

EMCLAIRE FINANCIAL CORP
Form 10-Q
May 10, 2010

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 March 31, 2010

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: 000-18464

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

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

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

(724) 867-2311
(Registrant's telephone number)

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

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

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

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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 1,431,404 at May 10, 2010.

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 March 31, 2010 and December 31, 2009
(Dollar amounts in thousands, except share data)

Assets	March 31, 2010	December 31, 2009
Cash and due from banks	\$ 2,593	\$ 2,822
Interest earning deposits with banks	24,920	36,130
Cash and cash equivalents	27,513	38,952
Securities available for sale, at fair value	130,946	105,243
Loans receivable, net of allowance for loan losses of \$3,174 and \$3,202	291,282	292,615
Federal bank stocks, at cost	4,125	4,125
Bank-owned life insurance	5,439	5,388
Accrued interest receivable	1,706	1,574
Premises and equipment, net	9,096	9,170
Goodwill	3,664	3,657
Core deposit intangible	2,433	2,585
Prepaid expenses and other assets	4,332	4,217
Total Assets	\$ 480,536	\$ 467,526
Liabilities and Stockholders' Equity		
Liabilities:		
Deposits:		
Non-interest bearing	\$ 74,417	\$ 67,033
Interest bearing	325,245	318,292
Total deposits	399,662	385,325
Short-term borrowed funds	5,000	5,000
Long-term borrowed funds	35,000	35,000
Accrued interest payable	729	711
Accrued expenses and other liabilities	2,415	4,456
Total Liabilities	442,806	430,492
Commitments and Contingent Liabilities	-	-
Stockholders' Equity:		
Cumulative preferred stock, \$1.00 par value, \$7,500 liquidation value, 3,000,000 shares authorized; 7,500 issued and outstanding	7,434	7,430
Warrants	88	88

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Common stock, \$1.25 par value, 12,000,000 shares authorized;

1,559,421 shares issued; 1,431,404 shares
outstanding

	1,949		1,949
Additional paid-in capital	14,726		14,685
Treasury stock, at cost; 128,017 shares	(2,653)		(2,653)
Retained earnings	16,351		15,967
Accumulated other comprehensive loss	(165)		(432)
Total Stockholders' Equity	37,730		37,034
Total Liabilities and Stockholders' Equity	\$ 480,536	\$	467,526

See accompanying notes to consolidated financial statements.

Emclaire Financial Corp.
Consolidated Statements of Operations (Unaudited)
For the three months ended March 31, 2010 and 2009
(Dollar amounts in thousands, except per share data)

	For the three months ended March 31,	
	2010	2009
Interest and dividend income:		
Loans receivable, including fees	\$ 4,413	\$ 4,236
Securities:		
Taxable	608	529
Exempt from federal income tax	265	152
Federal bank stocks	11	5
Interest earning deposits with banks	84	89
Total interest and dividend income	5,381	5,011
Interest expense:		
Deposits	1,426	1,540
Borrowed funds	446	410
Total interest expense	1,872	1,950
Net interest income	3,509	3,061
Provision for loan losses	128	297
Net interest income after provision for loan losses	3,381	2,764
Noninterest income:		
Fees and service charges	322	340
Commissions on financial services	180	83
Title premiums	18	2
Net gain on sale of available for sale securities	99	56
Net gain on sale of loans	-	4
Earnings on bank-owned life insurance	58	56
Other	165	179
Total noninterest income	842	720
Noninterest expense:		
Compensation and employee benefits	1,830	1,438
Premises and equipment	550	481
Intangible amortization expense	152	-
Professional fees	114	173
FDIC expense	141	44
Other	604	486
Total noninterest expense	3,391	2,622
Income before income taxes	832	862
Provision for income taxes	150	194
Net income	682	668
Accumulated preferred stock dividends and discount accretion	98	98

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Net income available to common stockholders	\$	584	\$	570
Basic and diluted earnings per common share	\$	0.41	\$	0.40
Average common shares outstanding		1,431,404		1,431,404

See accompanying notes to consolidated financial statements.

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Emclaire Financial Corp.
Condensed Consolidated Statements of Cash Flows (Unaudited)
For the three months ended March 31, 2010 and 2009
(Dollar amounts in thousands)

	For the three months ended March 31,	
	2010	2009
Cash flows from operating activities		
Net income	\$ 682	\$ 668
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization of premises and equipment	216	196
Provision for loan losses	128	297
Net amortization (accretion)	(16)	9
Amortization of intangible assets and mortgage servicing rights	156	4
Realized gains on sales of available for sale securities, net	(99)	(56)
Net gains on sales of loans	-	(4)
Net losses on foreclosed real estate	32	-
Originations of loans sold	-	(159)
Proceeds from the sale of loans	-	163
Restricted stock and stock option compensation	41	24
Increase in bank-owned life insurance, net	(51)	(50)
(Increase) decrease in accrued interest receivable	(132)	164
Increase in prepaid expenses and other assets	(275)	(4)
Increase in accrued interest payable	18	6
Decrease in accrued expenses and other liabilities	(45)	(855)
Net cash provided by operating activities	655	403
Cash flows from investing activities		
Loan originations and principal collections, net	1,149	(9,591)
Available for sale securities:		
Sales	5,080	4,107
Maturities, repayments and calls	17,013	18,193
Purchases	(49,272)	(3,998)
Proceeds from the sale of foreclosed real estate	35	16
Purchases of premises and equipment	(142)	(452)
Net cash provided by (used in) investing activities	(26,137)	8,275
Cash flows from financing activities		
Net increase in deposits	14,337	8,543
Net change in borrowings	-	(1,188)
Dividends paid	(294)	(512)
Net cash provided by financing activities	14,043	6,843
Increase (decrease) in cash and cash equivalents	(11,439)	15,521

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Cash and cash equivalents at beginning of period		38,952		16,571
Cash and cash equivalents at end of period	\$	27,513	\$	32,092
Supplemental information:				
Interest paid	\$	1,854	\$	1,944
Income taxes paid		100		-
Supplemental noncash disclosure:				
Transfers from loans to foreclosed real estate		51		76

See accompanying notes to consolidated financial statements.

Emclaire Financial Corp.
Consolidated Statements of Changes in Stockholders' Equity (Unaudited)
For the three months ended March 31, 2010 and 2009
(Dollar amounts in thousands, except per share data)

	For the three months ended March 31,	
	2010	2009
Balance at beginning of period	\$ 37,034	\$ 36,123
Net income	682	668
Other comprehensive income (loss):		
Change in net unrealized gains (losses) on available for sale securities, net of taxes	332	(93)
Less: reclassification adjustment for gains included in net income, net of taxes	65	37
Other comprehensive income (loss)	267	(130)
Total comprehensive income	949	538
Stock compensation expense	41	24
Dividends declared on preferred stock	(94)	(54)
Dividends declared on common stock	(200)	(458)
Balance at end of period	\$ 37,730	\$ 36,173
Common cash dividend per share	\$ 0.14	\$ 0.32

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 company and the holding company of Farmers National Bank of Emlenton (the "Bank") and Emclaire Settlement Services, LLC (the "Title Company"). The Corporation provides a variety of financial products and services to individuals and businesses through its offices in western Pennsylvania. Its primary deposit products are checking, savings and certificate of deposit accounts and its primary lending products are residential and commercial mortgages, commercial business 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, 2009, as contained in the Corporation's 2009 Annual Report on Form 10-K filed with the SEC.

The balance sheet at December 31, 2009 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, 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. Earnings per Common Share.

Basic earnings per common share (EPS) excludes dilution and is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted EPS reflects the potential dilution that could occur if securities or contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Corporation. Options and restricted stock awards of 108,750 shares of common stock and warrants to purchase 50,111 shares of common stock were not included in computing diluted earnings per share because their cumulative effects were not dilutive for the three month period ended March 31, 2010 and 2009.

4. Securities.

The following table summarizes the Corporation's securities as of March 31, 2010 and December 31, 2009:

(Dollar amounts in thousands)	Amortized cost	Unrealized gains	Unrealized losses	Fair value
Available for sale:				
March 31, 2010:				
U.S. Treasury and federal agency	\$ 2,977	\$ 44	\$ -	\$ 3,021
U.S. government sponsored entities and agencies	66,992	102	(111)	66,983
Mortgage-backed securities: residential	27,982	228	(35)	28,175
Collateralized mortgage obligations	3,077	-	(11)	3,066
State and political subdivisions	26,059	777	(11)	26,825
Equity securities	3,003	54	(181)	2,876
	\$ 130,090	\$ 1,205	\$ (349)	\$ 130,946
December 31, 2009:				
U.S. Treasury and federal agency	\$ 2,976	\$ 25	\$ -	\$ 3,001
U.S. government sponsored entities and agencies	50,953	113	(269)	50,797
Mortgage-backed securities: residential	16,459	109	(38)	16,530
Collateralized mortgage obligations	5,130	4	(4)	5,130
State and political subdivisions	26,271	696	-	26,967
Equity securities	3,003	-	(185)	2,818
	\$ 104,792	\$ 947	\$ (496)	\$ 105,243

The following table summarizes scheduled maturities of the Corporation's securities as of March 31, 2010:

(Dollar amounts in thousands)	Available for sale Amortized cost	Fair value
Due in one year or less	\$ 266	\$ 272
Due after one year through five years	65,514	65,573
Due after five through ten years	21,149	21,621
Due after ten years	40,158	40,604
No scheduled maturity	3,003	2,876
	\$ 130,090	\$ 130,946

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.

4. Securities (continued).

Information pertaining to securities with gross unrealized losses as of March 31, 2010 and December 31, 2009, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

(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
March 31, 2010:						
U.S. government sponsored entities and agencies	\$ 36,395	\$ (111)	\$ -	\$ -	\$ 36,395	\$ (111)
Mortgage-backed securities:						
residential	11,873	(35)	-	-	11,873	(35)
Collateralized mortgage obligations	1,247	(5)	774	(6)	2,021	(11)
State and political subdivisions	344	(11)	-	-	344	(11)
Equity securities	932	(105)	685	(76)	1,617	(181)
	\$ 50,791	\$ (267)	\$ 1,459	\$ (82)	\$ 52,250	\$ (349)
December 31, 2009:						
U.S. government sponsored entities and agencies	\$ 32,716	\$ (269)	\$ -	\$ -	\$ 32,716	\$ (269)
Mortgage-backed securities:						
residential	1,961	(38)	-	-	1,961	(38)
Collateralized mortgage obligations	1,275	(2)	910	(2)	2,185	(4)
Equity securities	1,341	(110)	686	(75)	2,027	(185)
	\$ 37,293	\$ (419)	\$ 1,596	\$ (77)	\$ 38,889	\$ (496)

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 and (3) the intent of the Corporation to sell the security, and (4) whether it is more likely than not the Corporation will have to sell the security before recovery of its cost basis.

The following table presents information related to the Corporation's gains and losses on the sales of equity and debt securities, and losses recognized for the other-than-temporary impairment of investments:

(Dollar amounts in thousands)	Gross Realized Gains	Gross Realized Losses	Other-than-temporary Impairment Losses	Net Gains (Losses)
Three months ended March 31, 2010:				
Equity securities	\$ -	\$ -	\$ -	\$ -
Debt securities	99	-	-	99
	\$ 99	\$ -	\$ -	\$ 99
Three months ended March 31, 2009:				

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Equity securities	\$	-	\$	-	\$	-	\$	-
Debt securities		56		-		-		56
	\$	56	\$	-	\$	-	\$	56

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4. Securities (continued).

There were five equity and thirty-four debt securities in an unrealized loss position as of March 31, 2010. Equity securities owned by the Corporation consist of common stock of various financial service providers. These investment securities have traditionally been high-performing stocks and 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 and believes these securities have potential to appreciate in value over the long-term, while providing for a reasonable dividend yield. For investments in equity securities, in addition to the general factors mentioned above for determining whether the decline in market value is other-than-temporary, the analysis of whether an equity security is other-than-temporarily impaired includes a review of the profitability and capital adequacy and all information available to determine the financial position and near term prospects of each issuer. Based on that evaluation, 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 equity securities with unrealized losses as of March 31, 2010 to be other-than-temporarily impaired.

For debt securities, an additional and critical component of the evaluation for other-than-temporary impairment is the identification of credit-related impairment of securities where it is likely that the Corporation will not receive cash flows sufficient to recover the entire amortized cost basis of the security. 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 March 31, 2010 to be other-than-temporarily impaired.

5. Loans Receivable.

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

(Dollar amounts in thousands)	March 31, 2010	December 31, 2009
Mortgage loans on real estate:		
Residential first mortgages	\$ 74,837	\$ 74,099
Home equity loans and lines of credit	76,221	77,284
Commercial real estate	89,282	89,952
	240,340	241,335
Other loans:		
Commercial business	41,473	41,588
Consumer	12,643	12,894
	54,116	54,482
Total loans, gross	294,456	295,817
Less allowance for loan losses	3,174	3,202
Total loans, net	\$ 291,282	\$ 292,615
Nonaccrual loans	\$ 3,136	\$ 2,359
Loans 90 days or more past due and still accruing	101	59

Total nonperforming loans	\$	3,237	\$	2,418
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6. Goodwill and Intangible Assets.

The following table summarizes the Corporation's acquired goodwill and intangible assets as of March 31, 2010 and December 31, 2009:

(Dollar amounts in thousands)	March 31, 2010		December 31, 2009	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Goodwill	\$ 3,664	\$ -	\$ 3,657	\$ -
Core deposit intangibles	4,027	1,595	4,027	1,443
Total	\$ 7,691	\$ 1,595	\$ 7,684	\$ 1,443

During the third quarter of 2009, the Corporation recorded goodwill and a core deposit intangible of \$2.2 million and \$2.8 million, respectively, associated with a branch purchase transaction. Goodwill is not amortized but is evaluated for impairment on an annual basis or whenever events or changes in circumstances indicate the carrying value may not be recoverable. No goodwill impairment charges were recorded during 2009 or in the first quarter of 2010. 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 first three months of 2010, the Corporation recorded intangible amortization expense totaling \$152,000.

7. Employee Benefit Plans.

The Corporation maintains a defined contribution 401(k) Plan. Eligible employees participate by providing tax-deferred contributions up to 20% of qualified compensation. Employee contributions are vested at all times. The Corporation provides a matching contribution of up to 4% of the participant's salary. Matching contributions for the three months ended March 31, 2010 and 2009 amounted to \$43,000 and \$37,000, respectively.

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

The Corporation uses December 31 as the measurement date for its plans.

The components of the periodic pension cost are as follows:

(Dollar amounts in thousands)	For the three months ended		Year ended
	2010	March 31, 2009	
Service cost	\$ 79	\$ 62	\$ 296
Interest cost	75	75	281
Expected return on plan assets	(79)	(66)	(258)
Prior service costs	(8)	(8)	(31)
Recognized net actuarial loss	12	27	75
Net periodic pension cost	\$ 79	\$ 90	\$ 363

The Corporation previously disclosed in its financial statements for the year ended December 31, 2009 that it expected to contribute \$425,000 to its pension plan in 2010. As of March 31, 2010, there have been no contributions. The Corporation presently anticipates contributing \$425,000 to its pension plan in 2010.

8. Stock Compensation Plans.

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

A summary of option activity under the Plan as of March 31, 2010, and changes during the period then ended is presented below:

	Options	Weighted-Average Exercise Price	Aggregate Intrinsic Value	Weighted-Average Remaining Term (in years)
Outstanding as of January 1, 2010	96,250	\$ 24.79	\$ -	7.8
Granted	-	-	-	-
Exercised	-	-	-	-
Forfeited	-	-	-	-
Outstanding as of March 31, 2010	96,250	\$ 24.79	\$ -	7.6
Exercisable as of March 31, 2010	-	\$ -	\$ -	-

A summary of the status of the Corporation's nonvested shares as of March 31, 2010, and changes during the period then ended is presented below:

	Options	Weighted-Average Grant-date Fair Value
Nonvested at January 1, 2010	96,250	\$ 3.02
Granted	-	-
Vested	-	-
Forfeited	-	-
Nonvested as of March 31, 2010	96,250	\$ 3.02

During the three month period ended March 31, 2010, the Corporation granted 1,250 restricted stock awards with a face value of \$17,000 based on the grant date stock price of \$13.60. In addition, the Corporation granted 4,500 shares of restricted stock awards in 2008 and 6,750 shares of restricted stock awards in 2009 with face values of \$101,000 and \$91,000, respectively based on the grant date stock prices of \$22.50 and \$13.50, respectively. Restricted stock awards are 100% vested on the third anniversary date of the grant.

For the three month periods ended March 31, 2009 and 2008, the Corporation recognized \$41,000 and \$24,000, respectively, in stock compensation expense. As of March 31, 2010, there was \$194,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized over the next three years.

9. Fair Values of Financial Instruments.

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: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level 2: Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability.

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e. supported with little or no market activity).

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

The following valuation techniques were used to measure fair value of assets in the tables below:

Available for sale securities – Fair value on available for sale securities is based upon quoted market prices when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2).

Impaired loans – Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. Most of the Corporation's loans are collateral dependent and, accordingly, fair value is measured based on the estimated fair market value of the collateral less the estimate costs to sell. Fair value of the loan's collateral is typically determined by appraisals or independent valuation (Level 3). Upon management's ongoing review, adjustments may be made to an appraised value to reflect various factors such as the age of the appraisal, known changes in the market or the collateral and management's estimation of the costs to sell. As of March 31, 2010 and December 31, 2009, the fair value consisted of loan balances of \$808,000 and \$590,000, respectively, net of a valuation allowance of \$139,000 and \$128,000, respectively. These impaired loans consisted primarily of commercial real estate. Additional provision for loan losses of \$62,000 was recorded during the quarter ended March 31, 2010.

9. Fair Values of Financial Instruments (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)

Description	Total	(Level 1) Quoted Prices in Active Markets for Identical Assets			(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
March 31, 2010:						
U.S. Treasury and federal agency	\$ 3,021	\$ -	\$ 3,021	\$ -		
U.S. government sponsored entities and agencies	66,983	-	66,983	-		
Mortgage-backed securities: residential	28,175	-	28,175	-		
Collateralized mortgage obligations	3,066	-	3,066	-		
State and political subdivision	26,825	-	26,825	-		
Equity securities	2,876	2,151	725	-		
	\$ 130,946	\$ 2,151	\$ 128,795	\$ -		

December 31, 2009:

U.S. government sponsored entities and agencies	\$ 3,001	\$ -	\$ 3,001	\$ -		
Mortgage-backed securities: residential	50,797	-	50,797	-		
Collateralized mortgage obligations	16,530	-	16,530	-		
State and political subdivision	5,130	-	5,130	-		
Corporate securities	26,967	-	26,967	-		
Equity securities	2,818	2,093	725	-		
	\$ 105,243	\$ 2,093	\$ 103,150	\$ -		

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)

Description	Total	(Level 1) Quoted Prices in Active Markets for Identical Assets			(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
March 31, 2010:						
Impaired loans	\$ 669	\$ -	\$ -	\$ -	\$ 669	
	\$ 669	\$ -	\$ -	\$ -	\$ 669	

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December 31, 2009:

Impaired loans	\$	462	\$	-	\$	-	\$	462
	\$	462	\$	-	\$	-	\$	462

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9. Fair Values of Financial Instruments (continued).

The following table sets forth the carrying amount and fair value of the Corporation's financial instruments included in the consolidated balance sheet as of March 31, 2010:

(Dollar amounts in thousands)	March 31, 2010		December 31, 2009	
	Carrying amount	Fair value	Carrying amount	Fair value
Financial assets:				
Cash and cash equivalents	\$ 27,513	\$ 27,513	\$ 38,952	\$ 38,952
Securities	130,946	130,946	105,243	105,243
Loans receivable, net	291,282	297,606	292,615	298,197
Federal bank stocks	4,125	N/A	4,125	N/A
Accrued interest receivable	1,706	1,706	1,574	1,574
Financial liabilities:				
Deposits	399,662	404,701	385,325	389,443
Borrowed funds	40,000	43,303	40,000	43,258
Accrued interest payable	729	729	711	711
Off-balance sheet commitments	-	-	-	-

Management uses its best judgment in estimating the fair value of the Corporation's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Corporation could have realized in a sale transaction on the dates indicated. The estimated fair value amounts have been measured as of the dates shown and have not been re-evaluated or updated for purposes of these financial statements subsequent to those respective dates.

This information should not be interpreted as an estimate of the fair value of the entire Corporation since a fair value calculation is only provided for a limited portion of the Corporation's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Corporation's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate fair values of the Corporation's financial instruments at March 31, 2010 and December 31, 2009:

Carrying amount is the estimated fair value for cash and cash equivalents, securities, federal bank stocks, accrued interest receivable and payable, demand deposits, borrowed funds, and variable rate loans or deposits that reprice frequently and fully. For fixed rate loans or deposits and for variable rate loans or deposits with infrequent repricing or repricing limits, fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk. Fair value of debt is based on current rates for similar financing. It was not practicable to determine the fair value of federal bank stocks due to restrictions placed on the stocks transferability.

Estimates of the fair value of off-balance sheet items were not made because of the short-term nature of these arrangements and the credit standing of the counterparties. Also, unfunded loan commitments relate principally to variable rate commercial loans. Therefore, the fair value of these instruments is not material.

10. Adoption of New Accounting Standards.

In January 2010, the Financial Accounting Standards Board (FASB) issued guidance increasing fair value disclosure and to clarify some existing disclosure requirements about fair value measurement. It requires separate presentation of significant transfers into and out of Levels 1 and 2 of the fair value hierarchy and disclosure of the reasons for such transfers. It will also require the presentation of purchases, sales, issuances and settlements within Level 3 on a gross basis rather than a net basis. The amendments also clarify that disclosures should be disaggregated by class of asset or liability and that disclosures about inputs and valuation techniques should be provided for both recurring and non-recurring fair value measurements. These new disclosure requirements were adopted by the Corporation during the current period, with the exception of the requirement concerning gross presentation of Level 3 activity, which is effective for fiscal years beginning after December 15, 2010. With respect to the portions of this amendment that were adopted during the current period, the adoption of this standard did not have a significant impact on the Corporation's consolidated financial statements. The Corporation believes that the adoption of the remaining portion of this amendment will not have a significant impact on the consolidated 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 Emclair Financial Corp. and its wholly owned subsidiaries, the Bank and the Title Company, for the three months ended March 31, 2010, compared to the same period in 2009 and should be read in conjunction with the Corporation's December 31, 2009 Annual Report on Form 10-K filed with the SEC and with the accompanying consolidated financial statements and notes presented on pages 1 through 14 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 having 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 \$13.0 million or 2.8% to \$480.5 million at March 31, 2010 from \$467.5 million at December 31, 2009. This increase resulted from an increase in securities of \$25.7 million, partially offset by decreases in cash and cash equivalents and loans receivable, net of allowance for loan losses, of \$11.4 million and \$1.3 million, respectively. The net increase in the Corporation's assets was primarily funded by increases in customer deposits.

Total liabilities increased \$12.3 million or 2.9% to \$442.8 million at March 31, 2010 from \$430.5 million at December 31, 2009, while total stockholders' equity increased \$696,000 or 1.9% to \$37.7 million at March 31, 2010 from \$37.0 million at December 31, 2009. The increase in total liabilities resulted primarily from increases in customer deposits.

RESULTS OF OPERATIONS

Comparison of Results for the Three Month Period Ended March 31, 2010 and 2009

General. Net income increased \$14,000 or 2.1% to \$682,000 for the three months ended March 31, 2010 from \$668,000 for the same period in 2009. This \$14,000 increase was the result of increases in net interest income and noninterest income of \$448,000 and \$122,000, respectively, and decreases in the provision for loan losses and the provision for income taxes of \$169,000 and \$44,000, respectively. Partially offsetting these favorable items, noninterest expense increased \$769,000.

Net interest income. Net interest income on a tax equivalent basis increased \$479,000 or 15.1% to \$3.7 million for the three months ended March 31, 2010 from \$3.2 million for the same period in 2009. This net increase can be attributed to an increase in tax equivalent interest income of \$401,000 and a decrease in interest expense of \$78,000.

Interest income. Interest income on a tax equivalent basis increased \$401,000 or 7.8% to \$5.5 million for the three months ended March 31, 2010, compared to \$5.1 million for the same period in the prior year. This increase can be attributed to increases in interest on loans, securities and federal bank stock dividends of \$159,000, \$241,000 and \$6,000, respectively, partially offset by a decrease in interest-earning deposits with banks of \$5,000.

Tax equivalent interest earned on loans receivable increased \$159,000 or 3.7% to \$4.4 million for the three months ended March 31, 2010, compared to \$4.3 million for the same period in 2009. This increase resulted primarily from average loans increasing \$15.7 million or 5.6%, accounting for \$237,000 in additional loan interest income. This increase can be attributed to growth in the Corporation's existing loan portfolio and loans acquired through the third quarter 2009 purchase of the Titusville banking office from PNC (formerly National City Bank). Offsetting this favorable volume increase, the average yield on loans receivable decreased 12 basis points to 6.10% for the three months ended March 31, 2010, versus 6.22% for the same period in 2009, due to declining market interest rates, accounting for a \$78,000 decrease in interest income.

Tax equivalent interest earned on securities increased \$241,000 or 32.2% to \$990,000 for the three months ended March 31, 2010, compared to \$749,000 for the same period in 2009. The average volume of securities increased \$54.3 million, primarily as a result of the deployment of net cash received in the branch purchase, accounting for a \$518,000 increase in interest income. Offsetting this favorable volume increase, the average yield on securities decreased 151 basis points to 3.49% for the three months ended March 31, 2010, versus 5.00% for the same period in 2009, due primarily to shorter-termed security purchases made in the third and fourth quarters of 2009 and first quarter of 2010 at market yields lower than the overall average of the existing portfolio. This unfavorable yield variance accounted for a \$278,000 decrease in interest income.

Interest earned on interest-earning deposit accounts decreased \$5,000 or 5.6% to \$84,000 for the three months ended March 31, 2010 from \$89,000 for the same period in 2009. The average volume of these assets increased \$6.2 million, increasing interest income by \$22,000. Offsetting this volume increase, the average yield on interest-earning deposit accounts decreased 43 basis points to 1.20% for the three months ended March 31, 2010, compared to 1.63% for the same period in the prior year, accounting for a \$27,000 decrease in interest income.

Dividends on federal bank stocks increased \$6,000 to \$11,000 for the three month period ended March 31, 2010 from \$5,000 for the same period in 2009. The average yield on these assets increased 55 basis points to 1.08% for the three months ended March 31, 2010, compared to 0.53% for the same period the prior year.

Interest expense. Interest expense decreased \$78,000 or 4.0% to \$1.9 million for the three months ended March 31, 2010 from \$2.0 million for the same period in 2009. This decrease in interest expense can be attributed to a decrease in interest incurred on deposits of \$114,000, partially offset by an increase in interest incurred on borrowed funds of

\$36,000.

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Interest expense incurred on deposits decreased \$114,000 or 7.4% to \$1.4 million for the three months ended March 31, 2010 compared to \$1.5 million for the same period in 2009. The average cost of interest-bearing deposits decreased 82 basis points to 1.81% for the three months ended March 31, 2010, compared to 2.63% for the same period in 2009 causing a \$557,000 decrease in interest expense. Partially offsetting this favorable rate variance, the average volume of interest-bearing deposits increased \$81.8 million or 34.4% to \$319.6 million for the three months ended March 31, 2010, compared to \$237.8 million for the same period in 2009 causing a \$443,000 increase in interest expense. This increase was primarily due to deposits assumed through the aforementioned branch purchase.

Interest expense incurred on borrowed funds increased \$36,000 or 8.8% to \$446,000 for the three months ended March 31, 2010, compared to \$410,000 for the same period in the prior year. This increase can be attributed to an increase in the average cost of borrowed funds of 158 basis points to 4.52% for the three months ended March 31, 2010, compared to 2.94% for the same period in 2009 causing a \$179,000 increase in interest expense. This increase in the average cost was due to higher short-term borrowing rates resulting from the third quarter 2009 \$5.0 million advance on a line of credit with Atlantic Central Bankers Bank. The line of credit has a current rate of 4.75%. Partially offsetting this unfavorable cost increase, the average balance of borrowed funds decreased \$16.5 million or 76.8% to \$5.0 million for the three months ended March 31, 2010, compared to \$21.5 million for the same period in the prior year, causing a \$143,000 decrease in interest expense. This volume decrease was related to a decrease in short-term borrowings.

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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 non-accrual 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 March 31,					
	2010			2009		
	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate
Interest-earning assets:						
Loans, taxable	\$ 288,234	\$ 4,347	6.12%	\$ 263,114	\$ 4,120	6.35%
Loans, tax exempt	6,965	95	5.53%	16,373	163	4.03%
Total loans receivable	295,199	4,442	6.10%	279,487	4,283	6.22%
Securities, taxable	88,522	608	2.79%	47,128	529	4.55%
Securities, tax exempt	26,562	382	5.83%	13,652	220	6.54%
Total securities	115,084	990	3.49%	60,780	749	5.00%
Interest-earning deposits with banks						
Federal bank stocks	28,354	84	1.20%	22,130	89	1.63%
Total interest-earning cash equivalents	4,125	11	1.08%	3,797	5	0.53%
Total interest-earning assets	32,479	95	1.19%	25,927	94	1.47%
Cash and due from banks	442,762	5,527	5.06%	366,194	5,126	5.68%
Other noninterest-earning assets	2,156			2,173		
	23,183			16,533		
Total Assets	\$ 468,101			\$ 384,900		
Interest-bearing liabilities:						
Interest-bearing demand deposits	\$ 158,314	\$ 230	0.59%	\$ 109,466	\$ 313	1.16%
Time deposits	161,236	1,196	3.01%	128,301	1,227	3.88%
Total interest-bearing deposits	319,550	1,426	1.81%	237,767	1,540	2.63%
Borrowed funds, short-term	5,001	59	4.78%	21,536	24	0.45%
Borrowed funds, long-term	35,000	387	4.48%	35,000	386	4.48%
Total borrowed funds	40,001	446	4.52%	56,536	410	2.94%
Total interest-bearing liabilities	359,551	1,872	2.11%	294,303	1,950	2.69%
Noninterest-bearing demand deposits	67,912	-	-	50,319	-	-
Funding and cost of funds	427,463	1,872	1.78%	344,622	1,950	2.29%

Other noninterest-bearing liabilities	3,135	4,218
Total Liabilities	430,598	348,840
Stockholders' Equity	37,503	36,060
Total Liabilities and Stockholders' Equity	\$ 468,101	\$ 384,900
Net interest income	\$ 3,655	\$ 3,176
Interest rate spread (difference between weighted average rate on interest-earning assets and interest-bearing liabilities)	2.95%	2.99%
Net interest margin (net interest income as a percentage of average interest-earning assets)	3.35%	3.52%

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

(Dollar amounts in thousands)	Three months ended March 31, 2010 versus 2009		
	Volume	Rate	Total
Interest income:			
Loans	\$ 237	\$ (78)	\$ 159
Securities	519	(278)	241
Interest-earning deposits with banks	22	(27)	(5)
Federal bank stocks	-	6	6
Total interest-earning assets	778	(377)	401
Interest expense:			
Interest-bearing deposits	443	(557)	(114)
Borrowed funds	(143)	179	36
Total interest-bearing liabilities	300	(378)	(78)
Net interest income	\$ 478	\$ 1	\$ 479

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 known and inherent losses that are both probable and reasonably 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 non-performing 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 non-performing assets for the quarter ended March 31, 2010 and 2009 is as follows:

(Dollar amounts in thousands)	At or for the three months ended March 31,	
	2010	2009
Balance at the beginning of the period	\$ 3,202	\$ 2,651
Provision for loan losses	128	297
Charge-offs	(167)	(71)
Recoveries	11	8
Balance at the end of the period	\$ 3,174	\$ 2,885
Non-performing loans	\$ 3,237	\$ 1,747

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Non-performing assets	3,470	1,857
Non-performing loans to total loans	1.10%	0.63%
Non-performing assets to total assets	0.72%	0.49%
Allowance for loan losses to total loans	1.08%	1.04%
Allowance for loan losses to non-performing loans	98.04%	165.14%

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The provision for loan losses decreased \$169,000 or 56.9% to \$128,000 for the three month period ended March 31, 2010 from \$297,000 for the same period in the prior year due to a decline in overall delinquency in the loan portfolio. At March 31, 2010, loans past due 30 days or more totaled \$5.0 million, compared to \$7.7 million in delinquent loans at December 31, 2009.

Nonperforming loans increased \$1.5 million to \$3.2 million at March 31, 2010 from \$1.7 million at March 31, 2009 as a result of pressure on borrowers related to the prevailing poor economic climate. During the quarter ended March 31, 2010, nonperforming loans increased by \$800,000 from \$2.4 million at December 31, 2009. This increase was due primarily to the addition of an \$811,000 credit relationship to nonaccrual status due to its recent performance.

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

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

The Corporation regularly reviews the problem loans and other assets in its portfolio to determine whether any require classification in accordance with the Corporation’s policy and applicable regulations. As of March 31, 2010, the Corporation’s classified and criticized assets amounted to \$15.8 million, with \$9.3 million classified as substandard, \$48,000 classified as doubtful and \$6.4 million identified as special mention. Included in classified and criticized assets at March 31, 2010 are two separate loans exhibiting credit deterioration impacting the ability of the borrowers to comply with their present loan repayment terms.

The first loan, with an outstanding balance of \$3.0 million at March 31, 2010, was originated for the construction of a hotel, restaurant and retail plaza secured by such property, the borrower’s personal residence, a separate residence and a separate farm. The hotel, restaurant and retail plaza are complete and operational. However, cash flows from operations have not been constant due to the seasonal business of the hotel. In addition, the borrower does not have other liquid sources of cash flow. As a result, the borrower has listed substantial real estate holdings for sale. Pending such sales, the Bank anticipates that the relationship may continue to have cash flow issues which may impact the timely payment of principal and interest to the Bank. At March 31, 2010, the loan was current but identified as special mention. Ultimately, due to the estimated value of the borrower’s significant real estate holdings, the Bank does not currently expect to incur any significant loss on this loan.

The second loan, with an outstanding balance of \$2.2 million at March 31, 2010, is a consumer installment loan for the purpose of the consolidating various personal debts. This loan is secured by a lien on the primary residence of the first borrower discussed above, an assigned life insurance policy and the assignment of patent royalty income. Due to business difficulties and decreased royalty income, payments on the loan have not always been timely. At March 31, 2010, the loan was performing but was classified substandard. As a result of the estimated value of the lien on the property owned by the first borrower, the estimated cash flow of royalty income and the borrower’s business prospects, the Bank does not currently expect to incur any significant loss on this loan.

Noninterest income. Noninterest income increased \$122,000 or 16.9% to \$842,000 during the three months ended March 31, 2010, compared to \$720,000 during the same period in the prior year. This increase was primarily due to increased commissions on financial services and gains on the sale of securities. Commissions on financial services increased \$97,000 due in part to a second financial services representative added to cover the Titusville and surrounding market areas. The Corporation recorded gains on the sale of certain U.S agency securities totaling \$99,000 during the first quarter of 2010 compared to gains totaling \$56,000 on the sale of similar type investments during the first quarter of 2009.

Noninterest expense. Noninterest expense increased \$769,000 or 29.3% to \$3.4 million during the three months ended March 31, 2010 compared to \$2.6 million for the same period in 2009. This increase in noninterest expense can be attributed to increases in compensation and employee benefits, premises and equipment, intangible amortization, FDIC expense and other noninterest expenses of \$392,000, \$69,000, \$152,000, \$97,000 and \$118,000, respectively, partially offset by a decrease in professional fees of \$59,000.

Compensation and employee benefits increased \$392,000 or 27.3% to \$1.8 million for the three months ended March 31, 2010 compared to \$1.4 million for the same period in the prior year. This increase can be primarily attributed to normal salary and wage increases and staff added in connection with the 2009 branch purchase.

Premises and equipment increased \$69,000 or 14.3% to \$550,000 for the three months ended March 31, 2010, compared to \$481,000 for the same period in the prior year. This increase was primarily related to the 2009 branch purchase and increased fixed asset depreciation expenses.

Associated with the branch purchase, the Bank recognized \$152,000 of core deposit intangible amortization expense during the first quarter of 2010. Further discussion related to goodwill and intangible assets related to the branch office purchase can be found in the "Notes to Consolidated Financial Statements" beginning on page 5.

Professional fees decreased \$59,000 or 34.1% to \$114,000 for the three months ended March 31, 2010, compared to \$173,000 for the same period in the prior year. This decrease was primarily related to a decrease in legal and consulting fees associated with the 2009 branch office purchase.

FDIC expense increased \$97,000 to \$141,000 for the three months ended March 31, 2010, compared to \$44,000 for the same period in the prior year. This increase was primarily the result of increased base assessment rates applied to all FDIC insured depository institutions.

Other noninterest expense increased \$118,000 or 24.3% to \$604,000 during the three months ended March 31, 2010, compared to \$486,000 for the same period in the prior year. This increase was primarily due to increased telephone and communications, printing and office supplies, contributions, internet banking and collection expenses.

Provision for income taxes. The provision for income taxes decreased \$44,000 or 22.7% to \$150,000 for the three months ended March 31, 2010 compared to \$194,000 for the same period in the prior year. This decrease was primarily related to a decrease in the effective tax rate to 18.0% for the three months ended March 31, 2010, compared to 22.5% for the same period in 2009. This lower effective tax rate resulted from an increased portion of pre-tax income having been generated from tax-exempt investment securities and loans. The difference between the statutory rate of 34% and the Corporation's effective tax rate is 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 March 31, 2010, the Corporation used its sources of funds primarily to fund loan originations and security purchases. As of such date, the Corporation had outstanding loan commitments, including undisbursed loans and amounts available under credit lines, totaling \$48.8 million, and standby letters of credit totaling \$1.1 million.

At March 31, 2010, time deposits amounted to \$158.8 million or 39.8% of the Corporation's total consolidated deposits, including approximately \$56.6 million of which are scheduled to mature within the next year. Management of the Corporation believes it has adequate resources to fund all of its commitments, all of its commitments will be funded as required by related maturity dates and based upon past experience and current pricing policies it can adjust the rates of time deposits to retain a substantial portion of maturing liabilities.

Aside from liquidity available from customer deposits or through sales and maturities of securities, the Corporation has alternative sources of funds such as a term borrowing capacity from the FHLB and the Federal Reserve's Term Auction Facility and Discount Window. At March 31, 2010, the Corporation's borrowing capacity with the FHLB, net of funds borrowed, was \$126.2 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.

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. 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.

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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) the intent of the Corporation to sell a security, and (4) whether it is more likely than not the Corporation will have to sell the security before recovery of its cost basis.

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, at March 31, 2010, the Corporation's interest-earning assets maturing or repricing within one year totaled \$129.1 million while the Corporation's interest-bearing liabilities maturing or repricing within one-year totaled \$145.0 million, providing an excess of interest-bearing liabilities over interest-earning assets of \$15.9 million. At March 31, 2010, the percentage of the Corporation's assets to liabilities maturing or repricing within one year was 89.0%.

For more information, see "Market Risk Management" in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2009.

Item 4T. 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 Principal Accounting Officer (PAO), as appropriate, to allow timely decisions regarding required disclosure based on the definition of "disclosure controls and procedures" in Rule 13a-15(e).

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.

As of March 31, 2010, the Corporation carried out an evaluation, under the supervision and with the participation of the Corporation's management, including the Corporation's CEO and PAO, 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 PAO 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.

PART II - OTHER INFORMATION

Item 1. Legal Proce