
| June 30, 2014:                        |       |                                                                     |                                                                     |              |
| Impaired commercial real estate loans | \$558 | Sales comparison approach/<br>Contractual provision of USDA<br>loan | Adjustment for differences<br>between comparable sales              | 10%          |
| Impaired commercial business loans    | 1,670 | Liquidation value of business<br>assets                             | Adjustment for differences<br>between comparable business<br>assets | 44% -<br>76% |

December 31, 2013:

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|                                       |       |                                                                  |                                                     |          |
|---------------------------------------|-------|------------------------------------------------------------------|-----------------------------------------------------|----------|
| Impaired commercial real estate loans | 2,340 | Sales comparison approach/<br>Contractual provision of USDA loan | Adjustment for differences between comparable sales | 0% - 10% |
| Other residential real estate owned   | 80    | Sales comparison approach                                        | Adjustment for differences between comparable sales | 10%      |

The two tables above exclude two impaired residential mortgage loans totaling \$144,000 and a \$1.9 million commercial real estate loan classified as troubled debt restructures which were measured at fair value using a discounted cash flow methodology at June 30, 2014.

Included in impaired commercial real estate loans is a loan guaranteed by the United States Department of Agriculture (USDA) with balances of \$346,000 and \$350,000, respectively, as of June 30, 2014 and December 31, 2013. The guarantee covers 90% of the principal balance outstanding. In determining the fair value of this loan, the Corporation considered the contractual provisions of the loan and did not rely on the fair value of the underlying collateral. As such, the Corporation applied a 10% discount to the loan which represents the portion of the loan at risk. The weighted average discount on impaired loans as of June 30, 2014 and December 31, 2013 was 40.4% and 1.5%, respectively.

**9. Fair Value (continued)**

The following table sets forth the carrying amount and estimated fair values of the Corporation's financial instruments included in the consolidated balance sheet as of June 30, 2014 and December 31, 2013:

(Dollar amounts in thousands)

| Description                   | Carrying Amount | Fair Value Total | Measurements using: Level 1 | Level 2 | Level 3 |
|-------------------------------|-----------------|------------------|-----------------------------|---------|---------|
| June 30, 2014:                |                 |                  |                             |         |         |
| Financial Assets:             |                 |                  |                             |         |         |
| Cash and cash equivalents     | \$37,494        | \$37,494         | \$37,494                    | \$-     | \$-     |
| Securities available for sale | 146,527         | 146,527          | 5,093                       | 140,781 | 653     |
| Loans, net                    | 360,469         | 364,670          | -                           | -       | 364,670 |
| Federal bank stock            | 2,791           | N/A              | N/A                         | N/A     | N/A     |
| Accrued interest receivable   | 1,530           | 1,530            | 52                          | 477     | 1,001   |
|                               | 548,812         | 550,221          | 42,639                      | 141,258 | 366,324 |
| Financial Liabilities:        |                 |                  |                             |         |         |
| Deposits                      | 514,403         | 516,772          | 394,222                     | 122,550 | -       |
| Borrowed funds                | 17,150          | 18,078           | -                           | 18,078  | -       |
| Accrued interest payable      | 253             | 253              | 6                           | 247     | -       |
|                               | 531,806         | 535,103          | 394,228                     | 140,875 | -       |

|                               | Carrying Amount | Fair Value Total | Measurements using: Level 1 | Level 2 | Level 3 |
|-------------------------------|-----------------|------------------|-----------------------------|---------|---------|
| December 31, 2013:            |                 |                  |                             |         |         |
| Financial Assets:             |                 |                  |                             |         |         |
| Cash and cash equivalents     | \$16,658        | \$16,658         | \$16,658                    | \$-     | \$-     |
| Securities available for sale | 117,304         | 117,304          | 5,936                       | 110,715 | 653     |
| Loans, net                    | 352,430         | 356,123          | -                           | -       | 356,123 |
| Federal bank stock            | 3,977           | N/A              | N/A                         | N/A     | N/A     |
| Accrued interest receivable   | 1,466           | 1,466            | 34                          | 430     | 1,002   |
|                               | 491,835         | 491,551          | 22,628                      | 111,145 | 357,778 |
| Financial Liabilities:        |                 |                  |                             |         |         |
| Deposits                      | 432,006         | 434,552          | 325,983                     | 108,569 | -       |
| Borrowed funds                | 44,150          | 45,241           | -                           | 45,241  | -       |
| Accrued interest payable      | 292             | 292              | 5                           | 287     | -       |
|                               | 476,448         | 480,085          | 325,988                     | 154,097 | -       |

**10. Accumulated Other Comprehensive Income (Loss)**

The following tables summarize the changes within each classification of accumulated other comprehensive income (loss), net of tax, for the three months ended June 30, 2014 and 2013 and summarizes the significant amounts reclassified out of each component of accumulated other comprehensive income:

| (Dollar amounts in thousands)                                    | Unrealized Gains<br>and Losses on<br>Available-for-Sale<br>Securities | Defined<br>Benefit<br>Pension<br>Items | Totals    |
|------------------------------------------------------------------|-----------------------------------------------------------------------|----------------------------------------|-----------|
| Accumulated Other Comprehensive Loss at April 1, 2014            | \$ (1,492                                                             | ) \$(1,410)                            | \$(2,902) |
| Other comprehensive income before reclassification               | 1,006                                                                 | -                                      | 1,006     |
| Amounts reclassified from accumulated other comprehensive income | -                                                                     | -                                      | -         |
| Net current period other comprehensive income                    | 1,006                                                                 | -                                      | 1,006     |
| Accumulated Other Comprehensive Loss at June 30, 2014            | \$ (486                                                               | ) \$(1,410)                            | \$(1,896) |

| (Dollar amounts in thousands)                                      | Amount Reclassified<br>from Accumulated<br>Other Comprehensive<br>Income<br>For the three months<br>ended June 30, 2014 | Affected Line Item in the<br>Statement Where Net<br>Income is Presented |
|--------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------|
| Details about Accumulated Other<br>Comprehensive Income Components |                                                                                                                         |                                                                         |
| Unrealized gains and losses on available-for-sale securities       | \$ -                                                                                                                    | Gain on sale of securities                                              |
|                                                                    | -                                                                                                                       | Tax expense                                                             |
| Total reclassifications for the period                             | \$ -                                                                                                                    | Net of tax                                                              |

| (Dollar amounts in thousands)                                    | Unrealized Gains<br>and Losses on<br>Available-for-Sale<br>Securities | Defined<br>Benefit<br>Pension<br>Items | Totals    |
|------------------------------------------------------------------|-----------------------------------------------------------------------|----------------------------------------|-----------|
| Accumulated Other Comprehensive Income at April 1, 2013          | \$ 2,071                                                              | \$(1,795)                              | \$276     |
| Other comprehensive income before reclassification               | (2,713                                                                | ) -                                    | (2,713)   |
| Amounts reclassified from accumulated other comprehensive income | (65                                                                   | ) -                                    | (65 )     |
| Net current period other comprehensive loss                      | (2,778                                                                | ) -                                    | (2,778)   |
| Accumulated Other Comprehensive Loss at June 30, 2013            | \$ (707                                                               | ) \$(1,795)                            | \$(2,502) |

| (Dollar amounts in thousands)                                      | Amount Reclassified<br>from Accumulated<br>Other Comprehensive<br>Income<br>For the three months<br>ended June 30, 2013 | Affected Line Item in the<br>Statement Where Net<br>Income is Presented |
|--------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------|
| Details about Accumulated Other<br>Comprehensive Income Components |                                                                                                                         |                                                                         |
| Unrealized gains and losses on available-for-sale securities       | \$ 99<br>(34                                                                                                            | Gain on sale of securities<br>) Tax expense                             |
| Total reclassifications for the period                             | \$ 65                                                                                                                   | Net of tax                                                              |

**10. Accumulated Other Comprehensive Income (Loss) (continued)**

The following tables summarize the changes within each classification of accumulated other comprehensive income (loss), net of tax, for the six months ended June 30, 2014 and 2013 and summarizes the significant amounts reclassified out of each component of accumulated other comprehensive income:

| (Dollar amounts in thousands)                                    | Unrealized Gains<br>and Losses on<br>Available-for-Sale<br>Securities | Defined<br>Benefit<br>Pension<br>Items | Totals    |
|------------------------------------------------------------------|-----------------------------------------------------------------------|----------------------------------------|-----------|
| Accumulated Other Comprehensive Income at January 1, 2014        | \$ (1,870                                                             | ) \$(1,410)                            | \$(3,280) |
| Other comprehensive income before reclassification               | 1,818                                                                 | -                                      | 1,818     |
| Amounts reclassified from accumulated other comprehensive income | (434                                                                  | ) -                                    | (434 )    |
| Net current period other comprehensive loss                      | 1,384                                                                 | -                                      | 1,384     |
| Accumulated Other Comprehensive Income at June 30, 2014          | \$ (486                                                               | ) \$(1,410)                            | \$(1,896) |

| (Dollar amounts in thousands)                                      | Amount Reclassified<br>from Accumulated<br>Other Comprehensive<br>Income<br>For the six months<br>ended June 30, 2014 | Affected Line Item in the<br>Statement Where Net<br>Income is Presented |
|--------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------|
| Details about Accumulated Other<br>Comprehensive Income Components |                                                                                                                       |                                                                         |
| Unrealized gains and losses on available-for-sale securities       | \$ 658                                                                                                                | Gain on sale of securities                                              |
|                                                                    | (224                                                                                                                  | ) Tax expense                                                           |
| Total reclassifications for the period                             | \$ 434                                                                                                                | Net of tax                                                              |

| (Dollar amounts in thousands)                                    | Unrealized Gains<br>and Losses on<br>Available-for-Sale<br>Securities | Defined<br>Benefit<br>Pension<br>Items | Totals  |
|------------------------------------------------------------------|-----------------------------------------------------------------------|----------------------------------------|---------|
| Accumulated Other Comprehensive Income at January 1, 2013        | \$ 2,365                                                              | \$(1,795)                              | \$570   |
| Other comprehensive income before reclassification               | (2,951                                                                | ) -                                    | (2,951) |
| Amounts reclassified from accumulated other comprehensive income | (121                                                                  | ) -                                    | (121 )  |
| Net current period other comprehensive loss                      | (3,072                                                                | ) -                                    | (3,072) |

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Accumulated Other Comprehensive Income at June 30, 2013                      \$   (707                      )   \$(1,795)   \$(2,502)

(Dollar amounts in thousands)

| Details about Accumulated Other Comprehensive Income Components | Amount Reclassified from Accumulated Other Comprehensive Income For the six months ended June 30, 2013 | Affected Line Item in the Statement Where Net Income is Presented |
|-----------------------------------------------------------------|--------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------|
| Unrealized gains and losses on available-for-sale securities    | \$   184<br>(63                                                                                        | Gain on sale of securities<br>) Tax expense                       |
| Total reclassifications for the period                          | \$   121                                                                                               | Net of tax                                                        |

## 11. New Accounting Standards

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers* (Topic 606). The ASU creates a new topic, Topic 606, to provide guidance on revenue recognition for entities that enter into contracts with customers to transfer goods or services or enter into contracts for the transfer of nonfinancial assets. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Additional disclosures are required to provide quantitative and qualitative information regarding the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The new guidance is effective for annual reporting periods, and interim reporting periods within those annual periods, beginning after December 5, 2016. Early adoption is not permitted. Management is currently evaluating the impact of the adoption of this guidance on the Corporation's financial statements.

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

This section discusses the consolidated financial condition and results of operations of Emclaire Financial Corp and its wholly owned subsidiaries, the Bank and the Title Company, for the three and six months ended June 30, 2014, compared to the same periods in 2013 and should be read in conjunction with the Corporation's Annual Report on Form 10-K for the year ended December 31, 2013, filed with the SEC and with the accompanying consolidated financial statements and notes presented on pages 1 through 28 of this Form 10-Q.

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

## CHANGES IN FINANCIAL CONDITION

Total assets increased \$57.9 million, or 11.0%, to \$583.7 million at June 30, 2014 from \$525.8 million at December 31, 2013. This increase resulted primarily from increases in cash and equivalents, securities and loans receivable of \$20.8 million, \$29.2 million and \$8.0 million, respectively, which was funded by an \$82.4 million increase in customer deposits. This deposit increase also funded a \$27.0 million decrease in borrowed funds.

Total liabilities increased \$55.5 million, or 11.5%, to \$536.2 million at June 30, 2014 from \$480.8 million at December 31, 2013, resulting primarily from an \$82.4 million increase in customer deposits, partially offset by a \$27.0 million decrease in borrowed funds. Deposit growth consisted of an \$11.1 million, or 10.6%, increase in noninterest bearing deposits and a \$71.3 million, or 21.8%, increase in interest bearing deposits. The decrease in borrowed funds resulted from the repayment of a \$5.0 million FHLB long term advance and \$22.0 million of FHLB short term advances utilized to fund normal operating fluctuations.

Stockholders' equity increased \$2.4 million to \$47.5 million at June 30, 2014 from \$45.1 million at December 31, 2013. Book value and tangible book value per common share were \$23.99 and \$21.43, respectively, at June 30, 2014, compared to \$22.66 and \$20.04, respectively, at December 31, 2013.

At June 30, 2014, the Bank was considered “well-capitalized” under regulatory guidelines with a Tier 1 leverage ratio, Tier 1 risk-based capital ratio and total risk-based capital ratio of 8.03%, 13.79% and 15.04%, respectively, compared to 8.58%, 14.08% and 15.34%, respectively, at December 31, 2013.

## RESULTS OF OPERATIONS

### Comparison of Results for the Three Months Ended June 30, 2014 and 2013

**General.** Net income decreased \$61,000, or 6.5%, to \$878,000 for the three months ended June 30, 2014 from \$939,000 for the same period in 2013. This decrease was the result of a decrease in noninterest income of \$198,000 and increases in noninterest expense, the provision for loan losses and the provision for income taxes of \$74,000, \$30,000 and \$10,000, respectively, partially offset by an increase in net interest income of \$251,000.

**Net interest income.** Net interest income on a tax equivalent basis increased \$242,000, or 5.9%, to \$4.3 million for the three months ended June 30, 2014 from \$4.1 million for the three months ended June 30, 2013. This increase can be attributed to a decrease in interest expense of \$243,000, as interest income was essentially unchanged.

**Interest income.** Interest income on a tax equivalent basis decreased \$1,000, to \$5.1 million for the three months ended June 30, 2014 and for the same period in 2013. This decrease can be attributed to decreases in interest on securities and loans of \$35,000 and \$2,000, respectively, partially offset by increases in dividends on federal bank stocks and interest earned on interest-earning deposits with banks of \$27,000 and \$9,000, respectively.

Tax equivalent interest earned on loans receivable decreased \$2,000, to \$4.2 million for the three months ended June 30, 2014 and for the same period in 2013. This decrease resulted from a 24 basis point decline in the average yield on loans to 4.71% for the three months ended June 30, 2014, versus 4.95% for the same period in 2013. This unfavorable yield variance accounted for a \$212,000 decrease in interest income. Partially offsetting this unfavorable yield variance, average loans increased \$17.5 million, or 5.2%, accounting for an increase of \$210,000 in loan interest income.

Tax equivalent interest earned on securities decreased \$35,000, or 4.0%, to \$850,000 for the three months ended June 30, 2014 as compared to \$885,000 for the three months ended June 30, 2013. This decrease resulted from an 8 basis point decline in the average yield on securities to 2.40% for the three months ended June 30, 2014, versus 2.48% for the same period in 2013. This unfavorable yield variance accounted for a \$28,000 decrease in interest income. Also contributing to this unfavorable yield variance, the average balance of securities decreased \$1.1 million, or 0.8%,

accounting for a \$7,000 decrease in interest income.

Dividends on federal bank stocks increased \$27,000 to \$44,000 for the three months ended June 30, 2014 from \$17,000 for the same period in 2013. This increase resulted from a 401 basis point increase in the average yield on federal bank stocks to 6.33% for the three months ended June 30, 2014, compared to 2.32% for the same period in 2013. The increase in the yield was the result of an increase in the FHLB's dividend rate to 4.0% for the quarter ended June 30, 2014, compared to 1.0% for the same period in 2013.

**Interest expense.** Interest expense decreased \$243,000, or 24.3%, to \$756,000 for the three months ended June 30, 2014 from \$999,000 for the same period in 2013. This decrease in interest expense can be attributed to a decrease in interest incurred on deposits and borrowed funds of \$198,000 and \$45,000, respectively.

Interest expense incurred on deposits decreased \$198,000, or 24.6%, to \$607,000 for the three months ended June 30, 2014 compared to \$805,000 for the same period in 2013. The average cost of interest-bearing deposits decreased 30 basis points to 0.63% for the three months ended June 30, 2014, compared to 0.93% for the same period in 2013, resulting in a \$288,000 decrease in interest expense. This decrease in the cost of deposits was primarily due to deposits repricing during 2013 and the first half of 2014 in the prevailing low interest-rate environment. Partially offsetting this favorable variance, the average balance of interest-bearing deposits increased \$42.2 million, or 12.2%, to \$387.7 million for the three months ended June 30, 2014, compared to \$345.5 million for the same period in 2013 causing a \$90,000 increase in interest expense. Average noninterest bearing deposits increased \$8.7 million, or 8.2%, to \$114.4 million from \$105.7 million, facilitating the overall decline in the Corporation's cost of funds.

Interest expense incurred on borrowed funds decreased \$45,000, or 23.2%, to \$149,000 for the three months ended June 30, 2014, compared to \$194,000 for the same period in the prior year. The average cost of long term borrowed funds decreased 50 basis points to 3.36% for the three months ended June 30, 2014, compared to 3.86% for the same period in 2013, causing a \$23,000 decrease in interest expense. This was due primarily to the capitalization of \$24,000 of interest during the quarter ended June 30, 2014 related to the Cranberry Township banking office construction compared to \$10,000 for the same period in the prior year. Additionally, the average balance of long term borrowed funds decreased \$5.0 million, or 25.0%, accounting for a \$44,000 decrease in interest expense. This resulted from the early repayment of a \$5.0 million FHLB long term advance during the first quarter of 2014. The Corporation recognized a \$550,000 prepayment penalty associated with this early repayment. Partially offsetting the favorable variance related to long term borrowings, the average cost of short term borrowed funds increased 406 basis points, which caused a \$22,000 increase in interest expense. Short-term borrowings at June 30, 2014 included a \$2.2 million line of credit balance with a correspondent bank with a rate of 4.25%. The Corporation advanced \$2.2 million on this line of credit during the third quarter of 2013 and utilized the proceeds to partially fund the \$5.0 million SBLF preferred stock redemption.

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

| (Dollar amounts in thousands)           | Three months ended June 30, |          |                 |      |                    |          |                 |
|-----------------------------------------|-----------------------------|----------|-----------------|------|--------------------|----------|-----------------|
|                                         | 2014                        |          |                 | 2013 |                    |          |                 |
|                                         | Average<br>Balance          | Interest | Yield /<br>Rate |      | Average<br>Balance | Interest | Yield /<br>Rate |
| Interest-earning assets:                |                             |          |                 |      |                    |          |                 |
| Loans, taxable                          | \$334,796                   | \$3,903  | 4.68 %          |      | \$318,536          | \$3,928  | 4.95 %          |
| Loans, tax exempt                       | 20,450                      | 266      | 5.22 %          |      | 19,217             | 243      | 5.06 %          |
| Total loans receivable                  | 355,246                     | 4,169    | 4.71 %          |      | 337,753            | 4,171    | 4.95 %          |
| Securities, taxable                     | 106,789                     | 493      | 1.85 %          |      | 100,690            | 470      | 1.87 %          |
| Securities, tax exempt                  | 35,141                      | 357      | 4.07 %          |      | 42,346             | 415      | 3.93 %          |
| Total securities                        | 141,930                     | 850      | 2.40 %          |      | 143,036            | 885      | 2.48 %          |
| Interest-earning deposits with banks    | 37,192                      | 27       | 0.29 %          |      | 16,628             | 18       | 0.43 %          |
| Federal bank stocks                     | 2,788                       | 44       | 6.33 %          |      | 2,935              | 17       | 2.32 %          |
| Total interest-earning cash equivalents | 39,980                      | 71       | 0.71 %          |      | 19,563             | 35       | 0.72 %          |
| Total interest-earning assets           | 537,156                     | 5,090    | 3.80 %          |      | 500,352            | 5,091    | 4.08 %          |
| Cash and due from banks                 | 2,205                       |          |                 |      | 2,062              |          |                 |
| Other noninterest-earning assets        | 31,461                      |          |                 |      | 27,241             |          |                 |
| Total Assets                            | \$570,822                   |          |                 |      | \$529,655          |          |                 |
| Interest-bearing liabilities:           |                             |          |                 |      |                    |          |                 |
| Interest-bearing demand deposits        | \$266,833                   | \$106    | 0.16 %          |      | \$225,068          | \$94     | 0.17 %          |
| Time deposits                           | 120,846                     | 501      | 1.66 %          |      | 120,455            | 711      | 2.37 %          |
| Total interest-bearing deposits         | 387,679                     | 607      | 0.63 %          |      | 345,523            | 805      | 0.93 %          |
| Borrowed funds, short-term              | 2,150                       | 23       | 4.31 %          |      | 1,447              | 1        | 0.25 %          |
| Borrowed funds, long-term (1)           | 15,000                      | 126      | 3.36 %          |      | 20,000             | 193      | 3.86 %          |
| Total borrowed funds                    | 17,150                      | 149      | 3.48 %          |      | 21,447             | 194      | 3.62 %          |
| Total interest-bearing liabilities      | 404,829                     | 756      | 0.75 %          |      | 366,970            | 999      | 1.09 %          |

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|                                                                                                                             |           |         |        |           |         |        |
|-----------------------------------------------------------------------------------------------------------------------------|-----------|---------|--------|-----------|---------|--------|
| Noninterest-bearing demand deposits                                                                                         | 114,363   | -       | -      | 105,684   | -       | -      |
| Funding and cost of funds                                                                                                   | 519,192   | 756     | 0.58 % | 472,654   | 999     | 0.85 % |
| Other noninterest-bearing liabilities                                                                                       | 4,819     |         |        | 5,195     |         |        |
| Total Liabilities                                                                                                           | 524,011   |         |        | 477,849   |         |        |
| Stockholders' Equity                                                                                                        | 46,811    |         |        | 51,806    |         |        |
| Total Liabilities and Stockholders' Equity                                                                                  | \$570,822 |         |        | \$529,655 |         |        |
| Net interest income                                                                                                         |           | \$4,334 |        |           | \$4,092 |        |
| Interest rate spread (difference between weighted average rate on interest-earning assets and interest-bearing liabilities) |           |         | 3.05 % |           |         | 2.99 % |
| Net interest margin (net interest income as a percentage of average interest-earning assets)                                |           |         | 3.24 % |           |         | 3.28 % |

(1) Interest on long-term borrowed funds for the quarterly periods ended June 30, 2014 and 2013 was reduced by \$24,000 and \$10,000, respectively, related to capitalized interest costs on construction in progress.

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

| (Dollar amounts in thousands)        | Three months ended June 30,<br>2014 versus 2013 |           |         |
|--------------------------------------|-------------------------------------------------|-----------|---------|
|                                      | Increase (Decrease) due to                      |           |         |
|                                      | Volume                                          | Rate      | Total   |
| Interest income:                     |                                                 |           |         |
| Loans                                | \$ 210                                          | \$ (212 ) | \$ (2 ) |
| Securities                           | (7 )                                            | (28 )     | (35 )   |
| Interest-earning deposits with banks | 17                                              | (8 )      | 9       |
| Federal bank stocks                  | (1 )                                            | 28        | 27      |
| Total interest-earning assets        | 219                                             | (220 )    | (1 )    |
| Interest expense:                    |                                                 |           |         |
| Interest-bearing deposits            | 90                                              | (288 )    | (198 )  |
| Borrowed funds, short-term           | -                                               | 22        | 22      |
| Borrowed funds, long-term            | (44 )                                           | (23 )     | (67 )   |
| Total interest-bearing liabilities   | 46                                              | (289 )    | (243 )  |
| Net interest income                  | \$ 173                                          | \$ 69     | \$ 242  |

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

Information pertaining to the allowance for loan losses and nonperforming assets for the three months ended June 30, 2014 and 2013 is as follows:

(Dollar amounts in thousands) At or for the three months ended

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|                                                   | June 30,<br>2014 |   | 2013     |   |
|---------------------------------------------------|------------------|---|----------|---|
| Balance at the beginning of the period            | \$ 4,921         |   | \$ 5,488 |   |
| Provision for loan losses                         | 183              |   | 153      |   |
| Charge-offs                                       | (66 )            |   | (978 )   |   |
| Recoveries                                        | 8                |   | 7        |   |
| Balance at the end of the period                  | \$ 5,046         |   | \$ 4,670 |   |
| Nonperforming loans                               | \$ 7,692         |   | \$ 5,329 |   |
| Nonperforming assets                              | 7,712            |   | 5,564    |   |
| Nonperforming loans to total loans                | 2.10             | % | 1.57     | % |
| Nonperforming assets to total assets              | 1.32             | % | 1.05     | % |
| Allowance for loan losses to total loans          | 1.38             | % | 1.38     | % |
| Allowance for loan losses to non-performing loans | 65.60            | % | 87.63    | % |

Nonperforming loans increased \$2.4 million to \$7.7 million at June 30, 2014 from \$5.3 million at June 30, 2013. The increase in nonperforming loans during the quarter ended June 30, 2014 was primarily due to a \$2.4 million loan relationship being placed on nonaccrual status due to the borrower's inadequate working capital and liquidity sources. This relationship, which is considered impaired, consists of six commercial business loans, one commercial real estate loan and one residential mortgage. The loans are secured by commercial real estate, residential real estate, equipment, accounts receivable and inventory. This relationship was assigned specific reserves of \$385,000 during the quarter ended June 30, 2014. In addition, a \$637,000 commercial relationship was placed on nonaccrual status during the quarter ended March 31, 2014, after the Corporation received information from the borrower which reflected a weakened financial condition. This relationship consists of a commercial real estate loan secured by a commercial property and a commercial line of credit secured by accounts receivable, inventory and other business assets, both of which were considered impaired at June 30, 2014. The commercial real estate loan and commercial line of credit had specific reserves of \$52,000 and \$154,000, respectively, at June 30, 2014. Partially offsetting these increases were principal reductions of \$121,000 resulting from credit workouts and repayments. Of the \$7.7 million in nonperforming loans, \$6.9 million were not past due at June 30, 2014. During the three months ended June 30, 2014, nonperforming loans increased \$1.7 million, primarily due to the aforementioned eight loan relationship being put on nonaccrual status during the quarter.

As of June 30, 2014, the Corporation's classified and criticized assets amounted to \$13.4 million, or 2.3% of total assets, with \$11.7 million classified as substandard and \$1.7 identified as special mention. This compares to classified and criticized assets of \$12.7 million, or 2.4% of total assets, with \$11.8 million classified as substandard and \$930,000 identified as special mention at December 31, 2013. The \$1.6 million increase in criticized and classified assets was primarily the result of two commercial loan relationships being downgraded to special mention during the quarter ended March 31, 2014.

The provision for loan losses increased \$30,000, or 19.6%, to \$183,000 for the three months ended June 30, 2014 from \$153,000 for the same period in the prior year. While the Corporation allocated \$385,000 of the allowance for loan losses to the aforementioned loans placed on nonaccrual status and recognized as impaired during the quarter, the provision for loan losses only increased marginally as the general reserve pool previously had \$224,000 attributable to these loans and there was a positive impact in the allowance for loan losses due to an improvement in the historical loss ratios.

**Noninterest income.** Noninterest income decreased \$198,000, or 19.2%, to \$833,000 for the three months ended June 30, 2014, compared to \$1.0 million for the same period in the prior year. This decrease resulted from a \$99,000 decrease in net gains on the sale of securities and decreases in commissions on financial services and fees and service charges of \$63,000 and \$34,000, respectively. During the quarter ended June 30, 2013, the Corporation realized securities gains of \$99,000 related to the sale of certain mortgage-backed securities that were experiencing accelerated prepayments compared to no security gains in the 2014 quarterly period.

**Noninterest expense.** Noninterest expense increased \$74,000, or 2.0%, to \$3.7 million for the three months ended June 30, 2014, compared to \$3.6 million for the same period in the prior year. This increase in noninterest expense can

be attributed to increases in other noninterest expense, premises and equipment, and professional fees of \$122,000, \$77,000 and \$5,000, respectively, partially offset by decreases in compensation and employee benefits, intangible asset amortization and FDIC expense of \$100,000, \$16,000 and \$14,000, respectively. Noninterest expense for the second quarter of 2014 included \$151,000 related to the Bank's new branch offices in Cranberry Township, Pennsylvania and Saint Marys, Pennsylvania, which opened in May 2014 and October 2013, respectively.

Compensation and employee benefits expense decreased \$100,000, or 5.2%, to \$1.8 million for the three months ended June 30, 2014, compared to \$1.9 million for the same period in the prior year. This decrease can be attributed to a \$35,000 decrease in commission expense as the Corporation discontinued providing retail brokerage and other investment services during the third quarter of 2013 and a \$20,000 reduction in retirement benefits costs resulting from the 2013 curtailment of the Bank's pension plan. Payroll taxes also decreased \$22,000 as the Corporation received a refund from prior year overpayments of state unemployment taxes.

Premise and equipment expense increased \$77,000, or 14.6%, to \$604,000 for the three months ended June 30, 2014, compared to \$527,000 for the same period in the prior year. Premise and equipment expense for the second quarter of 2014 included \$50,000 in expenses related to the Bank's new branch offices in Cranberry Township, Pennsylvania and Saint Marys, Pennsylvania.

Professional fees increased \$5,000, or 2.8%, to \$183,000 for the three months ended June 30, 2014, compared to \$178,000 for the same period in the prior year.

The Corporation recognized \$57,000 of core deposit intangible amortization expense during the second quarter of 2014 compared to \$73,000 for the same period in the prior year. This amortization relates to a branch acquisition completed in the third quarter of 2009. Further discussion of goodwill and intangible assets related to the branch office acquisition can be found in the “Notes to Consolidated Financial Statements” beginning on page 6.

FDIC insurance decreased \$14,000, or 13.7%, to \$88,000 for the three months ended June 30, 2014, compared to \$102,000 for the same period in the prior year. The decrease was primarily the result of a decrease in the Bank’s FDIC insurance assessment rate.

**Provision for income taxes.** The provision for income taxes increased \$10,000, or 4.9%, to \$216,000 for the three months ended June 30, 2014 compared to \$206,000 for the same period in the prior year. The Corporation’s effective tax rate increased to 19.7% for the second quarter of 2014 from 18.0% for the same quarter in the prior year. The difference between the statutory rate of 34% and the Corporation’s effective tax rate of 19.7% for the quarter ended June 30, 2014 was due to tax-exempt income earned on certain tax-free loans and securities and bank-owned life insurance.

#### Comparison of Results for the Six Months Ended June 30, 2014 and 2013

**General.** Net income decreased \$77,000, or 4.3%, to \$1.7 million for the six months ended June 30, 2014 from \$1.8 million for the same period in 2013. This decrease was the result of increases in noninterest expense and the provision for loan losses of \$720,000 and \$50,000, respectively, partially offset by increases in net interest income and noninterest income of \$376,000 and \$311,000, respectively, and a decrease in the provision for income taxes of \$6,000.

**Net interest income.** Net interest income on a tax equivalent basis increased \$371,000, or 4.6%, to \$8.5 million for the six months ended June 30, 2014 from \$8.1 million for the six months ended June 30, 2013. This increase can be attributed to a decrease in interest expense of \$537,000, partially offset by a decrease in tax equivalent interest income of \$166,000.

**Interest income.** Interest income on a tax equivalent basis decreased \$166,000, or 1.6%, to \$10.0 million for the six months ended June 30, 2014 compared to \$10.2 million for the six months ended June 30, 2013. This decrease can be

attributed to decreases in interest on loans and securities of \$166,000 and \$51,000, respectively, partially offset by an increase in interest-earning deposits with banks and interest earned on federal bank stocks of \$7,000 and \$44,000, respectively.

Tax equivalent interest earned on loans receivable decreased \$166,000, or 2.0%, to \$8.3 million for the six months ended June 30, 2014 compared to \$8.4 million for the six months ended June 30, 2013. This decrease resulted from a 28 basis point decline in the average yield on loans to 4.72% for the six months ended June 30, 2014, versus 5.00% for the same period in 2013. This unfavorable yield variance accounted for a \$487,000 decrease in interest income. Partially offsetting this unfavorable yield variance, average loans increased \$13.3 million, or 3.9%, accounting for an increase of \$321,000 in loan interest income.

Tax equivalent interest earned on securities decreased \$51,000, or 3.0%, to \$1.6 million for the six months ended June 30, 2014 compared to \$1.7 million for the six months ended June 30, 2013. This decrease resulted from a 14 basis point decline in the average yield on securities to 2.49% for the six months ended June 30, 2014, versus 2.63% for the same period in 2013, due primarily to the sale of higher-yielding securities. This unfavorable yield variance accounted for a \$94,000 decrease in interest income. Partially offsetting this unfavorable yield variance, the average balance of securities increased \$3.3 million, or 2.6%, accounting for a \$43,000 increase in interest income.

**Interest expense.** Interest expense decreased \$537,000, or 26.4%, to \$1.5 million for the six months ended June 30, 2014 from \$2.0 million for the same period in 2013. This decrease in interest expense can be attributed to a decrease in interest incurred on deposits and borrowed funds of \$474,000 and \$63,000, respectively.

Interest expense incurred on deposits decreased \$474,000, or 28.9%, to \$1.2 million for the six months ended June 30, 2014 compared to \$1.6 million for the same period in 2013. The average cost of interest-bearing deposits decreased 34 basis points to 0.65% for the six months ended June 30, 2014, compared to 0.99% for the same period in 2013, resulting in a \$605,000 decrease in interest expense. This decrease in the cost of deposits was primarily due to deposits repricing during 2013 and the first half of 2014 in the prevailing low interest-rate environment. Partially offsetting this favorable variance, the average balance of interest-bearing deposits increased \$28.7 million, or 8.6%, to \$364.2 million for the six months ended June 30, 2014, compared to \$335.5 million for the same period in 2013 causing a \$131,000 increase in interest expense. Average noninterest bearing deposits increased \$7.5 million, or 7.4%, to \$110.0 million from \$102.5 million, facilitating the overall decline in the Corporation's cost of funds.

Interest expense incurred on borrowed funds decreased \$63,000, or 16.1%, to \$329,000 for the six months ended June 30, 2014, compared to \$392,000 for the same period in the prior year. The average cost of long term borrowed funds decreased 55 basis points to 3.39% for the six months ended June 30, 2014, compared to 3.94% for the same period in 2013, causing a \$50,000 decrease in interest expense. This was due primarily to the capitalization of \$53,000 of interest during the six months ended June 30, 2014 related to the Cranberry Township banking office construction compared to \$10,000 for the same period in the prior year. Additionally, the average balance of long term borrowed funds decreased \$3.3 million, or 16.6%, accounting for a \$61,000 decrease in interest expense. This resulted from the early repayment of a \$5.0 million FHLB long term advance during the first quarter of 2014. The Corporation recognized a \$550,000 prepayment penalty associated with this early repayment. Partially offsetting the favorable variance related to long term borrowings, the average balance of short term borrowed funds increased \$3.5 million, which caused an \$18,000 increase in interest expense. Short-term borrowings at June 30, 2014 included a \$2.2 million line of credit balance with a correspondent bank with a rate of 4.25% advanced by the Corporation during the third quarter of 2013 to partially fund the \$5.0 million SBLF preferred stock redemption. Additionally, the average cost of short term borrowed funds increased 202 basis points to 2.28% for the six months ended June 30, 2014, compared to 0.26% for the same period in 2013, causing a \$30,000 increase in interest expense.

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

(Dollar amounts in thousands)

Six months ended June 30,

|                                         | 2014      |          |         | 2013      |          |         |
|-----------------------------------------|-----------|----------|---------|-----------|----------|---------|
|                                         | Average   | Interest | Yield / | Average   | Interest | Yield / |
|                                         | Balance   |          | Rate    | Balance   |          | Rate    |
| Interest-earning assets:                |           |          |         |           |          |         |
| Loans, taxable                          | \$334,252 | \$7,772  | 4.69 %  | \$322,241 | \$7,977  | 4.99 %  |
| Loans, tax exempt                       | 19,277    | 497      | 5.20 %  | 18,019    | 458      | 5.13 %  |
| Total loans receivable                  | 353,529   | 8,269    | 4.72 %  | 340,260   | 8,435    | 5.00 %  |
| Securities, taxable                     | 96,417    | 897      | 1.88 %  | 89,182    | 887      | 2.01 %  |
| Securities, tax exempt                  | 35,559    | 731      | 4.15 %  | 39,455    | 792      | 4.05 %  |
| Total securities                        | 131,976   | 1,628    | 2.49 %  | 128,637   | 1,679    | 2.63 %  |
| Interest-earning deposits with banks    | 24,724    | 38       | 0.31 %  | 15,196    | 31       | 0.41 %  |
| Federal bank stocks                     | 3,126     | 79       | 5.10 %  | 2,897     | 35       | 2.44 %  |
| Total interest-earning cash equivalents | 27,850    | 117      | 0.85 %  | 18,093    | 66       | 0.74 %  |
| Total interest-earning assets           | 513,355   | 10,014   | 3.93 %  | 486,990   | 10,180   | 4.22 %  |
| Cash and due from banks                 | 2,162     |          |         | 1,996     |          |         |
| Other noninterest-earning assets        | 30,914    |          |         | 26,755    |          |         |
| Total Assets                            | \$546,431 |          |         | \$515,741 |          |         |
| Interest-bearing liabilities:           |           |          |         |           |          |         |
| Interest-bearing demand deposits        | \$246,199 | \$186    | 0.15 %  | \$211,812 | \$164    | 0.16 %  |
| Time deposits                           | 118,002   | 983      | 1.68 %  | 123,698   | 1,479    | 2.41 %  |
| Total interest-bearing deposits         | 364,201   | 1,169    | 0.65 %  | 335,510   | 1,643    | 0.99 %  |
| Borrowed funds, short-term              | 4,298     | 49       | 2.28 %  | 822       | 1        | 0.26 %  |
| Borrowed funds, long-term (1)           | 16,685    | 280      | 3.39 %  | 20,000    | 391      | 3.94 %  |
| Total borrowed funds                    | 20,983    | 329      | 3.16 %  | 20,822    | 392      | 3.79 %  |
| Total interest-bearing liabilities      | 385,184   | 1,498    | 0.78 %  | 356,332   | 2,035    | 1.15 %  |
| Noninterest-bearing demand deposits     | 110,008   | -        | -       | 102,467   | -        | -       |

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|                                                                                                                             |           |         |        |           |         |        |
|-----------------------------------------------------------------------------------------------------------------------------|-----------|---------|--------|-----------|---------|--------|
| Funding and cost of funds                                                                                                   | 495,192   | 1,498   | 0.61 % | 458,799   | 2,035   | 0.89 % |
| Other noninterest-bearing liabilities                                                                                       | 4,705     |         |        | 5,142     |         |        |
| Total Liabilities                                                                                                           | 499,897   |         |        | 463,941   |         |        |
| Stockholders' Equity                                                                                                        | 46,534    |         |        | 51,800    |         |        |
| Total Liabilities and Stockholders' Equity                                                                                  | \$546,431 |         |        | \$515,741 |         |        |
| Net interest income                                                                                                         |           | \$8,516 |        |           | \$8,145 |        |
| Interest rate spread (difference between weighted average rate on interest-earning assets and interest-bearing liabilities) |           |         | 3.15 % |           |         | 3.07 % |
| Net interest margin (net interest income as a percentage of average interest-earning assets)                                |           |         | 3.35 % |           |         | 3.37 % |

(1) Interest on long-term borrowed funds for the periods ended June 30, 2014 and 2013 was reduced by \$53,000 and \$10,000, respectively, related to capitalized interest costs on construction in progress.

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

| (Dollar amounts in thousands)        | Six months ended June 30,<br>2014 versus 2013 |           |           |
|--------------------------------------|-----------------------------------------------|-----------|-----------|
|                                      | Increase (Decrease) due to                    |           |           |
|                                      | Volume                                        | Rate      | Total     |
| Interest income:                     |                                               |           |           |
| Loans                                | \$ 321                                        | \$ (487 ) | \$ (166 ) |
| Securities                           | 43                                            | (94 )     | (51 )     |
| Interest-earning deposits with banks | 16                                            | (9 )      | 7         |
| Federal bank stocks                  | 3                                             | 41        | 44        |
| Total interest-earning assets        | 383                                           | (549 )    | (166 )    |
| Interest expense:                    |                                               |           |           |
| Interest-bearing deposits            | 131                                           | (605 )    | (474 )    |
| Borrowed funds, short-term           | 18                                            | 30        | 48        |
| Borrowed funds, long-term            | (61 )                                         | (50 )     | (111 )    |
| Total interest-bearing liabilities   | 88                                            | (625 )    | (537 )    |
| Net interest income                  | \$ 295                                        | \$ 76     | \$ 371    |

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

Information pertaining to the allowance for loan losses and nonperforming assets for the six months ended June 30, 2014 and 2013 is as follows:

(Dollar amounts in thousands) At or for the six months ended

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|                                                   | June 30, |   | 2013     |   |
|---------------------------------------------------|----------|---|----------|---|
|                                                   | 2014     |   |          |   |
| Balance at the beginning of the period            | \$ 4,869 |   | \$ 5,350 |   |
| Provision for loan losses                         | 345      |   | 295      |   |
| Charge-offs                                       | (197 )   |   | (1,014 ) |   |
| Recoveries                                        | 29       |   | 39       |   |
| Balance at the end of the period                  | \$ 5,046 |   | \$ 4,670 |   |
| Non-performing loans                              | \$ 7,692 |   | \$ 5,329 |   |
| Non-performing assets                             | 7,712    |   | 5,564    |   |
| Non-performing loans to total loans               | 2.10     | % | 1.57     | % |
| Non-performing assets to total assets             | 1.32     | % | 1.05     | % |
| Allowance for loan losses to total loans          | 1.38     | % | 1.38     | % |
| Allowance for loan losses to non-performing loans | 65.60    | % | 87.63    | % |

Nonperforming loans increased \$2.4 million to \$7.7 million at June 30, 2014 from \$5.3 million at June 30, 2013. The increase in nonperforming loans was primarily due to a \$2.4 million loan relationship being placed on nonaccrual status during the quarter ended June 30, 2014. This relationship, which is considered impaired, consists of six commercial business loans, one commercial real estate loan and one residential mortgage. This relationship was assigned specific reserves of \$385,000 during the quarter ended June 30, 2014. In addition, a \$637,000 commercial relationship was placed on nonaccrual status during the quarter ended March 31, 2014, after the Corporation received information from the borrower which reflected a weakened financial condition. This relationship consists of a commercial real estate loan secured by a commercial property and a commercial line of credit secured by accounts receivable, inventory and other business assets, both of which were considered impaired at June 30, 2014. The commercial real estate loan and commercial line of credit had specific reserves of \$52,000 and \$154,000, respectively, at June 30, 2014. Partially offsetting these increases were principal reductions resulting from credit workouts and repayments. Of the \$7.7 million in nonperforming loans, \$6.9 million were not past due at June 30, 2014. During the six months ended June 30, 2014, nonperforming loans increased \$2.6 million, primarily due to the aforementioned loan relationships being put on nonaccrual status during the period.

As of June 30, 2014, the Corporation's classified and criticized assets amounted to \$13.4 million, or 2.3% of total assets, with \$11.7 million classified as substandard and \$1.7 identified as special mention. This compares to classified and criticized assets of \$12.7 million, or 2.4% of total assets, with \$11.8 million classified as substandard and \$930,000 identified as special mention at December 31, 2013. The overall increase in criticized and classified assets was primarily the result of two commercial loan relationships being downgraded to special mention during the six months ended June 30, 2014.

The provision for loan losses increased \$50,000, or 17.0%, to \$345,000 for the six months ended June 30, 2014 from \$295,000 for the same period in the prior year. While the Corporation allocated \$600,000 of the allowance for loan losses to the aforementioned loans placed on nonaccrual status and recognized as impaired during the six months ended June 30, 2014, the provision for loan losses only increased marginally as the general reserve pool previously had amounts attributable to these loans and there was a positive impact in the allowance for loan losses due to an improvement in the historical loss ratios.

**Noninterest income.** Noninterest income increased \$311,000, or 15.9%, to \$2.3 million for the six months ended June 30, 2014, compared to \$2.0 million for the same period in the prior year. This increase resulted from a \$474,000 increase in net gains on the sale of securities. During the six months ended June 30, 2014, the Corporation realized securities gains of \$658,000 primarily related to a balance sheet management strategy whereby securities were sold to prepay a \$5.0 million FHLB long term advance and associated securities gains were used to offset the impact of prepayment penalties associated with the early retirement of the advance. During the six months ended June 30, 2013, the Corporation realized securities gains of \$184,000 related to the sale of certain mortgage backed securities that were experiencing accelerated prepayments. Partially offsetting this increase related to security gains, commissions on financial services and fees and service charges decreased \$117,000 and \$55,000, respectively.

**Noninterest expense.** Noninterest expense increased \$720,000, or 10.0%, to \$7.9 million for the six months ended June 30, 2014, compared to \$7.2 million for the same period in the prior year. This increase in noninterest expense can be attributed primarily to an increase in other noninterest expense of \$720,000, primarily related to a \$550,000 prepayment penalty assessed on the aforementioned early retirement of debt. Also contributing to the increase in noninterest expense was an increase in premises and equipment of \$135,000, primarily related to expenses for two new full-service banking offices opened during 2014. These increases were partially offset by decreases in compensation and employee benefits, intangible asset amortization, professional fees and FDIC expense of \$63,000, \$31,000, \$9,000 and \$32,000, respectively.

Compensation and employee benefits expense decreased \$63,000, or 1.6%, to \$3.8 million for the six months ended June 30, 2014. This decrease can be attributed to a \$61,000 decrease in commission expense as the Corporation discontinued providing retail brokerage and other investment services during the third quarter of 2013 and a \$42,000 reduction in retirement benefits costs resulting from the 2013 curtailment of the Bank's pension plan. Payroll taxes also decreased \$31,000 primarily from the receipt of a refund from prior year overpayments of state unemployment taxes.

Premise and equipment expense increased \$135,000, or 12.6%, to \$1.2 million for the six months ended June 30, 2014, compared to \$1.1 million for the same period in the prior year. Premise and equipment expense for the first half of 2014 included \$83,000 in expenses related to the Bank's new branch offices in Saint Marys and Cranberry Township, Pennsylvania.

Professional fees decreased \$9,000, or 2.5%, to \$346,000 for the six months ended June 30, 2014, compared to \$355,000 for the same period in the prior year.

The Corporation recognized \$113,000 of core deposit intangible amortization expense during the first half of 2014 compared to \$145,000 for the same period in the prior year. This amortization relates to a branch acquisition completed in the third quarter of 2009. Further discussion of goodwill and intangible assets related to the branch office acquisition can be found in the "Notes to Consolidated Financial Statements" beginning on page 6.

FDIC insurance decreased \$32,000, or 15.4%, to \$176,000 for the six months ended June 30, 2014, compared to \$208,000 for the same period in the prior year. The decrease was primarily the result of a decrease in the Bank's FDIC insurance assessment rate.

**Provision for income taxes.** The provision for income taxes decreased \$6,000, or 1.4%, to \$433,000 for the six months ended June 30, 2014 compared to \$439,000 for the same period in the prior year. The Corporation's effective tax rate increased to 20.1% for the first half of 2014 from 19.6% for the same period in the prior year. The difference between the statutory rate of 34% and the Corporation's effective tax rate of 20.1% for the six months ended June 30, 2014 was due to tax-exempt income earned on certain tax-free loans and securities and bank-owned life insurance.

## LIQUIDITY

The Corporation's primary sources of funds generally have been deposits obtained through the offices of the Bank, borrowings from the FHLB and Federal Reserve, and amortization and prepayments of outstanding loans and maturing securities. During the three months ended June 30, 2014, the Corporation used its sources of funds primarily to fund security purchases and loan advances and to repay borrowed funds. As of June 30, 2014, the Corporation had outstanding loan commitments, including undisbursed loans and amounts available under credit lines, totaling \$52.1 million, and standby letters of credit totaling \$188,000.

At June 30, 2014, time deposits amounted to \$120.8 million, or 23.5% of the Corporation's total consolidated deposits, including approximately \$43.1 million of which are scheduled to mature within the next year. Management of the

Corporation believes (i) it has adequate resources to fund all of its commitments, (ii) all of its commitments will be funded as required by related maturity dates and (iii) based upon past experience and current pricing policies, it can adjust the rates of time deposits to retain a substantial portion of maturing liabilities if necessary.

Aside from liquidity available from customer deposits or through sales and maturities of securities, the Corporation has alternative sources of funds such as a term borrowing capacity from the FHLB and the Federal Reserve's discount window. At June 30, 2014, the Corporation had borrowed funds of \$17.2 million consisting of \$15.0 million in long-term FHLB advances and a \$2.2 million short-term advance on a line of credit with a correspondent bank. At June 30, 2014, the Corporation's borrowing capacity with the FHLB, net of funds borrowed and other commitments, was \$145.3 million.

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

## RECENT REGULATORY DEVELOPMENTS

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

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

## CRITICAL ACCOUNTING POLICIES

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

techniques.

The most significant accounting policies followed by the Corporation are presented in Note 1 to the consolidated financial statements included in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2013. These policies, along with the disclosures presented in the other financial statement notes provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Management views critical accounting policies to be those which are highly dependent on subjective or complex judgments, estimates and assumptions and where changes in those estimates and assumptions could have a significant impact on the financial statements. Management has identified the following as critical accounting policies.

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

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

***Goodwill and intangible assets.*** Goodwill represents the excess cost over fair value of assets acquired in a business combination. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their estimated residual values. The impairment test is a two-step process that begins with an initial impairment evaluation. If the initial evaluation suggests that an impairment of the asset value exists, the second step is to determine the amount of the impairment. If the tests conclude that goodwill is impaired, the carrying value is adjusted and an impairment charge is recorded. As of November 30, 2013, the required annual impairment test of goodwill was performed and management concluded that no impairment existed as of that date.

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

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

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

Interest rate sensitivity is the result of differences in the amounts and repricing dates of the Bank's rate sensitive assets and rate sensitive liabilities. These differences, or interest rate repricing "gap", provide an indication of the extent that the Corporation's net interest income is affected by future changes in interest rates. A gap is considered positive when the amount of interest rate-sensitive assets exceeds the amount of interest rate-sensitive liabilities and is considered negative when the amount of interest rate-sensitive liabilities exceeds the amount of interest rate-sensitive assets. Generally, during a period of rising interest rates, a negative gap would adversely affect net interest income while a positive gap would result in an increase in net interest income. Conversely, during a period of falling interest rates, a negative gap would result in an increase in net interest income and a positive gap would adversely affect net interest income. The closer to zero that gap is maintained, generally, the lesser the impact of market interest rate changes on net interest income.

Assumptions about the timing and variability of cash flows are critical in gap analysis. Particularly important are the assumptions driving mortgage prepayments and the expected attrition of the core deposits portfolios. These assumptions are based on the Corporation's historical experience, industry standards and assumptions provided by a federal regulatory agency, which management believes most accurately represents the sensitivity of the Corporation's assets and liabilities to interest rate changes. As of June 30, 2014, the Corporation's interest-earning assets maturing or repricing within one year totaled \$191.6 million while the Corporation's interest-bearing liabilities maturing or repricing within one-year totaled \$171.8 million, providing an excess of interest-earning assets over interest-bearing liabilities of \$19.8 million. At June 30, 2014, the percentage of the Corporation's assets to liabilities maturing or repricing within one year was 111.5%.

For more information, see "Market Risk Management" in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2013.

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

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

As of June 30, 2014, the Corporation carried out an evaluation, under the supervision and with the participation of the Corporation's management, including the Corporation's CEO and CFO, of the effectiveness of the design and operation of the Corporation's disclosure controls and procedures. Based on the foregoing, the Corporation's CEO and CFO concluded that the Corporation's disclosure controls and procedures were effective. There have been no significant changes in the Corporation's internal controls or in other factors that could significantly affect the internal controls subsequent to the date the Corporation completed its evaluation.

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

#### **PART II - OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

Not applicable.

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

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

(a) Not applicable.

(b) Not applicable.

**Item 6. Exhibits**

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

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

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

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

**101.INS** XBRL Instance Document

**101.SCH** XBRL Taxonomy Extension Schema Document

**101.CAL** XBRL Taxonomy Extension Calculation Linkbase Document

**101.DEF** XBRL Taxonomy Extension Definitions Linkbase Document

**101.LAB** XBRL Taxonomy Extension Label Linkbase Document

**101.PRE** XBRL Taxonomy Extension Presentation Linkbase Document

**Signatures**

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

EMCLAIRE  
FINANCIAL CORP

Date: August 11, 2014 By: /s/ William C. Marsh  
William C. Marsh  
Chairman of the Board,  
President and Chief  
Executive Officer

Date: August 11, 2014 By: /s/ Matthew J. Lucco  
Matthew J. Lucco  
Chief Financial Officer  
Treasurer