EMCLAIRE FINANCIAL CORP
Form 10-Q
August 12, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended **June 30, 2016**

or

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

For the transition period from _____________ to _____________

Commission File Number: **001-34527**

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

Pennsylvania	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)

N/A
(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 x 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 x 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 x

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

The number of shares outstanding of the Registrant's common stock was 2,146,308 at August 12, 2016.

EMCLAIRE FINANCIAL CORP

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PART I - FINANCIAL INFORMATION

Item 1. Interim Financial Statements

Emclaire Financial Corp

Consolidated Balance Sheets (Unaudited)

As of June 30, 2016 and December 31, 2015

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

	June 30, 2016	December 31, 2015
Assets		
Cash and due from banks	$3,015	$ 2,359
Interest earning deposits with banks	35,546	9,187
Cash and cash equivalents	38,561	11,546
Securities available for sale	106,145	112,981
Loans receivable, net of allowance for loan losses of $5,431 and $5,205	498,724	429,891
Federal bank stocks, at cost	3,764	4,240
Bank-owned life insurance	11,221	11,056
Accrued interest receivable	1,837	1,501
Premises and equipment, net	17,125	16,114
Goodwill	10,291	3,664
Core deposit intangible, net	681	554
Prepaid expenses and other assets	9,276	9,048
Total Assets	$697,625	$ 600,595
Liabilities and Stockholders' Equity		
Liabilities:		
Deposits:		
Non-interest bearing	$122,793	$ 119,790
Interest bearing	474,093	370,097
Total deposits	596,886	489,887
Short-term borrowed funds	2,500	14,250
Long-term borrowed funds	35,000	35,000

Accrued interest payable	254	179
Accrued expenses and other liabilities	8,134	8,440
Total Liabilities	642,774	547,756
Commitments and Contingent Liabilities	-	-
Stockholders' Equity:		
Common stock, $1.25 par value, 12,000,000 shares authorized; 2,248,325 and 2,246,825 shares issued; 2,146,308 and 2,144,808 shares outstanding, respectively	2,810	2,808
Additional paid-in capital	27,809	27,701
Treasury stock, at cost; 102,017 shares	(2,114)	(2,114)
Retained earnings	28,822	28,206
Accumulated other comprehensive loss	(2,476)	(3,762)
Total Stockholders' Equity	54,851	52,839
Total Liabilities and Stockholders' Equity	$697,625	$ 600,595

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, 2016 and 2015

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

	For the three months ended June 30,		For the six months ended June 30,	
	2016	2015	2016	2015
Interest and dividend income:				
Loans receivable, including fees	$ 5,185	$ 4,470	$ 9,887	$ 8,670
Securities:				
Taxable	441	520	874	1,045
Exempt from federal income tax	156	214	316	435
Federal bank stocks	52	29	87	102
Interest earning deposits with banks	43	19	62	34
Total interest and dividend income	5,877	5,252	11,226	10,286
Interest expense:				
Deposits	721	535	1,309	1,082
Borrowed funds	296	177	540	359
Total interest expense	1,017	712	1,849	1,441
Net interest income	4,860	4,540	9,377	8,845
Provision for loan losses	121	203	302	371
Net interest income after provision for loan losses	4,739	4,337	9,075	8,474
Noninterest income:				
Fees and service charges	386	378	731	726
Commissions on financial services	-	5	1	10
Title premiums	8	6	19	17
Net gain on sales of available for sale securities	81	34	83	34
Earnings on bank-owned life insurance	100	97	198	194
Other	367	328	690	646
Total noninterest income	942	848	1,722	1,627
Noninterest expense:				
Compensation and employee benefits	2,177	2,050	4,225	4,118
Premises and equipment	692	655	1,378	1,324
Intangible asset amortization	56	49	105	98
Professional fees	190	178	373	380

Federal deposit insurance	89	98	182	195
Acquisition costs	92	-	401	-
Other	1,168	981	1,818	1,861
Total noninterest expense	4,464	4,011	8,482	7,976
Income before provision for income taxes	1,217	1,174	2,315	2,125
Provision for income taxes	287	247	583	417
Net income	930	927	1,732	1,708
Preferred stock dividends	-	25	-	50
Net income available to common stockholders	$ 930	$ 902	$ 1,732	$ 1,658
Basic earnings per common share	$ 0.43	$ 0.48	$ 0.81	$ 0.91
Diluted earnings per common share	0.43	0.48	0.80	0.90
Average common shares outstanding - basic	2,146,160	1,864,298	2,145,484	1,823,086
Average common shares outstanding - diluted	2,156,378	1,876,260	2,154,708	1,834,387

See accompanying notes to consolidated financial statements.

Emclaire Financial Corp

Consolidated Statements of Comprehensive Income (Unaudited)

For the three and six months ended June 30, 2016 and 2015

(Dollar amounts in thousands)

	For the three months ended June 30,		For the six months ended June 30,	
	2016	2015	2016	2015
Net income	$ 930	$ 927	$ 1,732	$ 1,708
Other comprehensive income (loss)				
Unrealized gains/(losses) on securities:				
Unrealized holding gain/(loss) arising during the period	699	(1,256)	2,030	(218)
Reclassification adjustment for gains included in net income	(81)	(34)	(83)	(34)
	618	(1,290)	1,947	(252)
Tax effect	(210)	439	(662)	86
Net of tax	408	(851)	1,285	(166)
Comprehensive income	$ 1,338	$ 76	$ 3,017	$ 1,542

See accompanying notes to consolidated financial statements.

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Emclaire Financial Corp

Condensed Consolidated Statements of Cash Flows (Unaudited)

For the six months ended June 30, 2016 and 2015

(Dollar amounts in thousands)

	For the six months ended June 30, 2016			2015		
Cash flows from operating activities						
Net income	$	1,732		$	1,708	
Adjustments to reconcile net income to net cash provided by operating activities:						
Depreciation and amortization		550			500	
Provision for loan losses		302			371	
Amortization of premiums, net		176			166	
Amortization of intangible assets and mortgage servicing rights		115			98	
Realized gains on sales of available for sale securities, net		(83	)		(34	)
Net gains on foreclosed real estate		(10	)		(18	)
Write-down of foreclosed real estate		-			6	
Stock compensation expense		111			108	
Increase in bank-owned life insurance, net		(165	)		(162	)
Increase in accrued interest receivable		(102	)		(5	)
		75			(2,997	)

(Increase) decrease in prepaid expenses and other assets		
Increase (decrease) in accrued interest payable	46	(12)
Decrease in accrued expenses and other liabilities	(702)	(237)
Net cash provided by (used in) operating activities	2,045	(508)
Cash flows from investing activities		
Loan originations and principal collections, net	3,604	864
Purchase of residential mortgage loans	(6,911)	(14,647)
Settlement of syndicated national credits	-	(7,039)
Available for sale securities:		
Sales	6,118	1,791
Maturities, repayments and calls	11,060	12,701
Purchases	(8,258)	(11,555)
Net cash paid for acquisition	(3,309)	-
Redemption (purchase) of federal bank stocks	1,454	(106)
Proceeds from the sale of foreclosed real estate	171	102
Purchases of premises and equipment	(392)	(404)
Net cash provided by (used in) investing activities	3,537	(18,293)
Cash flows from financing activities		
Net increase in deposits	34,299	10,593
Repayments on Federal Home Loan Bank advances	(5,000)	-

Proceeds from other long-term debt		5,000		-
Net change in short-term borrowings		(11,750)		1,000
Proceeds from exercise of stock options, including tax benefit		-		4
Dividends paid		(1,116)		(905)
Proceeds from the issuance of common stock		-		8,162
Net cash provided by financing activities		21,433		18,854
Increase in cash and cash equivalents		27,015		53
Cash and cash equivalents at beginning of period		11,546		11,856
Cash and cash equivalents at end of period	$	38,561	$	11,909
Supplemental information:				
Interest paid	$	942	$	1,453
Income taxes paid		-		525
Supplemental noncash disclosure:				
Transfers from loans to foreclosed real estate		147		263

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, 2016 and 2015

(Dollar amounts in thousands, except per share data)

	For the three months ended June 30,		For the six months ended June 30,	
	2016	2015	2016	2015
Balance at beginning of period	$ 54,007	$ 49,061	$ 52,839	$ 47,990
Net income	930	927	1,732	1,708
Other comprehensive income (loss)	408	(851)	1,285	(166)
Stock compensation expense	64	55	111	108
Dividends declared on preferred stock	-	(25)	-	(50)
Dividends declared on common stock	(558)	(428)	(1,116)	(855)
Exercise of stock options, including tax benefit	-	-	-	4
Issuance of common stock (350,000 shares)	-	8,162	-	8,162
Balance at end of period	$ 54,851	$ 56,901	$ 54,851	$ 56,901
Cash dividend per common share	$ 0.26	$ 0.24	$ 0.52	$ 0.48

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, 2015, as contained in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2015 filed with the SEC.

The balance sheet at December 31, 2015 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. 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. Mergers and Acquisitions

On April 30, 2016, the Corporation completed its acquisition of United American Savings Bank (United American) in accordance with the terms of the Agreement and Plan of Merger, dated as of December 30, 2015, by and among the Corporation, the Bank and United American (the Merger Agreement). Pursuant to the Merger Agreement, the Corporation acquired United American through a reverse merger of a newly created, wholly-owned subsidiary of the Bank into United American. Immediately after the merger, United American merged with and into The Farmers National Bank of Emlenton, with The Farmers National Bank of Emlenton being the surviving bank. At December 31, 2015, United American had reported assets of $89.3 million. The Corporation acquired all of the outstanding shares of common stock of United American for cash consideration of $13.2 million ($42.67 per share).

The acquisition expanded the Corporation's franchise into contiguous markets and increased the Corporation's consolidated total assets, loans and deposits.

The assets and liabilities of United American were recorded on the Corporation's consolidated balance sheet at their estimated fair value as of April 30, 2016, and their results of operations have been included in the consolidated income statement since such date.

2. Mergers and Acquisitions (continued)

Included in the purchase price was goodwill and a core deposit intangible of $6.6 million and $232,000, respectively. Goodwill is the excess of the purchase price over the fair value of the net assets acquired and is the result of expected operational synergies and other factors. This goodwill is not expected to be deductible for tax purposes. The goodwill will not be amortized, but will be measured annually for impairment or more frequently if circumstances require. The core deposit intangible will be amortized over a weighted average estimated life of ten years using the double declining balance method. Core deposit intangible expense projected for the succeeding five years beginning 2016 is estimated to be $31,000, $40,000, $32,000, $26,000 and $20,000 per year, respectively, and $83,000 in total for years after 2020.

While the Corporation believes that the accounting for the acquisition is complete, accounting guidance allows for adjustments to goodwill for a period of up to one year after the acquisition date for information that becomes available that reflects circumstances at the acquisition date. The following table summarizes the estimated fair value of the assets acquired and liabilities assumed:

(Dollar amounts in thousands)

Assets acquired:	
Cash and cash equivalents	$9,899
Securities available for sale	60
Loans receivable	66,145
Federal bank stocks	978
Accrued interest receivable	234
Premises and equipment	1,169
Goodwill	6,626
Core deposit intangible	232
Prepaid expenses and other assets	989
Total assets acquired	86,332
Liabilities assumed:	
Deposits	72,700
Accrued interest payable	29
Accrued expenses and other liabilities	395
Total liabilities assumed	73,124
Consideration paid	$13,208

The fair value of loans was determined using discounted cash flows. The book balance of the loans at the time of the acquisition was $66.1 million before considering United American’s allowance for loan losses, which was not carried over. The fair value disclosed above reflects a credit-related adjustment of $(927,000) and an adjustment for other factors of $982,000. Loans evidencing credit deterioration since origination (purchased credit impaired loans) included in loans receivable were immaterial.

Costs related to the acquisition totaled $92,000 for the three months ended June 30, 2016. These costs included legal fees, system conversion costs and other professional fees of $50,000, $32,000 and $10,000, respectively. For the six months ended June 30, 2016, costs related to the acquisition totaled $401,000 including legal fees, system conversion costs and other costs of $194,000, $132,000 and $75,000, respectively.

3. Issuance of Common Stock

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

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

On August 18, 2011, the Corporation entered into a Securities Purchase Agreement (the Agreement) with the U.S. Treasury Department, pursuant to which the Corporation issued and sold to the U.S. Treasury 10,000 shares of Senior Non-Cumulative Perpetual Preferred Stock, Series B (Series B Preferred Stock), having a liquidation preference of $1,000 per share, for aggregate proceeds of $10.0 million, pursuant to the U.S. Treasury's SBLF program. On September 17, 2013, with the approval of the Corporation's primary federal banking regulator, the Corporation redeemed 5,000 shares, or 50%, of its Series B Preferred Stock held by the U.S. Treasury at an aggregate redemption price of $5.0 million, plus accrued but unpaid dividends. On September 30, 2015, the Corporation redeemed the remaining 5,000 shares of its Series B Preferred Stock held by the U.S. Treasury at an aggregate redemption price of $5.0 million, plus accrued but unpaid dividends. Following this redemption, the Corporation does not have any Series B Preferred Stock outstanding.

5. 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.

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

	For the three months ended		For the six months ended	
(Dollar amounts in thousands, except for per share amounts)	June 30,		June 30,	
	2016	2015	2016	2015
Earnings per common share - basic				
Net income	$930	$927	$1,732	$1,708
Less: Preferred stock dividends	-	25	-	50
Net income available to common stockholders	$930	$902	$1,732	$1,658
Average common shares outstanding	2,146,160	1,864,298	2,145,484	1,823,086
Basic earnings per common share	$0.43	$0.48	$0.81	$0.91
Earnings per common share - diluted				
Net income available to common stockholders	$930	$902	$1,732	$1,658
Average common shares outstanding	2,146,160	1,864,298	2,145,484	1,823,086
	10,218	11,962	9,224	11,301

Add: Dilutive effects of assumed issuance of restricted stock and exercise of stock options				
Average shares and dilutive potential common shares	2,156,378	1,876,260	2,154,708	1,834,387
Diluted earnings per common share	$0.43	$0.48	$0.80	$0.90
Stock options not considered in computing earnings per share because they were antidilutive	67,000	67,000	67,000	67,000

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6. Securities

The following table summarizes the Corporation's securities as of June 30, 2016 and December 31, 2015:

(Dollar amounts in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale:				
June 30, 2016:				
U.S. Treasury and federal agency	$ 1,493	$ 19	$ -	$ 1,512
U.S. government sponsored entities and agencies	8,401	7	(1)	8,407
U.S. agency mortgage-backed securities: residential	28,542	962	-	29,504
U.S. agency collateralized mortgage obligations: residential	28,321	50	(260)	28,111
State and political subdivisions	27,972	532	-	28,504
Corporate debt securities	8,014	44	-	8,058
Equity securities	1,829	238	(18)	2,049
	$ 104,572	$ 1,852	$ (279)	$ 106,145
December 31, 2015:				
U.S. Treasury and federal agency	$ 1,493	$ -	$ (27)	$ 1,466
U.S. government sponsored entities and agencies	8,998	2	(47)	8,953
U.S. agency mortgage-backed securities: residential	32,947	256	(53)	33,150
U.S. agency collateralized mortgage obligations: residential	32,289	23	(872)	31,440
State and political subdivisions	28,352	264	(25)	28,591
Corporate debt securities	7,507	1	(21)	7,487
Equity securities	1,769	188	(63)	1,894
	$ 113,355	$ 734	$ (1,108)	$ 112,981

The following table summarizes scheduled maturities of the Corporation's debt securities as of June 30, 2016. 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.

	Available for sale	
(Dollar amounts in thousands)	Amortized Cost	Fair Value
Due in one year or less	$ 1,711	$ 1,716
Due after one year through five years	16,342	16,480
Due after five through ten years	27,088	27,532
Due after ten years	739	753

Mortgage-backed securities: residential	28,542	29,504
Collateralized mortgage obligations: residential	28,321	28,111
	$102,743	$104,096

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6. Securities (continued)

Information pertaining to securities with gross unrealized losses at June 30, 2016 and December 31, 2015, aggregated by investment category and length of time that individual securities have been in a continuous loss position are included in the table below:

(Dollar amounts in thousands)	Less than 12 Months		12 Months or More		Total	
Description of Securities	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
June 30, 2016:						
U.S. government sponsored entities and agencies	$1,000	$ (1)	$-	$ -	$1,000	$ (1)
U.S. agency collateralized mortgage obligations: residential	2,218	(65)	13,241	(195)	15,459	(260)
Equity securities	232	(18)	-	-	232	(18)
	$3,450	$ (84)	$13,241	$ (195)	$16,691	$ (279)
December 31, 2015:						
U.S. Treasury and federal agency	$-	$ -	$1,466	$ (27)	$1,466	$ (27)
U.S. government sponsored entities and agencies	4,962	(36)	1,989	(11)	6,951	(47)
U.S. agency mortgage-backed securities: residential	6,710	(53)	-	-	6,710	(53)
U.S. agency collateralized mortgage obligations: residential	4,283	(41)	25,336	(831)	29,619	(872)
State and political subdivisions	1,028	(2)	1,819	(23)	2,847	(25)
Corporate debt securities	3,484	(20)	500	(1)	3,984	(21)
Equity securities	1,137	(63)	-	-	1,137	(63)
	$21,604	$ (215)	$31,110	$ (893)	$52,714	$ (1,108)

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 ended June 30, 2016	2015	For the six months ended June 30, 2016	2015
Proceeds	$2,439	$1,791	$6,118	$1,791
Gains	81	34	83	34
Tax provision related to gains	28	12	28	12

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.

6. Securities (continued)

There was one equity security in an unrealized loss position for less than 12 months as of June 30, 2016. Equity securities owned by the Corporation consist of common stock of various financial service providers. The investment security is in unrealized loss positions as a result of recent market volatility. The Corporation does not invest in these securities with the intent to sell them for a profit in the near term. For investments in equity securities, in addition to the general factors mentioned above for determining whether the decline in market value is other-than-temporary, the analysis of whether an equity security is other-than-temporarily impaired includes a review of the profitability, capital adequacy and other relevant information available to determine the financial position and near term prospects of each issuer. The results of analyzing the aforementioned metrics and financial fundamentals suggest recovery of amortized cost as the sector improves. Based on that evaluation, and given that the Corporation’s current intention is not to sell any impaired security and it is more likely than not it will not be required to sell this security before the recovery of its amortized cost basis, the Corporation does not consider the equity security with an unrealized loss as of June 30, 2016 to be other-than-temporarily impaired.

There were 14 debt securities in an unrealized loss position as of June 30, 2016, of which 11 were in an unrealized loss position for more than 12 months. Of these 14 securities, 13 were government-backed collateralized mortgage obligations and 1 was a U.S. government sponsored entity and agency security. The unrealized losses associated with these securities were not due to the deterioration in the credit quality of the issuer that would likely result in the 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, 2016 to be other-than-temporarily impaired.

7. 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, 2016	December 31, 2015
Mortgage loans on real estate:		
Residential first mortgages	$184,414	$ 139,305
Home equity loans and lines of credit	91,604	87,410
Commercial real estate	154,890	129,691
	430,908	356,406
Other loans:		
Commercial business	66,197	71,948

Consumer	7,050	6,742
	73,247	78,690
Total loans, gross	504,155	435,096
Less allowance for loan losses	5,431	5,205
Total loans, net	$498,724	$ 429,891

Included in total loans above are net deferred costs of $1.2 million and $835,000 at June 30, 2016 and December 31, 2015, respectively.

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.

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7. 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 Mortgages	Home Equity & Lines of Credit	Commercial Real Estate	Commercial Business	Consumer	Total
Three months ended June 30, 2016:						
Allowance for loan losses:						
Beginning Balance	$ 1,577	$ 636	$ 1,926	$ 1,162	$ 51	$ 5,352
Charge-offs	(8)	(33)	-	-	(6)	(47)
Recoveries	-	1	3	-	1	5
Provision	127	41	189	(242)	6	121
Ending Balance	$ 1,696	$ 645	$ 2,118	$ 920	$ 52	$ 5,431
Six months ended June 30, 2016:						
Allowance for loan losses:						
Beginning Balance	$ 1,429	$ 586	$ 2,185	$ 960	$ 45	$ 5,205
Charge-offs	(40)	(33)	-	-	(15)	(88)
Recoveries	-	1	7	-	4	12
Provision	307	91	(74)	(40)	18	302
Ending Balance	$ 1,696	$ 645	$ 2,118	$ 920	$ 52	$ 5,431
At June 30, 2016:						
Ending ALL balance attributable to loans:						
Individually evaluated for impairment	$ 19	$ -	$ -	$ -	$ -	$ 19
Collectively evaluated for impairment	1,677	645	2,118	920	52	5,412
Total	$ 1,696	$ 645	$ 2,118	$ 920	$ 52	$ 5,431
Total loans:						
Individually evaluated for impairment	$ 136	$ -	$ 823	$ 690	$ -	$ 1,649
Acquired loans	29,818	6,266	30,386	1,505	300	68,275
Collectively evaluated for impairment	154,460	85,338	123,681	64,002	6,750	434,231

Total	$ 184,414	$ 91,604	$ 154,890	$ 66,197	$ 7,050	$ 504,155
At December 31, 2015:						
Ending ALL balance attributable to loans:						
Individually evaluated for impairment	$ 29	$ -	$ 5	$ 76	$ -	$ 110
Collectively evaluated for impairment	1,400	586	2,180	884	45	5,095
Total	$ 1,429	$ 586	$ 2,185	$ 960	$ 45	$ 5,205
Total loans:						
Individually evaluated for impairment	$ 169	$ -	$ 839	$ 999	$ -	$ 2,007
Collectively evaluated for impairment	139,136	87,410	128,852	70,949	6,742	433,089
Total	$ 139,305	$ 87,410	$ 129,691	$ 71,948	$ 6,742	$ 435,096
Three months ended June 30, 2015:						
Allowance for loan losses:						
Beginning Balance	$ 1,088	$ 611	$ 2,233	$ 1,360	$ 48	$ 5,340
Charge-offs	-	(22)	-	(182)	(6)	(210)
Recoveries	-	25	6	-	6	37
Provision	170	8	(78)	104	(1)	203
Ending Balance	$ 1,258	$ 622	$ 2,161	$ 1,282	$ 47	$ 5,370
Six months ended June 30, 2015:						
Allowance for loan losses:						
Beginning Balance	$ 955	$ 543	$ 2,338	$ 1,336	$ 52	$ 5,224
Charge-offs	(4)	(85)	-	(182)	(29)	(300)
Recoveries	-	30	12	20	13	75
Provision	307	134	(189)	108	11	371
Ending Balance	$ 1,258	$ 622	$ 2,161	$ 1,282	$ 47	$ 5,370

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

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.

At June 30, 2016, there was no allowance for loan losses allocated to loans acquired in the April 2016 merger with United American.

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, 2016:

(Dollar amounts in thousands)

	Impaired Loans with Specific Allowance					
	As of June 30, 2016			For the three months ended June 30, 2016		
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages	$ 78	$ 78	$ 19	$ 78	$ 1	$ 1
Home equity and lines of credit	-	-	-	-	-	-
Commercial real estate	-	-	-	-	-	-
Commercial business	-	-	-	315	-	-
Consumer	-	-	-	-	-	-
Total	$ 78	$ 78	$ 19	$ 393	$ 1	$ 1

For the six months ended June 30, 2016		
Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period

Residential first\ mortgages	$ 109	$ 2	$ 2
Home equity and lines of credit	-	-	-
Commercial real estate	31	-	-
Commercial business	517	-	-
Consumer	-	-	-
Total	$ 657	$ 2	$ 2

Impaired Loans with No Specific Allowance

	As of June 30, 2016		For the three months ended June 30, 2016		
	Unpaid Principal Balance	Recorded Investment	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages	$ 91	$ 58	$ 58	$ -	$ -
Home equity and lines of credit	-	-	-	-	-
Commercial real estate	1,222	823	840	-	-
Commercial business	690	690	382	1	1
Consumer	-	-	-	-	-
Total	$ 2,003	$ 1,571	$ 1,280	$ 1	$ 1

	For the six months ended June 30, 2016		
	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages	$ 38	$ 2	$ 2
Home equity and lines of credit	-	-	-
Commercial real estate	809	1	1
Commercial business	280	1	1
Consumer	-	-	-
Total	$ 1,127	$ 4	$ 4

7. 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, 2015:

(Dollar amounts in thousands)

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

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

7. 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, 2016:

(Dollar amounts in thousands)

	Impaired Loans with Specific Allowance					
	As of June 30, 2015			For the three months ended June 30, 2015		
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages	$169	$ 169	$ 27	$170	$ 2	$ 2
Home equity and lines of credit	-	-	-	-	-	-
Commercial real estate	3,538	2,597	216	2,603	49	41
Commercial business	1,159	1,159	342	1,859	118	106
Consumer	-	-	-	-	-	-
Total	$4,866	$ 3,925	$ 585	$4,632	$ 169	$ 149

	For the six months ended June 30, 2015		
	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages	$170	$ 4	$ 4
Home equity and lines of credit	-	-	-
Commercial real estate	2,627	49	41
Commercial business	2,113	118	106
Consumer	-	-	-
Total	$4,910	$ 171	$ 151

Impaired Loans with No Specific Allowance

As of June 30, 2015	For the three months ended June 30, 2015

	Unpaid Principal Balance	Recorded Investment	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages	$ -	$ -	$ 55	$ 7	$ 7
Home equity and lines of credit	-	-	-	-	-
Commercial real estate	805	406	608	1	1
Commercial business	73	73	62	-	-
Consumer	-	-	-	-	-
Total	$ 878	$ 479	$ 725	$ 8	$ 8

	For the six months ended June 30, 2015		
	Average Recorded Investment	Interest Income Recognized in Period	Cash Basis Interest Recognized in Period
Residential first mortgages	$ 75	$ 7	$ 7
Home equity and lines of credit	-	-	-
Commercial real estate	690	6	6
Commercial business	58	2	2
Consumer	-	-	-
Total	$ 823	$ 15	$ 15

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 presented above or in the tables that follow based on the amounts not being material.

7. 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, 2016 and December 31, 2015, the Corporation had $406,000 and $835,000, respectively, of loans classified as TDRs, which are included in impaired loans above. The Corporation had allocated $19,000 and $63,000 of specific allowance for these loans at June 30, 2016 and December 31, 2015, respectively.

During the three and six month periods ended June 30, 2016, the Corporation modified one home equity loan with a recorded investment of $10,000 due to a bankruptcy order. At June 30, 2016, the Corporation did not have any allowance for loan losses allocated to this specific loan. The modification did not have a material impact on the Corporation's income statement during the periods. During the three and six month periods ended June 30, 2015, the Corporation did not modify any 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, 2016, 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. During the three and six month periods ended June 30, 2015, there was a default on one $90,000 residential mortgage loan within 12 months following modification. The default did not have a material impact on the Corporation's income statement during the periods.

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

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

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

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

Historic: Management utilizes a computer model to develop the historical net charge-off experience which is used to formulate the assumptions employed in the migration analysis applied to estimate 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 estimate 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.

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

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, 2016 and December 31, 2015:

(Dollar amounts in thousands)

	Special
Not Rated	