

FIRST CAPITAL INC
Form 10-K
March 29, 2016

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the Fiscal Year Ended December 31, 2015

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: 0-25023

FIRST CAPITAL, INC.

(Exact name of registrant as specified in its charter)

Indiana
(State or other jurisdiction of
incorporation or organization)

35-2056949
(I.R.S. Employer Identification No.)

220 Federal Drive, N.W., Corydon, Indiana 47112
(Address of principal executive offices) (Zip Code)

Edgar Filing: FIRST CAPITAL INC - Form 10-K

Registrant's telephone number, including area code: (812) 738-2198

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

Title of each class	Name of each exchange on which registered
Common Stock, par value \$0.01 per share	The Nasdaq Stock Market LLC

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

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

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

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

(Check one): 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 Act). Yes No

The aggregate market value of the voting and non-voting common equity held by non-affiliates was \$84.6 million, based upon the closing price of \$27.07 per share as quoted on The Nasdaq Capital Market as of the last business day of the registrant's most recently completed second fiscal quarter ended June 30, 2015.

The number of shares outstanding of the registrant's common stock as of March 4, 2016 was 3,338,603.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2016 Annual Meeting of Stockholders

are incorporated by reference in Part III of this Form 10-K.

INDEX

	<u>Page</u>
Part I	
<u>Item 1. Business</u>	1
<u>Item 1A. Risk Factors</u>	31
<u>Item 1B. Unresolved Staff Comments</u>	36
<u>Item 2. Properties</u>	37
<u>Item 3. Legal Proceedings</u>	38
<u>Item 4. Mine Safety Disclosures</u>	38
Part II	
<u>Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	38
<u>Item 6. Selected Financial Data</u>	40
<u>Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	42
<u>Item 7A. Quantitative and Qualitative Disclosures about Market Risk</u>	54
<u>Item 8. Financial Statements and Supplementary Data</u>	54
<u>Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	54
<u>Item 9A. Controls and Procedures</u>	54
<u>Item 9B. Other Information</u>	55
Part III	
<u>Item 10. Directors, Executive Officers and Corporate Governance</u>	56
<u>Item 11. Executive Compensation</u>	56
<u>Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters Certain Relationships and Related Transactions, and Director Independence</u>	56 57

<u>Item</u> <u>13.</u>		
<u>Item</u> <u>14.</u>	<u>Principal Accounting Fees and Services</u>	<u>57</u>
Part IV		
<u>Item</u> <u>15.</u>	<u>Exhibits and Financial Statement Schedules</u>	<u>58</u>

SIGNATURES

This report contains certain “forward-looking statements” within the meaning of the federal securities laws. These statements are not historical facts, rather statements based on First Capital, Inc.’s current expectations regarding its business strategies, intended results and future performance. Forward-looking statements are preceded by terms such as “expects,” “believes,” “anticipates,” “intends” and similar expressions.

Forward-looking statements are not guarantees of future performance. Management’s ability to predict results or the effect of future plans or strategies is inherently uncertain. Numerous risks and uncertainties could cause or contribute to the Company’s actual results, performance and achievements to materially differ from those expressed or implied by the forward-looking statements. Factors which could affect actual results include, but are not limited to, interest rate trends; the general economic climate in the specific market area in which First Capital operates, as well as nationwide; First Capital’s ability to control costs and expenses; competitive products and pricing; loan delinquency rates; changes in federal and state legislation and regulation; and other factors disclosed periodically in the Company’s filings with the Securities and Exchange Commission. Additional factors that may affect our results are discussed in Item 1A to this Annual Report on Form 10-K titled “Risk Factors” below. These factors should be considered in evaluating the forward-looking statements and undue reliance should not be placed on such statements, whether included in this report or made elsewhere from time to time by the Company or on its behalf. Except as may be required by applicable law or regulation, First Capital assumes no obligation to update any forward-looking statements.

PART I

ITEM 1. BUSINESS

General

First Capital, Inc. (the “Company” or “First Capital”) was incorporated under Indiana law on September 11, 1998. On December 31, 1998, the Company became the holding company for First Federal Bank, A Federal Savings Bank (the “Bank”) upon the Bank’s reorganization as a wholly owned subsidiary of the Company resulting from the conversion of First Capital, Inc., M.H.C. (the “MHC”), from a federal mutual holding company to a stock holding company. On January 12, 2000, the Company completed a merger of equals with HCB Bancorp, the former holding company for Harrison County Bank, and the Bank changed its name to First Harrison Bank. On March 20, 2003, the Company acquired Hometown Bancshares, Inc. (“Hometown”), a bank holding company located in New Albany, Indiana. On December 4, 2015, the Company acquired Peoples Bancorp, Inc. of Bullitt County and its wholly-owned bank subsidiary, Peoples Bank of Bullitt County (“Peoples”), headquartered in Shepherdsville, Kentucky.

The Company’s primary business activity is the ownership of the outstanding common stock of the Bank. Management of the Company and the Bank are substantially similar and the Company neither owns nor leases any property, but instead uses the premises, equipment and furniture of the Bank in accordance with applicable regulations.

The Bank is regulated by the Office of the Comptroller of the Currency (the “OCC”) and the Federal Deposit Insurance Corporation (the “FDIC”). The Bank’s deposits are federally insured by the FDIC under the Deposit Insurance Fund. The Bank is a member of the Federal Home Loan Bank (“FHLB”) System.

Availability of Information

The Company's Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments to such reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are made available free of charge on the Company's Internet website, www.firstharrison.com, as soon as practicable after the Company electronically files such material with, or furnishes it to, the Securities and Exchange Commission. The contents of the Company's website shall not be incorporated by reference into this Form 10-K or into any reports the Company files with or furnishes to the Securities and Exchange Commission.

Market Area and Competition

The Bank considers Harrison, Floyd, Clark and Washington counties in Indiana and Bullitt County in Kentucky its primary market area. All of its offices are located in these five counties, which results in most of the Bank's loans being made in these five counties. The main office of the Bank is located in Corydon, Indiana, 35 miles west of Louisville, Kentucky. The Bank aggressively competes for business with local banks, as well as large regional banks. Its most direct competition for deposit and loan business comes from the commercial banks operating in these five counties. Based on data published by the FDIC, the Bank is the leader among FDIC-insured institutions in deposit market share in Harrison County, Indiana, which includes the Bank's main office, and in Bullitt County, Kentucky, where Peoples was headquartered.

Lending Activities

General. Over the last few years, the Bank has continued to transform the composition of its balance sheet from that of a traditional thrift institution to that of a commercial bank. On the asset side, this is being accomplished in part by selling in the secondary market the newly-originated qualified fixed-rate residential mortgage loans while retaining variable rate residential mortgage loans in the portfolio. This transformation is also enhanced by an expanded commercial lending staff dedicated to growing commercial real estate and commercial business loans. The Bank also continues to originate consumer loans and residential construction loans for the loan portfolio. The Bank does not offer, and has not offered, Alt-A, sub-prime or no-document mortgage loans.

Loan Portfolio Analysis. The following table presents the composition of the Bank's loan portfolio by type of loan at the dates indicated.

	At December 31, 2015		2014		2013		2012		Percent Total
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	
(Dollars in thousands)									
Mortgage Loans:									
Residential ⁽¹⁾	\$ 147,933	40.32 %	\$ 106,679	34.61 %	\$ 107,029	35.65 %	\$ 108,097	37.37	
Land	12,962	3.53	11,028	3.58	10,309	3.43	9,607	3.32	
Commercial real estate	84,493	23.03	78,314	25.40	76,496	25.48	68,731	23.76	
Residential construction ⁽²⁾	16,391	4.47	10,347	3.36	14,423	4.80	12,753	4.41	
Commercial real estate construction	1,090	0.30	1,422	0.46	1,715	0.57	3,299	1.14	
Total mortgage loans	262,869	71.65	207,790	67.41	209,972	69.93	202,487	70.00	
Consumer Loans:									
Home equity and second mortgage loans	38,476	10.49	37,513	12.17	34,815	11.60	36,962	12.78	
Automobile loans	28,828	7.86	25,274	8.20	23,983	7.99	21,922	7.58	
Loans secured by savings accounts	2,096	0.57	1,018	0.33	1,138	0.38	770	0.27	
Unsecured loans	4,350	1.18	3,316	1.07	3,541	1.18	3,191	1.10	
Other ⁽³⁾	7,210	1.96	5,075	1.65	4,824	1.61	5,303	1.84	
Total consumer loans	80,960	22.06	72,196	23.42	68,301	22.76	68,148	23.57	
Commercial business loans	23,095	6.29	28,282	9.17	21,956	7.31	18,612	6.43	
Total gross loans	366,924	100.00%	308,268	100.00%	300,229	100.00%	289,247	100.00	
Less:									
Due to borrowers on loans in process	4,926		3,325		7,142		4,306		
Deferred loan fees net of direct costs	(583)		(506)		(341)		(202)		
Allowance for loan losses	3,415		4,846		4,922		4,736		
Total loans, net	\$ 359,166		\$ 300,603		\$ 288,506		\$ 280,407		

(1) Includes conventional one- to four-family and multi-family residential loans.

(2) Includes construction loans for which the Bank has committed to provide permanent financing.

(3) Includes loans secured by lawn and farm equipment, mobile homes and other personal property.

Residential Loans. The Bank's lending activities have concentrated on the origination of residential mortgages, both for sale in the secondary market and for retention in the Bank's loan portfolio. Residential mortgages secured by multi-family properties totaled \$25.7 million, or 17.4% of the residential loan portfolio at December 31, 2015. Substantially all residential mortgages are collateralized by properties within the Bank's market area.

The Bank offers both fixed-rate mortgage loans and adjustable rate mortgage ("ARM") loans typically with terms of 15 to 30 years. The Bank uses loan documents approved by the Federal National Mortgage Corporation ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") whether the loan is originated for investment or sale in the secondary market.

Historically, the Bank has retained its residential loan originations in its portfolio. Retaining fixed-rate loans in its portfolio subjects the Bank to a higher degree of interest rate risk. See "*Item 1A. Risk Factors—Above Average Interest Rate Risk Associated with Fixed-Rate Loans*" for a further discussion of certain risks of rising interest rates. Beginning in 2004, one of the Bank's strategic goals was to expand its mortgage business by originating mortgage loans for sale, while offering a full line of mortgage products to current and prospective customers. This practice increases the Bank's lending capacity and allows the Bank to more effectively manage its profitability since it is not required to predict the prepayment, credit or interest rate risks associated with retaining either the loan or the servicing asset. For the year ended December 31, 2015, the Bank originated and funded \$31.5 million of residential mortgage loans for sale in the secondary market. For a further discussion of the Bank's mortgage banking operations, see "*Item 1. Business—Mortgage Banking Activities.*"

ARM loans originated have interest rates that adjust at regular intervals of one to five years, with up to 2.0% caps per adjustment period and 6.0% lifetime caps, based upon changes in the prevailing interest rates on United States Treasury Bills. The Bank also originates "hybrid" ARM loans, which are fixed for an initial period three or five years and adjust annually thereafter. The Bank may occasionally use below market interest rates and other marketing inducements to attract ARM loan borrowers. The majority of ARM loans provide that the amount of any increase or decrease in the interest rate is limited to 2.0% (upward or downward) per adjustment period and generally contains minimum and maximum interest rates. Borrower demand for ARMs versus fixed-rate mortgage loans is a function of the level of interest rates, the expectations of changes in the level of interest rates and the difference between the interest rates and loan fees offered for fixed-rate mortgage loans and interest rates and loan fees for ARM loans. The relative amount of fixed-rate and ARM loans that can be originated at any time is largely determined by the demand for each in a competitive environment.

The Bank's lending policies generally limit the maximum loan-to-value ratio on fixed-rate and ARM loans to 80% of the lesser of the appraised value or purchase price of the underlying residential property unless private mortgage insurance to cover the excess over 80% is obtained, in which case the mortgage is limited to 95% (or 97% under a Freddie Mac program) of the lesser of appraised value or purchase price. The loan-to-value ratio, maturity and other provisions of the loans made by the Bank are generally reflected in the policy of making less than the maximum loan permissible under federal regulations, in accordance with established lending practices, market conditions and underwriting standards maintained by the Bank. The Bank requires title, fire and extended insurance coverage on all mortgage loans originated. All of the Bank's real estate loans contain due on sale clauses. The Bank generally obtains appraisals on all its real estate loans from outside appraisers.

Construction Loans. The Bank originates construction loans for residential properties and, to a lesser extent, commercial properties. Although the Bank originates construction loans that are repaid with the proceeds of a limited number of mortgage loans obtained by the borrower from another lender, the majority of the construction loans that the Bank originates are permanently financed in the secondary market by the Bank. Construction loans originated without a commitment by the Bank to provide permanent financing are generally originated for a term of six to 12 months and at a fixed interest rate based on the prime rate.

The Bank originates speculative construction loans to a limited number of builders operating and based in the Bank's primary market area and with whom the Bank has well-established business relationships. At December 31, 2015, the Bank had approved speculative construction loans, a construction loan for which there is not a commitment for permanent financing in place at the time the construction loan was originated, with total commitments of \$12.0 million and outstanding balances of \$8.2 million. The Bank limits the number of speculative construction loans outstanding to any one builder based on the Bank's assessment of the builder's capacity to service the debt.

Most construction loans are originated with a loan-to-value ratio not to exceed 80% of the appraised estimated value of the completed property. The construction loan documents require the disbursement of the loan proceeds in increments as construction progresses. Disbursements are based on periodic on-site inspections by an independent appraiser.

Construction lending is inherently riskier than residential mortgage lending. Construction loans, on average, generally have higher loan balances than residential mortgage loans. In addition, the potential for cost overruns because of the inherent difficulties in estimating construction costs and, therefore, collateral values and the difficulties and costs associated with monitoring construction progress, among other things, are major contributing factors to this greater credit risk. Speculative construction loans have the added risk that there is not an identified buyer for the completed home when the loan is originated, with the risk that the builder will have to service the construction loan debt and finance the other carrying costs of the completed home for an extended time period until a buyer is identified. Furthermore, the demand for construction loans and the ability of construction loan borrowers to service their debt depends highly on the state of the general economy, including market interest rate levels and the state of the economy of the Bank's primary market area. A material downturn in economic conditions could be expected to have a material adverse effect on the credit quality of the construction loan portfolio.

Commercial Real Estate Loans. Commercial real estate loans are generally secured by small retail stores, professional office space and, in certain instances, farm properties. Commercial real estate loans are generally originated with a loan-to-value ratio not to exceed 75% of the appraised value of the property. Property appraisals are performed by independent appraisers approved by the Bank's board of directors. The Bank seeks to originate commercial real estate loans at variable interest rates based on the prime lending rate or the United States Treasury Bill rate for terms ranging from ten to 15 years and with interest rate adjustment intervals of five years. The Bank also originates fixed-rate balloon loans with a short maturity, but a longer amortization schedule.

Commercial real estate lending affords the Bank an opportunity to receive interest at rates higher than those generally available from residential mortgage lending. However, loans secured by such properties usually are greater in amount, more difficult to evaluate and monitor and, therefore, involve a greater degree of risk than residential mortgage loans. Because payments on loans secured by multi-family and commercial properties are often dependent on the successful operation and management of the properties, repayment of such loans may be affected by adverse conditions in the real estate market or the economy. The Bank seeks to minimize these risks by limiting the maximum loan-to-value ratio to 75% and strictly scrutinizing the financial condition of the borrower, the quality of the collateral and the management of the property securing the loan. The Bank also obtains loan guarantees from financially capable parties based on a review of personal financial statements.

Commercial Business Loans. Commercial business loans are generally secured by inventory, accounts receivable, and business equipment such as trucks and tractors. Many commercial business loans also have real estate as collateral. The Bank generally requires a personal guaranty of payment by the principals of a corporate borrower, and reviews the personal financial statements and income tax returns of the guarantors. Commercial business loans are generally originated with loan-to-value ratios not exceeding 75%.

Aside from lines of credit, commercial business loans are generally originated for terms not to exceed seven years with variable interest rates based on the prime lending rate. Approved credit lines totaled \$38.7 million at December 31, 2015, of which \$15.7 million was outstanding. Lines of credit are originated at fixed and variable interest rates for one-year renewable terms.

A director of the Company and the Bank is a shareholder of a farm implement dealership that contracts with the Bank to provide sales financing to the dealership's customers. The Bank does not grant preferential credit under this arrangement. During the year ended December 31, 2015, the Bank granted approximately \$862,000 of credit to customers of the dealership and all loans purchased from the dealership had an aggregate outstanding balance of \$1.3 million at December 31, 2015. At December 31, 2015, five loans purchased from the dealership were delinquent 30 days or more with an aggregate outstanding balance of \$23,000. Under the terms of the agreement between Bank and the dealership, any losses from contracts purchased from the dealership are split evenly between the Bank and the dealership. No losses were recognized on contracts purchased from the dealership in 2015 or 2014.

Commercial business lending generally involves greater risk than residential mortgage lending and involves risks that are different from those associated with residential and commercial real estate lending. Real estate lending is generally considered to be collateral-based lending with loan amounts based on predetermined loan-to-collateral values and liquidation of the underlying real estate collateral is viewed as the primary source of repayment in the event of borrower default. Although commercial business loans are often collateralized by equipment, inventory, accounts receivable or other business assets, the liquidation of collateral in the event of a borrower default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories and equipment may be obsolete or of limited use, among other things. Accordingly, the repayment of a commercial business loan depends primarily on the creditworthiness of the borrower (and any guarantors); while liquidation of collateral is a secondary, and often insufficient, source of repayment. The Bank has seven commercial lenders and two commercial credit analysts committed to growing commercial business loans to facilitate the changes desired in the Bank's balance sheet. The Bank also uses an outside loan review company to review selected commercial credits on an annual basis.

Consumer Loans. The Bank offers a variety of secured or guaranteed consumer loans, including automobile and truck loans, home equity loans, home improvement loans, boat loans, mobile home loans and loans secured by savings deposits. In addition, the Bank offers unsecured consumer loans. Consumer loans are generally originated at fixed interest rates and for terms not to exceed seven years. The largest portion of the Bank's consumer loan portfolio consists of home equity and second mortgage loans followed by automobile and truck loans. Automobile and truck loans are originated on both new and used vehicles. Such loans are generally originated at fixed interest rates for terms up to five years and at loan-to-value ratios up to 90% of the blue book value in the case of used vehicles and 90% of the purchase price in the case of new vehicles.

The Bank originates variable-rate home equity and fixed-rate second mortgage loans generally for terms not to exceed five years. The loan-to-value ratio on such loans is limited to 80%, taking into account the outstanding balance on the first mortgage loan.

The Bank's underwriting procedures for consumer loans includes an assessment of the applicant's payment history on other debts and ability to meet existing obligations and payments on the proposed loans. Although the applicant's creditworthiness is a primary consideration, the underwriting process also includes a comparison of the value of the security, if any, to the proposed loan amount. The Bank underwrites and originates the majority of its consumer loans internally, which management believes limits exposure to credit risks relating to loans underwritten or purchased from brokers or other outside sources.

Consumer loans generally entail greater risk than do residential mortgage loans, particularly in the case of consumer loans which are unsecured or secured by assets that depreciate rapidly, such as automobiles. In the latter case, repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment for the outstanding loan and the remaining deficiency often does not warrant further substantial collection efforts against the borrower. In addition, consumer loan collections depend on the borrower's continuing financial stability, and, therefore, are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans. Such loans may also give rise to claims and defenses by the borrower against the Bank as the holder of the loan, and a borrower may be able to assert claims and defenses that it has against the seller of the underlying collateral.

Loan Maturity and Repricing

The following table sets forth certain information at December 31, 2015 regarding the dollar amount of loans maturing in the Bank's portfolio based on their contractual terms to maturity, but does not include potential prepayments. Demand loans, which are loans having neither a stated schedule of repayments nor a stated maturity, and overdrafts are reported as due in one year or less. Loan balances do not include undisbursed loan proceeds, unearned income and allowance for loan losses.

	Within One Year	After One Year Through 3 Years	After 3 Years Through 5 Years	After 5 Years Through 10 Years	After 10 Years Through 15 Years	After 15 Years	Total
(Dollars in thousands)							
Mortgage loans:							
Residential	\$ 15,796	\$ 21,158	\$ 28,644	\$ 34,101	\$ 22,714	\$ 25,520	\$ 147,933
Commercial real estate and land loans ⁽¹⁾	19,939	16,484	19,196	21,291	15,206	6,429	98,545
Residential construction ⁽²⁾	16,391	0	0	0	0	0	16,391
Consumer loans	19,931	21,848	8,755	14,167	13,149	3,110	80,960
Commercial business	11,792	6,170	2,623	1,644	792	74	23,095
Total gross loans	\$83,849	\$65,660	\$59,218	\$71,203	\$51,861	\$35,133	\$366,924

(1) Includes commercial real estate construction loans.

(2) Includes construction loans for which the bank has committed to provide permanent financing.

The following table sets forth the dollar amount of all loans due after December 31, 2016, which have fixed interest rates and floating or adjustable interest rates.

Edgar Filing: FIRST CAPITAL INC - Form 10-K

	Fixed Rates	Floating or Adjustable Rates
	(Dollars in thousands)	
Mortgage loans:		
Residential	\$88,501	\$43,636
Commercial real estate and land loans	22,997	55,609
Residential construction	0	0
Consumer loans	30,687	30,342
Commercial business	5,391	5,912
Total gross loans	\$147,576	\$135,499

7

Loan Solicitation and Processing. A majority of the Bank's loan originations are made to existing customers. Walk-ins and customer referrals are also a source of loan originations. Upon receipt of a loan application, a credit report is ordered to verify specific information relating to the loan applicant's employment, income and credit standing. A loan applicant's income is verified through the applicant's employer or from the applicant's tax returns. In the case of a real estate loan, an appraisal of the real estate intended to secure the proposed loan is undertaken, generally by an independent appraiser approved by the Bank. The mortgage loan documents used by the Bank conform to secondary market standards.

The Bank requires that borrowers obtain certain types of insurance to protect its interest in the collateral securing the loan. The Bank requires either a title insurance policy insuring that the Bank has a valid first lien on the mortgaged real estate or an opinion by an attorney regarding the validity of title. Fire and casualty insurance is also required on collateral for loans.

Loan Commitments and Letters of Credit. The Bank issues commitments to originate fixed- and adjustable-rate single-family residential mortgage loans and commercial loans conditioned upon the occurrence of certain events. Such commitments are made in writing on specified terms and conditions and are honored for up to 60 days from the date of application, depending on the type of transaction. The Bank had outstanding loan commitments of approximately \$7.9 million at December 31, 2015.

As an accommodation to its commercial business loan borrowers, the Bank issues standby letters of credit or performance bonds usually in favor of municipalities for whom its borrowers are performing services. At December 31, 2015, the Bank had outstanding letters of credit of \$1.3 million.

Loan Origination and Other Fees. Loan fees and points are a percentage of the principal amount of the mortgage loan that is charged to the borrower for funding the loan. The Bank usually charges a fixed origination fee on residential real estate loans and long-term commercial real estate loans. Current accounting standards require loan origination fees and certain direct costs of underwriting and closing loans to be deferred and amortized into interest income over the contractual life of the loan. Deferred fees and costs associated with loans that are sold are recognized as income at the time of sale. The Bank had \$583,000 of net deferred loan costs at December 31, 2015.

Mortgage Banking Activities. Mortgage loans originated and funded by the Bank and intended for sale in the secondary market are carried at the lower of aggregate cost or market value. Aggregate market value is determined based on the quoted prices under a "best efforts" sales agreement with a third party. Net unrealized losses are recognized through a valuation allowance by charges to income. Realized gains on sales of mortgage loans are included in noninterest income.

Commitments to originate and fund mortgage loans for sale in the secondary market are considered derivative financial instruments to be accounted for at fair value. The Bank's mortgage loan commitments subject to derivative

accounting are fixed rate mortgage commitments at market rates when initiated. At December 31, 2015, the Bank had commitments to originate \$589,000 in fixed-rate mortgage loans intended for sale in the secondary market after the loans are closed. Fair value is estimated based on fees that would be charged on commitments with similar terms.

Delinquencies. The Bank's collection procedures provide for a series of contacts with delinquent borrowers. A late charge is assessed and a late charge notice is sent to the borrower after the 15th day of delinquency. After 20 days, the collector places a phone call to the borrower. When a payment becomes 60 days past due, the collector issues a default letter. If a loan continues in a delinquent status for 90 days or more, the Bank generally initiates foreclosure or other litigation proceedings.

Nonperforming Assets. Loans are reviewed regularly and when loans become 90 days delinquent, the loan is placed on nonaccrual status and the previously accrued interest income is reversed unless, in the opinion of management, the outstanding interest remains collectible. Typically, payments received on a nonaccrual loan are applied to the outstanding principal and interest as determined at the time of collection of the loan when the likelihood of further loss on the loan is remote. Otherwise, the Bank applies the cost recovery method and applies all payments as a reduction of the unpaid principal balance.

Edgar Filing: FIRST CAPITAL INC - Form 10-K

The following table sets forth information with respect to the Bank's nonperforming assets for the dates indicated. Nonperforming assets include nonaccrual loans, accruing loans that are 90 days or more past due, and foreclosed real estate.

	At December 31,				
	2015	2014	2013	2012	2011
	(Dollars in thousands)				
Loans accounted for on a nonaccrual basis:					
Residential real estate ⁽¹⁾	\$1,648	\$919	\$1,533	\$2,773	\$2,528
Commercial real estate ⁽²⁾	2,291	449	1,576	2,961	2,858
Commercial business	167	1,642	1,898	1,776	1,928
Consumer	116	129	252	73	87
Total	4,222	3,139	5,259	7,583	7,401
Accruing loans past due 90 days or more:					
Residential real estate ⁽¹⁾	271	68	180	215	143
Commercial real estate ⁽²⁾	75	0	0	0	38
Commercial business	0	0	0	0	0
Consumer	9	17	47	74	182
Total	355	85	227	289	363
Total nonperforming loans	4,577	3,224	5,486	7,872	7,764
Foreclosed real estate, net	4,890	78	466	295	661
Total nonperforming assets	\$9,467	\$3,302	\$5,952	\$8,167	\$8,425
Total nonperforming loans to net loans	1.27 %	1.07 %	1.90 %	2.81 %	2.81 %
Total nonperforming loans to total assets	0.64 %	0.68 %	1.23 %	1.71 %	1.77 %
Total nonperforming assets to total assets	1.32 %	0.70 %	1.34 %	1.78 %	1.92 %

(1) Includes residential construction loans.

(2) Includes commercial real estate construction and land loans.

The increase in nonperforming assets from December 31, 2014 to December 31, 2015 is primarily due to the acquisition of Peoples in December 2015. At December 31, 2015, nonperforming assets acquired from Peoples included nonaccrual loans of \$1.7 million, accruing loans past due 90 days or more of \$346,000 and foreclosed real estate of \$4.3 million.

The Bank accrues interest on loans over 90 days past due when, in the opinion of management, the estimated value of collateral and collection efforts are deemed sufficient to ensure full recovery. The Bank did not recognize any interest

income on nonaccrual loans for the fiscal year ended December 31, 2015. The Bank would have recorded interest income of \$159,000 for the year ended December 31, 2015 had nonaccrual loans been current in accordance with their original terms.

Restructured Loans. Periodically, the Bank modifies loans to extend the term or make other concessions to help borrowers stay current on their loans and avoid foreclosure. The Bank does not forgive principal or interest on loans or modify interest rates to rates that are below market rates. These modified loans are also referred to as “troubled debt restructurings” or “TDRs”.

Restructured loans can involve loans remaining on nonaccrual, moving to nonaccrual, or continuing on accrual status, depending on the individual facts and circumstances of the borrower. Generally, a nonaccrual loan that is restructured in a TDR remains on nonaccrual status for a period of at least six months following the restructuring to ensure that the borrower performs in accordance with the restructured terms including consistent and timely payments. At December 31, 2015, TDRs totaled \$2.3 million with no related allowance for loan losses on TDRs. TDRs on nonaccrual status totaling \$609,000 at December 31, 2015 are included in the nonperforming loans totals above. TDRs performing according to their restructured terms and on accrual status totaled \$1.7 million at December 31, 2015. See Note 5 in the accompanying Notes to Consolidated Financial Statements, which is incorporated herein by reference, for additional information regarding TDRs.

Classified Assets. The OCC has adopted various regulations regarding problem assets of financial institutions. The regulations require that each insured institution review and classify its assets on a regular basis. In addition, in connection with examinations of insured institutions, OCC examiners have the authority to identify additional problem assets and, if appropriate, require them to be classified. There are three classifications for problem assets: substandard, doubtful and loss. “Substandard” assets have one or more defined weaknesses and are characterized by the distinct possibility that the insured institution will sustain some loss if the deficiencies are not corrected. “Doubtful” assets have the weaknesses of substandard assets with the additional characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss. An asset classified as “loss” is considered uncollectible and of such little value that continuance as an asset of the institution is not warranted. If an asset or portion thereof is classified as loss, the insured institution charges off an amount equal to 100% of the portion of the asset classified as loss. The regulations also provide for a “special mention” category, described as assets which do not currently expose the institution to sufficient risk to warrant adverse classification, but have potential weaknesses that deserve management’s close attention.

At December 31, 2015, the Bank had \$5.5 million in doubtful loans and \$6.3 million in substandard loans. In addition, the Bank identified \$9.1 million in loans as special mention loans at December 31, 2015.

Current accounting rules require that impaired loans be measured based on the present value of expected future cash flows discounted at the loan’s effective interest rate, the loan’s observable market price or the fair value of collateral if the loan is collateral dependent. A loan is classified as “impaired” by management when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due in accordance with the terms of the loan agreement. If the fair value, as measured by one of these methods, is less than the recorded investment in the impaired loan, the Bank establishes a valuation allowance with a provision charged to expense. Management reviews the valuation of impaired loans on a quarterly basis to consider changes due to the passage of time or revised estimates. At December 31, 2015, all impaired loans were considered to be collateral dependent for the purposes of determining fair value.

Values for collateral dependent loans are generally based on appraisals obtained from independent licensed real estate appraisers, with adjustments applied for estimated costs to sell the property, costs to complete unfinished or repair damaged property and other factors. New appraisals are generally obtained for all significant properties when a loan is identified as impaired, and a property is considered significant if the value of the property is estimated to exceed \$200,000. Subsequent appraisals are obtained as needed or if management believes there has been a significant change in the market value of the property. In instances where it is not deemed necessary to obtain a new appraisal, management bases its impairment and allowance for loan loss analysis on the original appraisal with adjustments for current conditions based on management’s assessment of market factors and management’s inspection of the property. At December 31, 2015, discounts from appraised values used to value impaired loans for estimates of changes in market conditions, the condition of the collateral, and estimated costs to sell the property ranged from 10% to 59%, with a weighted average discount of 16%.

An insured institution is required to establish and maintain an allowance for loan losses at a level that is adequate to absorb estimated credit losses associated with the loan portfolio, including binding commitments to lend. General allowances represent loss allowances which have been established to recognize the inherent risk associated with

lending activities. When an insured institution classifies problem assets as “loss,” it is required either to establish an allowance for losses equal to 100% of the amount of the assets, or charge off the classified asset. The amount of its valuation allowance is subject to review by the OCC, which can order the establishment of additional general loss allowances. The Bank regularly reviews the loan portfolio to determine whether any loans require classification in accordance with applicable regulations.

At December 31, 2015, 2014 and 2013, the aggregate amounts of the Bank's classified assets were as follows:

	At December 31,		
	2014	2013	2012
	(Dollars in thousands)		
Classified assets:			
Loss	\$—	\$—	\$—
Doubtful	5,537	3,139	5,259
Substandard	6,259	6,967	5,904
Special mention	9,082	3,937	4,066

The increase in classified assets from December 31, 2014 to December 31, 2015 is primarily due to the acquisition of Peoples in December 2015. At December 31, 2015, classified assets acquired from Peoples included loans classified as doubtful, substandard and special mention of \$3.0 million, \$1.9 million and \$4.9 million, respectively.

Loans classified as impaired in accordance with accounting standards included in the above regulatory classifications and the related allowance for loan losses are summarized below at the dates indicated:

	At December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Impaired loans with related allowance	\$472	\$2,034	\$3,129
Impaired loans with no allowance	5,474	3,005	3,791
Total impaired loans	\$5,946	\$5,039	\$6,920
Allowance for loan losses:			
Related to impaired loans	\$166	\$1,351	\$1,529
Related to other loans	3,249	3,495	3,393

See Note 5 in the accompanying Notes to Consolidated Financial Statements, which is incorporated herein by reference, for additional information regarding impaired loans and the related allowance for loan losses.

Foreclosed Real Estate. Foreclosed real estate held for sale is carried at fair value minus estimated costs to sell. Costs of holding foreclosed real estate are charged to expense in the current period, except for significant property improvements, which are capitalized. Valuations are periodically performed by management and an allowance is established by a charge to non-interest expense if the carrying value exceeds the fair value minus estimated costs to sell. The net income from operations of foreclosed real estate held for sale is reported in non-interest income. At December 31, 2015, the Bank had foreclosed real estate totaling \$4.9 million. See Note 7 in the accompanying Notes to Consolidated Financial Statements for additional information regarding foreclosed real estate.

Allowance for Loan Losses. Loans are the Bank's largest concentration of assets and continue to represent the most significant potential risk. In originating loans, the Bank recognizes that losses will be experienced and that the risk of loss will vary with, among other things, the type of loan made, the creditworthiness of the borrower over the term of the loan, general economic conditions and, in the case of a secured loan, the quality of the collateral. The Bank maintains an allowance for loan losses to absorb losses inherent in the loan portfolio. The allowance for loan losses represents management's estimate of probable loan losses based on information available as of the date of the financial statements. The allowance for loan losses is based on management's evaluation of the loan portfolio, including historical loan loss experience, delinquencies, known and inherent risks in the nature and volume of the loan portfolio, information about specific borrower situations, estimated collateral values, and economic conditions.

The loan portfolio is reviewed quarterly by management to evaluate the adequacy of the allowance for loan losses to determine the amount of any adjustment required after considering the loan charge-offs and recoveries for the quarter. Management applies a systematic methodology that incorporates its current judgments about the credit quality of the loan portfolio. In addition, the OCC, as an integral part of its examination process, periodically reviews the Bank's allowance for loan losses and may require the Bank to make additional provisions for estimated losses based on its judgments about information available to it at the time of its examination.

The methodology used in determining the allowance for loan losses includes segmenting the loan portfolio by identifying risk characteristics common to pools of loans, determining and measuring impairment of individual loans based on the present value of expected future cash flows or the fair value of collateral, and determining and measuring impairment for pools of loans with similar characteristics by applying loss factors that consider the qualitative factors which may affect the loss rates.

Specific allowances related to impaired loans and other classified loans are established where the present value of the loan's discounted cash flows, observable market price or collateral value (for collateral dependent loans) is lower than the carrying value of the loan. The identification of these loans results from the loan review process that identifies and monitors credits with weaknesses or conditions which call into question the full collection of the contractual payments due under the terms of the loan agreement. Factors considered by management include, among others, payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. At December 31, 2015, the Company's specific allowances totaled \$166,000.

For loans evaluated on a pool basis, management applies loss factors to pools of loans with common risk characteristics (e.g., residential mortgage loans, home equity loans, commercial real estate loans). The loss factors are derived from the Bank's historical loss experience. Loss factors are adjusted for significant qualitative factors that, in management's judgment, affect the collectability of the loan portfolio segment. The significant qualitative factors include the levels and trends in charge-offs and recoveries, trends in volume and terms of loans, levels and trends in delinquencies, the effects of changes in underwriting standards and other lending practices or procedures, the experience and depth of the lending management and staff, effects of changes in credit concentration, changes in industry and market conditions and national and local economic trends and conditions. Management evaluates these conditions on a quarterly basis and evaluates and modifies the assumptions used in establishing the loss factors.

At December 31, 2015, management applied specific qualitative factor adjustments to the residential real estate, construction, commercial real estate, commercial business, vacant land, and home equity and second mortgage portfolio segments which increased the estimated allowance for loan losses related to those portfolio segments by approximately \$1.4 million. These changes we made to reflect management's estimates of inherent losses in these portfolio segments at December 31, 2015.

At December 31, 2015, for each loan portfolio segment management applied an overall qualitative factor of 1.18 to the Company's historical loss factors. The overall qualitative factor is derived from management's analysis of changes and trends in the following qualitative factors:

Underwriting Standards – Management reviews the findings of periodic internal audit loan reviews, independent outsourced loan reviews and loan reviews performed by the banking regulators to evaluate the risk associated with changes in underwriting standards. At December 31, 2015, management assessed the risk associated with this component as neutral, requiring no adjustment to the historical loss factors.

Economic Conditions – Management analyzes trends in housing and unemployment data in the Louisville, Kentucky metropolitan area to evaluate the risk associated with economic conditions. Due to a decrease in new home construction and an increase in unemployment in the Company's primary market area, management assigned a risk factor of 1.20 for this component at December 31, 2015.

Past Due Loans – Management analyzes trends in past due loans for the Company to evaluate the risk associated with delinquent loans. In general, past due loan ratios have remained at elevated levels compared to historical amounts since 2007, and management assigned a risk factor of 1.20 for this component at December 31, 2015.

Other Internal and External Factors – This component includes management's consideration of other qualitative factors such as loan portfolio composition. The Company has focused on origination of commercial business and real estate loans in an effort to convert the Company's balance sheet from that of a traditional thrift institution to a commercial bank. In addition, the Company has increased its investment in mortgage loans in which it does not hold a first lien position. Commercial loans and second mortgage loans generally entail greater credit risk than residential mortgage loans secured by a first lien. As a result of changes in the loan portfolio composition, management assigned a risk factor of 1.30 for this component at December 31, 2015.

Each of the four factors above was assigned an equal weight to arrive at an average for the overall qualitative factor of 1.18 at December 31, 2015. The effect of the overall qualitative factor was to increase the estimated allowance for loan losses by \$457,000 at December 31, 2015.

Management also adjusts the historical loss factors for loans classified as watch, special mention and substandard that are not individually evaluated for impairment. The adjustments consider the increased likelihood of loss on classified loans based on the Company's separate historical loss experience for classified loans. The effect of these adjustments for classified loans was to increase the estimated allowance for loan losses by \$410,000 at December 31, 2015.

See Notes 1 and 5 in the accompanying Notes to Consolidated Financial Statements, which are incorporated herein by reference, for additional information regarding management's methodology for estimating the allowance for loan losses.

Edgar Filing: FIRST CAPITAL INC - Form 10-K

The following table sets forth an analysis of the Bank's allowance for loan losses for the periods indicated.

	Year Ended December 31,				
	2015	2014	2013	2012	2011
	(Dollars in thousands)				
Allowance at beginning of period	\$4,846	\$4,922	\$4,736	\$4,182	\$4,473
Provision for loan losses	50	190	725	1,525	1,825
	4,896	5,112	5,461	5,707	6,298
Recoveries:					
Residential real estate	11	7	60	16	18
Commercial real estate and land	34	6	17	1	0
Commercial business	9	17	74	10	45
Consumer	144	324	202	200	248
Total recoveries	198	354	353	227	311
Charge-offs:					
Residential real estate	128	140	353	418	819
Commercial real estate and land	0	0	92	108	396
Commercial business	1,205	6	20	17	333
Consumer	346	474	427	655	879
Total charge-offs	1,679	620	892	1,198	2,427
Net (charge-offs) recoveries	(1,481)	(266)	(539)	(971)	(2,116)
Balance at end of period	\$3,415	\$4,846	\$4,922	\$4,736	\$4,182
Ratio of allowance to total loans outstanding at the end of the period	0.93 %	1.57 %	1.64 %	1.64 %	1.47 %
Ratio of net charge-offs to average loans outstanding during the period	0.48 %	0.09 %	0.19 %	0.35 %	0.72 %

The decrease in the ratio of the allowance for loan losses to total loans outstanding from 2014 to 2015 is primarily due to a \$1.2 million charge-off on a commercial loan that had been fully reserved for in prior periods and the Peoples acquisition. Under accounting principles generally accepted in the United States of America ("U.S. GAAP"), acquired loans are recorded at their fair value at the date of acquisition including any discount related to credit risk. As such, loans acquired from Peoples in December 2015 with a fair value of \$55.7 million were initially acquired with no allowance for loan losses.

Allowance for Loan Losses Analysis

The following table sets forth the breakdown of the allowance for loan losses by loan category at the dates indicated.

	At December 31,		2014		2013		2012		2011	
	Amount	Percent of Outstanding Loans in Category	Amount	Percent of Outstanding Loans in Category	Amount	Percent of Outstanding Loans in Category	Amount	Percent of Outstanding Loans in Category	Amount	Percent of Outstanding Loans in Category
	(Dollars in thousands)									
Residential real estate ⁽¹⁾	\$574	44.79 %	\$669	37.97 %	\$874	40.45 %	\$922	41.78 %	\$874	40.45 %
Commercial real estate and land loans ⁽²⁾	1,698	26.86	1,702	29.44	1,436	29.48	1,381	28.22	1,381	28.22
Commercial business	261	6.29	1,480	9.17	1,446	7.31	1,223	6.43	1,223	6.43
Consumer	882	22.06	995	23.42	1,116	22.76	1,210	23.57	1,210	23.57
Total allowance for loan losses	\$3,415	100.00%	\$4,846	100.00%	\$4,922	100.00%	\$4,736	100.00%	\$4,736	100.00%

(1) Includes residential construction loans.

(2) Includes commercial real estate construction loans.

Investment Activities

Federally chartered savings institutions have authority to invest in various types of liquid assets, including United States Treasury obligations, securities of various federal agencies and of state and municipal governments, deposits at the applicable FHLB, certificates of deposit of federally insured institutions, certain bankers' acceptances and federal funds. Subject to various restrictions, such savings institutions may also invest a portion of their assets in commercial paper, corporate debt securities and mutual funds, the assets of which conform to the investments that federally chartered savings institutions are otherwise authorized to make directly. Savings institutions are also required to maintain minimum levels of liquid assets that vary from time to time. The Bank may decide to increase its liquidity above the required levels depending upon the availability of funds and comparative yields on investments in relation to return on loans.

The Bank is required under federal regulations to maintain a minimum amount of liquid assets and is also permitted to make certain other securities investments. The balance of the Bank's investments in short-term securities in excess of regulatory requirements reflects management's response to the significantly increasing percentage of deposits with short maturities. Management intends to hold securities with short maturities in the Bank's investment portfolio in

order to enable the Bank to match more closely the interest-rate sensitivities of its assets and liabilities.

The Bank periodically invests in mortgage-backed securities, including mortgage-backed securities guaranteed or insured by Ginnie Mae, Fannie Mae or Freddie Mac. Mortgage-backed securities generally increase the quality of the Bank's assets by virtue of the guarantees that back them, are more liquid than individual mortgage loans and may be used to collateralize borrowings or other obligations of the Bank. Of the Bank's total mortgage-backed securities portfolio at December 31, 2015, securities with a market value of \$216,000 have adjustable rates as of that date.

The Bank also invests in collateralized mortgage obligations ("CMOs") issued by Ginnie Mae, Fannie Mae and Freddie Mac, as well as private issuers. CMOs are complex mortgage-backed securities that restructure the cash flows and risks of the underlying mortgage collateral.

At December 31, 2015, neither the Company nor the Bank had an investment in securities (other than United States Government and agency securities), which exceeded 10% of the Company's consolidated stockholders' equity at that date.

The following table sets forth the securities portfolio at the dates indicated.

	At December 31, 2015			2014			2013		
	Fair Value	Amortized Cost	Percent of Portfolio	Weighted Average Yield ⁽¹⁾	Fair Value	Amortized Cost	Percent of Portfolio	Weighted Average Yield ⁽¹⁾	Fair Value
	(Dollars in thousands)								
Securities Held to Maturity⁽²⁾									
Mortgage-backed securities ⁽³⁾	\$4	\$4	0.01	1.93%	\$6	\$6	0.01	1.86%	\$9
	\$4	\$4	0.01 %		\$6	\$6	0.01 %		\$9
Securities Available for Sale									
Debt securities:									
U.S. agency:									
Due in one year or less	\$2,018	\$2,017	1.08 %	0.82%	\$0	\$0	0.00 %	0.00%	\$0
Due after one year through five years	47,819	48,032	25.82	1.25%	9,626	9,629	9.73	0.98%	7
Due after five years through ten years	31,509	31,616	17.00	1.69%	8,494	8,507	8.59	1.17%	1
Due after ten years through fifteen years	3,107	3,132	1.68	2.52%	0	0	0.00	0.00%	7
Mortgage-backed securities and CMOs ⁽³⁾	51,341	51,549	27.72	1.90%	46,681	46,596	47.07	1.84%	3
Municipal:									
Due in one year or less	504	504	0.27	0.42%	121	120	0.12	5.40%	0
Due after one year through five years	7,885	7,769	4.18	3.33%	6,160	6,049	6.11	3.15%	2
Due after five years through ten years	14,708	14,322	7.70	4.50%	12,358	11,859	11.98	4.97%	1
Due after ten years	27,742	26,932	14.48	4.39%	14,703	14,150	14.29	4.06%	1
Equity securities:									
Mutual funds	118	118	0.06	N/A	2,083	2,083	2.10	N/A	3
	\$186,751	\$185,991	99.99%		\$100,226	\$98,993	99.99%		\$1

(1) Yields are calculated on a fully taxable equivalent basis using a marginal federal income tax rate of 34%. Weighted average yields are calculated using average prepayment rates for the most recent three-month period.

(2) Securities held to maturity are carried at amortized cost.

(3) The expected maturities of mortgage-backed securities and collateralized mortgage obligations (CMOs) may differ from contractual maturities because the mortgages underlying the obligations may be prepaid without penalty.

Deposit Activities and Other Sources of Funds

General. Deposits and loan repayments are the major source of the Bank's funds for lending and investment activities and for its general business purposes. Loan repayments are a relatively stable source of funds, while deposit inflows and outflows and loan prepayments are significantly influenced by general interest rates and money market conditions. Borrowing may be used on a short-term basis to compensate for reductions in the availability of funds from other sources or may also be used on a longer-term basis for interest rate risk management.

Deposit Accounts. Deposits are attracted from within the Bank's primary market area through the offering of a broad selection of deposit instruments, including non-interest bearing checking accounts, negotiable order of withdrawal ("NOW") accounts, money market accounts, regular savings accounts, certificates of deposit and retirement savings plans. Deposit account terms vary, according to the minimum balance required, the time periods the funds must remain on deposit and the interest rate, among other factors. In determining the terms of its deposit accounts, the Bank considers the rates offered by its competition, profitability to the Bank, matching deposit and loan products and its customer preferences and concerns. The Bank generally reviews its deposit mix and pricing weekly.

The following table presents the maturity distribution of time deposits of \$100,000 or more as of December 31, 2015.

Maturity Period	Amount at December 31, 2015 (Dollars in thousands)
Three months or less	\$ 4,501
Over three through six months	4,824
Over six through 12 months	5,622
Over 12 months	13,409
Total	\$ 28,356

The following table sets forth the balances of deposits in the various types of accounts offered by the Bank at the dates indicated.

At December 31, 2015			2014			2013		
Amount	Percent of Total	Increase/ (Decrease)	Amount	Percent of Total	Increase/ (Decrease)	Amount	Percent of Total	Increase/ (Decrease)
(Dollars in thousands)								

Edgar Filing: FIRST CAPITAL INC - Form 10-K

Non-interest bearing demand NOW accounts	\$125,059	19.63	%	\$52,017	\$73,042	17.70	%	\$16,606	\$56,436	15.10	%	\$(279)
Savings accounts	208,677	32.75		31,372	177,305	42.97		26,542	150,763	40.33		(3,850)
Money market accounts	144,232	22.64		66,409	77,823	18.86		9,855	67,968	18.18		7,016
Fixed rate time deposits which mature:	62,413	9.79		53,833	8,580	2.08		(2,741)	11,321	3.03		81
Within one year	48,826	7.66		8,122	40,704	9.86		(1,477)	42,181	11.28		(11,192)
After one year, but within three years	37,595	5.90		11,266	26,329	6.38		(7,613)	33,942	9.08		(5,194)
After three years, but within five years	10,267	1.61		1,529	8,738	2.12		(2,373)	11,111	2.97		2,884
After five years	0	0.00		0	0	0.00		0	0	0.00		(5)
Club accounts	108	0.02		(7)	115	0.03		7	108	0.03		26
Total	\$637,177	100.00	%	\$224,541	\$412,636	100.00	%	\$38,806	\$373,830	100.00	%	\$(10,513)

Edgar Filing: FIRST CAPITAL INC - Form 10-K

The following table sets forth the amount and maturities of time deposits by rates at December 31, 2015.

	Amount Due					
	Less Than One Year	1 - 3 Years	3 - 5 Years	After 5 Years	Total	Percent of Total
	(Dollars in thousands)					
0.00% — 0.99%	\$42,378	\$27,393	\$5,808	\$ 0	\$75,579	78.17 %
1.00% — 1.99%	3,642	8,682	4,450	0	16,774	17.35
2.00% — 2.99%	2,798	1,515	9	0	4,322	4.47
3.00% — 3.99%	0	0	0	0	0	0.00
4.00% — 4.99%	8	5	0	0	13	0.01
5.00% — 5.99%	0	0	0	0	0	0.00
6.00% — 6.99%	0	0	0	0	0	0.00
Total	\$48,826	\$37,595	\$10,267	\$ 0	\$96,688	100.00 %

Borrowings. The Bank has at times relied upon advances from the FHLB to supplement its supply of lendable funds and to meet deposit withdrawal requirements. Advances from the FHLB are secured by certain first mortgage loans. The Bank also uses retail repurchase agreements as a source of borrowings.

The FHLB functions as a central reserve bank providing credit for savings and loan associations and certain other member financial institutions. As a member, the Bank is required to own capital stock in the FHLB and is authorized to apply for advances on the security of such stock and certain of its mortgage loans provided certain standards related to creditworthiness have been met. Advances are made pursuant to several different programs. Each credit program has its own interest rate and range of maturities. Depending on the program, limitations on the amount of advances are based either on a fixed percentage of an institution's net worth or on the FHLB's assessment of the institution's creditworthiness. Under its current credit policies, the FHLB generally limits advances to 20% of a member's assets, and short-term borrowing of less than one year may not exceed 10% of the institution's assets. The FHLB determines specific lines of credit for each member institution.

The following table sets forth certain information regarding the Bank's use of FHLB advances.

	At or For the Years Ended		
	December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Maximum balance at any month end	\$0	\$6,500	\$5,500
Average balance	340	1,137	4,135
Period end balance	0	0	5,500

Weighted average interest rate:

At end of period	0.00%	0.00 %	0.50 %
During the period	0.52%	0.44 %	3.65 %

The following table sets forth certain information regarding the Bank's use of retail repurchase agreements.

	At or For the Years Ended December 31,			
	2015	2014	2013	
	(Dollars in thousands)			
Maximum balance at any month end	\$0	\$10,617	\$13,041	
Average balance	0	4,601	11,015	
Period end balance	0	0	9,310	
Weighted average interest rate:				
At end of period	0.00%	0.00%	0.26%	
During the period	0.00%	0.26%	0.25%	

As a result of the Peoples acquisition, the Bank obtained an unsecured federal funds purchased line of credit through The Bankers Bank of Kentucky with a maximum borrowing amount of \$5.0 million. At December 31, 2015, the Bank had no outstanding federal funds purchased under the line of credit and the Bank had no borrowings under the federal funds purchased line of credit during 2015.

On July 31, 2015, the Company entered into a \$1.0 million revolving line of credit with Stock Yards Bank & Trust Company secured by stock of the Bank held by the Company. The interest rate charged under the line of credit is the prime rate less 0.25%. The following table sets forth certain information regarding the Company's use of the revolving line of credit for the year ended December 31, 2015.

(Dollars in thousands)

Maximum balance at any month end	\$0
Average balance	62
Period end balance	0
Weighted average interest rate:	
At end of period	0.00%
During the period	3.18%

Subsidiary Activities

The Bank is a subsidiary and is wholly-owned by the Company. First Harrison Investments, Inc. and First Harrison Holdings, Inc. are wholly-owned Nevada corporate subsidiaries of the Bank that jointly own First Harrison, LLC, a Nevada limited liability corporation that holds and manages an investment securities portfolio. First Harrison REIT, Inc. is a wholly-owned subsidiary of First Harrison Holdings, Inc., incorporated to hold a portion of the Bank's real estate mortgage loan portfolio. Heritage Hill, LLC is a wholly-owned subsidiary of the Bank acquired in connection with the acquisition of Peoples that holds and operates certain foreclosed real estate properties. On September 23, 2014, the Company formed FHB Risk Mitigation Services, Inc. ("Captive"). The Captive is a wholly-owned insurance subsidiary of the Company that provides property and casualty insurance coverage to the Company, the Bank and the Bank's subsidiaries, and reinsurance to eight other third party insurance captives, for which insurance may not be currently available or economically feasible in the insurance marketplace.

Personnel

As of December 31, 2015, the Bank had 167 full-time employees and 24 part-time employees. A collective bargaining unit does not represent the employees and the Bank considers its relationship with its employees to be good.

REGULATION AND SUPERVISION

General

As a savings and loan holding company, the Company is required by federal law to report to, and otherwise comply with the rules and regulations of, the Board of Governors of the Federal Reserve Board (the “Federal Reserve Board” or “FRB”). The Bank, an insured federal savings association, is subject to extensive regulation, examination and supervision by the OCC, as its primary federal regulator, and the FDIC, as the deposit insurer.

The Bank is a member of the FHLB System and, with respect to deposit insurance, of the Deposit Insurance Fund managed by the FDIC. The Bank must file reports with the OCC and the FDIC concerning its activities and financial condition and obtain regulatory approvals before entering into certain transactions such as mergers with, or acquisitions of, other financial institutions. The OCC and/or the FDIC conduct periodic examinations to test the Bank’s safety and soundness and compliance with various regulatory requirements. This regulation and supervision establishes a comprehensive framework of activities in which an institution can engage and is intended primarily for the protection of the insurance fund and depositors. The regulatory structure also gives the regulatory authorities extensive discretion in connection with their supervisory and enforcement activities and examination policies, including policies with respect to the classification of assets and the establishment of adequate loan loss reserves for regulatory purposes. Any change in such regulatory requirements and policies, whether by the OCC, the FDIC or Congress, could have a material adverse impact on the Company, the Bank and their operations.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) made extensive changes to the regulation of the Bank. Under the Dodd-Frank Act, the Office of Thrift Supervision (the “OTS”) was eliminated and responsibility for the supervision and regulation of federal savings associations such as the Bank was transferred to the OCC on July 21, 2011. The OCC is the agency that is primarily responsible for the regulation and supervision of national banks. Additionally, the Dodd-Frank Act created a new Consumer Financial Protection Bureau as an independent bureau of the FRB. The Consumer Financial Protection Bureau assumed responsibility for the implementation of the federal financial consumer protection and fair lending laws and regulations and has authority to impose new requirements. However, institutions of less than \$10 billion in assets, such as the Bank, will continue to be examined for compliance with consumer protection and fair lending laws and regulations by, and be subject to the enforcement authority of, their prudential regulators.

Certain regulatory requirements applicable to the Bank and to the Company are referred to below or elsewhere herein. The summary of statutory provisions and regulations applicable to savings associations and their holding companies set forth below and elsewhere in this document does not purport to be a complete description of such statutes and regulations and their effects on the Bank and the Company and is qualified in its entirety by reference to the actual laws and regulations.

BASEL III Capital Rules

In July 2013, the federal banking agencies published the Basel III Capital Rules establishing a new comprehensive capital framework for U.S. banking organizations. The rules implement the Basel Committee's December 2010 framework known as "Basel III" for strengthening international capital standards as well as certain provisions of the Dodd-Frank Act. The Basel III Capital Rules substantially revise the risk-based capital requirements applicable to savings and loan holding companies and depository institutions, including the Company and the Bank, compared to the former U.S. risk-based capital rules. The Basel III Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions' regulatory capital ratios. The Basel III Capital Rules also address risk weights and other issues affecting the denominator in banking institutions' regulatory capital ratios. The Basel III Capital Rules also implement the requirements of Section 939A of the Dodd-Frank Act to remove references to credit ratings from the federal banking agencies' rules. The Basel III Capital Rules became effective on January 1, 2015 (subject to a phase-in period).

The Basel III Capital Rules, among other things:

- introduce a new capital measure called "Common Equity Tier 1" ("CET1");
- specify that Tier 1 capital consists of CET1 and "Additional Tier 1 capital" instruments meeting specified requirements;
- define CET1 narrowly by requiring that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital; and
- expand the scope of the deductions/adjustments as compared to existing regulations.

When fully phased in on January 1, 2019, the Basel III Capital Rules will require the Company and the Bank to maintain:

- a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer" (which is added to the 4.5% CET1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of CET1 to risk-weighted assets of at least 7% upon full implementation);
- a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation);
- a minimum ratio of Total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation), and

- a minimum leverage ratio of 4%, calculated as the ratio of Tier 1 capital to average assets (as compared to a current minimum leverage ratio of 3% for banking organizations that either have the highest supervisory rating or have implemented the appropriate federal regulatory authority's risk-adjusted measure for market risk).

The aforementioned capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the conservation buffer (or below the combined capital conservation buffer and countercyclical capital buffer, when the latter is applied) will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

Under the Basel III Capital Rules, the initial minimum capital ratios as of January 1, 2015 are as follows:

- 4.5% CET1 to risk-weighted assets;
- 6.0% Tier 1 capital to risk-weighted assets;
- 8.0% Total capital to risk-weighted assets.

The Basel III Capital Rules provide for a number of deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets arising from temporary differences that could not be realized through net operating loss carrybacks and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such categories in the aggregate exceed 15% of CET1. Under the former capital standards, the effects of accumulated other comprehensive income items included in capital were excluded for the purposes of determining regulatory capital ratios. Under the Basel III Capital Rules, the effects of certain accumulated other comprehensive items are not excluded; however, non-advanced approaches banking organizations, including the Company, may make a one-time permanent election to continue to exclude these items. The Company and the Bank made this election in order to avoid significant variations in the level of capital depending upon the impact of interest rate fluctuations on the fair value of the Company's available-for-sale securities portfolio. The Basel III Capital Rules also preclude certain hybrid securities, such as trust preferred securities, as Tier 1 capital of bank holding companies, subject to phase-out. The Company has no trust preferred securities.

Implementation of the deductions and other adjustments to CET1 began on January 1, 2015 and will be phased-in over a four-year period (beginning at 40% on January 1, 2015 and an additional 20% per year thereafter). The implementation of the capital conservation buffer began on January 1, 2016 at the 0.625% level and will be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019).

The Basel III Capital Rules prescribe a standardized approach for risk weightings that expand the risk-weighting categories from the current four Basel I-derived categories (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures, and resulting in higher risk weights for a variety of asset categories. Specific changes from the former capital rules impacting the Company's determination of risk-weighted assets include, among other things:

- Applying a 150% risk weight instead of a 100% risk weight for certain high volatility commercial real estate acquisition, development and construction loans;
- Assigning a 150% risk weight to exposures (other than residential mortgage exposures) that are 90 days past due;
- Providing for a 20% credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable (currently set at 0%); and
- Providing for a risk weight, generally not less than 20% with certain exceptions, for securities lending transactions based on the risk weight category of the underlying collateral securing the transaction.

Management believes that, as of December 31, 2015, the Company and the Bank would meet all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if such requirements were currently in effect.

Holding Company Regulation

General. The Company is a unitary savings and loan holding company within the meaning of federal law. As such, the Company is registered with the FRB and subject to FRB regulations, examination, supervision and reporting requirements. In addition, the FRB has enforcement authorities over the Company and its non-savings association subsidiaries. Among other things, that authority permits the FRB to restrict or prohibit activities that it determines to be a serious risk to the subsidiary savings association.

Activities Restrictions. Pursuant to federal law and regulations and policy, a savings and loan holding company such as the Company may generally engage in the activities permitted for financial holding companies under Section 4(k) of the Bank Holding Company Act and certain other activities that have been authorized for savings and loan holding companies by regulation.

Federal law prohibits a savings and loan holding company from, directly or indirectly, or through one or more subsidiaries, acquiring more than 5% of the voting stock of another savings association or savings and loan holding company, without prior written approval of the FRB or from acquiring or retaining, with certain exceptions, more than 5% of a non-subsidiary savings association, a non-subsidiary holding company, or a non-subsidiary company engaged in activities other than those authorized by federal law, or from acquiring or retaining control of a depository institution that is not insured by the FDIC. In evaluating applications by holding companies to acquire savings associations, the FRB considers, among other things, factors such as the financial and managerial resources and future prospects of the Company and institution involved, the effect of the acquisition on the risk to the deposit insurance funds, the convenience and needs of the community and competitive effects.

The FRB may not approve any acquisition that would result in a multiple savings and loan holding company controlling savings associations in more than one state, subject to two exceptions: (i) the approval of interstate supervisory acquisitions by savings and loan holding companies; and (ii) the acquisition of a savings association in another state if the laws of the state of the target savings association specifically permit such acquisitions. The states vary in the extent to which they permit interstate savings and loan holding company acquisitions.

Source of Strength. The Dodd-Frank Act also extends the “source of strength” doctrine to savings and loan holding companies. The regulatory agencies must issue regulations requiring that all bank and savings and loan holding companies serve as a source of strength to their subsidiary depository institutions by providing capital, liquidity and other support to their subsidiary depository institutions in times of financial stress.

Dividends. The Bank must notify the FRB thirty (30) days before declaring any dividend to the Company. The FRB’s policy is that a bank holding company experiencing earnings weakness should not pay cash dividends exceeding its net income or which could only be funded in ways that weaken the bank holding company’s financial health, such as by borrowing. Additionally, the FRB possesses enforcement powers over bank holding companies and their non-bank

subsidiaries to prevent or remedy actions that represent unsafe or unsound practices or violations of applicable statutes and regulations. Among these powers is the ability to proscribe the payment of dividends by banks and bank holding companies.

Acquisition of the Company. Under the Federal Change in Control Act, a notice must be submitted to the FRB if any person (including a company), or group acting in concert, seeks to acquire direct or indirect “control” of a savings and loan holding company or savings association. Under certain circumstances, a change of control may occur, and prior notice is required, upon the acquisition of 10% or more of the Company’s outstanding voting stock, unless the FRB has found that the acquisition will not result in control of the Company. A change in control definitively occurs upon the acquisition of 25% or more of the Company’s outstanding voting stock. Under the Change in Control Act, the FRB generally has 60 days from the filing of a complete notice to act, taking into consideration certain factors, including the financial and managerial resources of the acquirer and the competitive effects of the acquisition. Any company that acquires control would then be subject to regulation as a savings and loan holding company.

Federal Banking Regulation

Business Activities. The activities of federal savings banks are governed by federal laws and regulations. Those laws and regulations delineate the nature and extent of the business activities in which federal savings banks may engage. In particular, certain lending authority for federal savings banks, *e.g.*, commercial, non-residential real property loans and consumer loans, is limited to a specified percentage of the institution's capital or assets.

Capital Requirements. The applicable capital regulations prior to January 1, 2015 required savings associations to meet three minimum capital standards: a 1.5% tangible capital to total assets ratio; a 4% tier 1 capital to total assets leverage ratio (3% for institutions receiving the highest rating on the CAMELS examination rating system) and an 8% risk-based capital ratio.

Prior to January 1, 2015, the risk-based capital standard for savings associations required the maintenance of Tier 1 (core) and total capital (which is defined as core capital and supplementary capital less certain specified deductions from total capital such as reciprocal holdings of depository institution capital instruments and equity investments) to risk-weighted assets of at least 4% and 8%, respectively. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet activities, recourse obligations, residual interests and direct credit substitutes, were multiplied by a risk-weight factor of 0% to 100%, assigned by the capital regulation based on the risks believed inherent in the type of asset. Core (Tier 1) capital was generally defined as common stockholders' equity (including retained earnings), certain non-cumulative perpetual preferred stock and related surplus and minority interests in equity accounts of consolidated subsidiaries less intangibles other than certain mortgage servicing rights and credit card relationships. The components of supplementary capital (Tier 2 Capital) included cumulative preferred stock, long-term perpetual preferred stock, mandatory convertible debt securities, subordinated debt and intermediate preferred stock, the allowance for loan and lease losses limited to a maximum of 1.25% of risk-weighted assets, and up to 45% of unrealized gains on available-for-sale equity securities with readily determinable fair market values. Overall, the amount of supplementary capital included as part of total capital could not exceed 100% of core capital.

The OCC also has authority to establish individual minimum capital requirements in appropriate cases upon a determination that an institution's capital level is or may become inadequate in light of the particular circumstances.

Effective January 1, 2015, the new capital standards discussed under "BASEL III Capital Rules" above became effective.

Prompt Corrective Regulatory Action. The Federal Deposit Insurance Act, as amended ("FDIA"), requires among other things, the federal banking agencies to take "prompt corrective action" in respect of depository institutions that do not meet minimum capital requirements. The FDIA includes the following five capital tiers: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" and "critically undercapitalized." A depository institution's

capital tier will depend upon how its capital levels compare with various relevant capital measures and certain other factors, as established by regulation. The relevant capital measures are the total risk-based capital ratio, the Tier 1 risk-based capital ratio, the common equity Tier 1 risk-based capital ratio, and the leverage ratio.

A bank will be (i) “well capitalized” if the institution has a total risk-based capital ratio of 10.0% or greater, a Tier 1 risk-based capital ratio of 8.0% or greater, a common equity Tier 1 risk-based capital ratio of 6.5% or greater, and a leverage ratio of 5.0% or greater, and is not subject to any order or written directive by any such regulatory authority to meet and maintain a specific capital level for any capital measure; (ii) “adequately capitalized” if the institution has a total risk-based capital ratio of 8.0% or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, a common equity Tier 1 risk-based capital ratio of 4.5% or greater, and a leverage ratio of 4.0% or greater and is not “well capitalized”; (iii) “undercapitalized” if the institution has a total risk-based capital ratio that is less than 8.0%, a Tier 1 risk-based capital ratio of less than 6.0%, a common equity Tier 1 risk-based capital ratio of less than 4.5%, or a leverage ratio of less than 4.0%; (iv) “significantly undercapitalized” if the institution has a total risk-based capital ratio of less than 6.0%, a Tier 1 risk-based capital ratio of less than 4.0%, a common equity Tier 1 risk-based capital ratio of less than 3.0%, or a leverage ratio of less than 3.0%; and (v) “critically undercapitalized” if the institution’s tangible equity is equal to or less than 2.0% of average quarterly tangible assets. An institution may be downgraded to, or deemed to be in, a capital category that is lower than indicated by its capital ratios if it is determined to be in an unsafe or unsound condition or if it receives an unsatisfactory examination rating with respect to certain matters. A bank’s capital category is determined solely for the purpose of applying prompt corrective action regulations, and the capital category may not constitute an accurate representation of the bank’s overall financial condition or prospects for other purposes.

The FDIA generally prohibits a depository institution from making any capital distributions (including payment of a dividend) or paying any management fee to its parent holding company if the depository institution would thereafter be “undercapitalized.” “Undercapitalized” institutions are subject to growth limitations and are required to submit a capital restoration plan. The agencies may not accept such a plan without determining, among other things, that the plan is based on realistic assumptions and is likely to succeed in restoring the depository institution’s capital. In addition, for a capital restoration plan to be acceptable, the depository institution’s parent holding company must guarantee that the institution will comply with such capital restoration plan. The bank holding company must also provide appropriate assurances of performance. The aggregate liability of the parent holding company is limited to the lesser of (i) an amount equal to 5.0% of the depository institution’s total assets at the time it became undercapitalized and (ii) the amount which is necessary (or would have been necessary) to bring the institution into compliance with all capital standards applicable with respect to such institution as of the time it fails to comply with the plan. If a depository institution fails to submit an acceptable plan, it is treated as if it is “significantly undercapitalized.”

“Significantly undercapitalized” depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become “adequately capitalized,” requirements to reduce total assets, and cessation of receipt of deposits from correspondent banks. “Critically undercapitalized” institutions are subject to the appointment of a receiver or conservator.

The appropriate federal banking agency may, under certain circumstances, reclassify a well-capitalized insured depository institution as adequately capitalized. The FDIA provides that an institution may be reclassified if the appropriate federal banking agency determines (after notice and opportunity for hearing) that the institution is in an unsafe or unsound condition or deems the institution to be engaging in an unsafe or unsound practice.

The appropriate agency is also permitted to require an adequately capitalized or undercapitalized institution to comply with the supervisory provisions as if the institution were in the next lower category (but not treat a significantly undercapitalized institution as critically undercapitalized) based on supervisory information other than the capital levels of the institution.

The Company believes that, as of December 31, 2015, the Bank was “well capitalized” based on the aforementioned ratios.

Insurance of Deposit Accounts. The Bank's deposits are insured up to applicable limits by the Deposit Insurance Fund of the FDIC. Deposit insurance per account owner is currently \$250,000. Under the Federal Deposit Insurance Corporation's risk-based assessment system, insured institutions are assigned a risk category based on supervisory evaluations, regulatory capital levels and certain other factors. An institution's assessment rate depends upon the category to which it is assigned, and certain adjustments specified by FDIC regulations. Institutions deemed less risky pay lower assessments. The FDIC may adjust the scale uniformly, except that no adjustment can deviate more than two basis points from the base scale without notice and comment. No institution may pay a dividend if in default of the federal deposit insurance assessment.

The Dodd-Frank Act required the FDIC to revise its procedures to base its assessments upon each insured institution's total assets less tangible equity instead of deposits. The FDIC finalized a rule, effective April 1, 2011, that set the assessment range at 2.5 to 45 basis points of total assets less tangible equity.

The FDIC has authority to increase insurance assessments. A significant increase in insurance premiums would likely have an adverse effect on the operating expenses and results of operations of the Bank. Management cannot predict what insurance assessment rates will be in the future.

Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or regulatory condition imposed in writing by the FDIC or the OCC. The management of the Bank does not know of any practice, condition or violation that might lead to termination of deposit insurance.

Loans to One Borrower. Federal law provides that savings associations are generally subject to the limits on loans to one borrower applicable to national banks. Generally, subject to certain exceptions, a savings association may not make a loan or extend credit to a single or related group of borrowers in excess of 15% of its unimpaired capital and surplus. An additional amount may be lent, equal to 10% of unimpaired capital and surplus, if secured by specified readily-marketable collateral.

Qualified Thrift Lender (QTL) Test. Federal law requires savings associations to meet a qualified thrift lender test. Under the test, a savings association is required to either qualify as a "domestic building and loan association" under the Internal Revenue Code or maintain at least 65% of its "portfolio assets" (total assets less: (i) specified liquid assets up to 20% of total assets; (ii) intangibles, including goodwill; and (iii) the value of property used to conduct business) in certain "qualified thrift investments" (primarily residential mortgages and related investments, including certain mortgage-backed securities but also including education, credit card and small business loans) in at least nine months out of each 12-month period.

A savings association that fails the qualified thrift lender test is subject to certain operating restrictions and the Dodd-Frank Act also specifies that failing the qualified thrift lender test is a violation of law that could result in an enforcement action and dividend limitations. As of December 31, 2015, the Bank maintained 65% of its portfolio assets in qualified thrift investments and, therefore, met the qualified thrift lender test.

Limitation on Capital Distributions. Federal regulations impose limitations upon all capital distributions by a savings association, including cash dividends, payments to repurchase its shares and payments to shareholders of another institution in a cash-out merger. Under the regulations, an application to and prior approval of the OCC is required before any capital distribution if the institution does not meet the criteria for “expedited treatment” of applications under OCC regulations (i.e., generally, examination and Community Reinvestment Act ratings in the two top categories), the total capital distributions for the calendar year exceed net income for that year plus the amount of retained net income for the preceding two years, the institution would be undercapitalized following the distribution or the distribution would otherwise be contrary to a statute, regulation or agreement with the OCC. If an application is not required, the institution must still provide 30 days prior written notice to FRB of the capital distribution if, like the Bank, it is a subsidiary of a holding company, as well as an informational notice filing to the OCC.

If the Bank's capital fell below its regulatory requirements or the OCC notified it that it was in need of increased supervision, the Bank's ability to make capital distributions could be restricted. In addition, the OCC could prohibit a proposed capital distribution by any institution, which would otherwise be permitted by the regulation, if the OCC determines that such distribution would constitute an unsafe or unsound practice.

Standards for Safety and Soundness. The federal banking agencies have adopted Interagency Guidelines prescribing Standards for Safety and Soundness in various areas such as internal controls and information systems, internal audit, loan documentation and credit underwriting, interest rate exposure, asset growth and quality, earnings and compensation, fees and benefits. The guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. If the OCC determines that a savings association fails to meet any standard prescribed by the guidelines, the OCC may require the institution to submit an acceptable plan to achieve compliance with the standard.

Community Reinvestment Act. All federal savings associations have a responsibility under the Community Reinvestment Act and related regulations to help meet the credit needs of their communities, including low- and moderate-income neighborhoods. An institution's failure to satisfactorily comply with the provisions of the Community Reinvestment Act could result in denials of regulatory applications. Responsibility for administering the Community Reinvestment Act, unlike other fair lending laws, is not being transferred to the Consumer Financial Protection Bureau. The Bank received a "satisfactory" Community Reinvestment Act rating in its most recently completed examination.

Transactions with Related Parties. The Bank's authority to engage in transactions with "affiliates" (e.g., any entity that controls, is under common control with, or, to a certain extent, controlled by the Bank, including the Company and its other subsidiaries) is limited by federal law. The aggregate amount of covered transactions with any individual affiliate is limited to 10% of the capital and surplus of the savings association. The aggregate amount of covered transactions with all affiliates is limited to 20% of the savings association's capital and surplus. Certain transactions with affiliates are required to be secured by collateral in an amount and of a type specified by federal law. The purchase of low quality assets from affiliates is generally prohibited. Transactions with affiliates must generally be on terms and under circumstances, that are at least as favorable to the institution as those prevailing at the time for comparable transactions with non-affiliated companies. In addition, savings associations are prohibited from lending to any affiliate that is engaged in activities that are not permissible for bank holding companies and no savings association may purchase the securities of any affiliate other than a subsidiary.

The Sarbanes-Oxley Act of 2002 generally prohibits loans by the Company to its executive officers and directors. However, the law contains a specific exception for loans by a depository institution to its executive officers and directors in compliance with federal banking laws. Under such laws, the Bank's authority to extend credit to executive officers, directors and 10% shareholders ("insiders"), as well as entities such persons control, is limited. The laws limit both the individual and aggregate amount of loans that the Bank may make to insiders based, in part, on the Bank's capital level and requires that certain board approval procedures be followed. Such loans are required to be made on terms substantially the same as those offered to unaffiliated individuals and not involve more than the normal risk of repayment. There is an exception for loans made pursuant to a benefit or compensation program that is widely available to all employees of the institution and does not give preference to insiders over other employees. Loans to

executive officers are subject to additional limitations based on the type of loan involved.

Enforcement. The OCC has primary enforcement responsibility over savings associations and has authority to bring actions against the institution and all institution-affiliated parties, including stockholders, and any attorneys, appraisers and accountants who knowingly or recklessly participate in wrongful action likely to have an adverse effect on an insured institution. Formal enforcement action may range from the issuance of a capital directive or cease and desist order to removal of officers and/or directors to institution of receivership, conservatorship or termination of deposit insurance. Civil penalties cover a wide range of violations and can amount to \$25,000 per day, or even \$1 million per day in especially egregious cases. The FDIC has the authority to recommend to the Director of the OCC that enforcement action to be taken with respect to a particular savings association. If action is not taken by the Director, the FDIC has authority to take such action under certain circumstances. Federal law also establishes criminal penalties for certain violations.

Assessments. Savings associations were previously required to pay assessments to the OTS to fund the agency's operations. The general assessments, paid on a semi-annual basis, are computer based upon the savings association's (including consolidated subsidiaries) total assets, condition and complexity of portfolio. The OCC assessments paid by the Bank for the year ended December 31, 2015 totaled \$134,000.

Federal Home Loan Bank System

The Bank is a member of the FHLB System, which consists of 12 regional FHLBs. The FHLB provides a central credit facility primarily for member institutions. The Bank, as a member of the FHLB, is required to acquire and hold shares of capital stock in that FHLB. The Bank was in compliance with this requirement with an investment in FHLB stock at December 31, 2015 of \$1.6 million.

The FHLBs have been required to provide funds for the resolution of insolvent thrifts in the late 1980s and contribute funds for affordable housing programs. These and similar requirements, or general economic conditions, could reduce the amount of dividends that the FHLBs pay to their members and result in the FHLBs imposing a higher rate of interest on advances to their members. If dividends were reduced, or interest on future FHLB advances increased, the Bank's net interest income would likely also be reduced.

Federal Reserve System

The FRB regulations require savings associations to maintain non-interest earning reserves against their transaction accounts (primarily NOW and regular checking accounts). The regulations generally provide that reserves be maintained against aggregate transaction accounts as follows for 2015: a 3% reserve ratio is assessed on net transaction accounts up to and including \$103.6 million; a 10% reserve ratio is applied above \$103.6 million. The first \$14.5 million of otherwise reservable balances (subject to adjustments by the FRB) are exempted from the reserve requirements. The Bank complies with the foregoing requirements. The amounts are adjusted annually and, for 2016, establish a 3% reserve ratio for aggregate transaction accounts up to \$110.2 million, a 10% ratio above \$110.2 million, and an exemption of \$15.2 million. In October 2008, the FRB began paying interest on certain reserve balances.

Other Regulations

The Bank's operations are also subject to federal laws applicable to credit transactions, including the:

- Truth-In-Lending Act, governing disclosures of credit terms to consumer borrowers;

Home Mortgage Disclosure Act of 1975, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;

Equal Credit Opportunity Act, prohibiting discrimination on the basis of race, creed or other prohibited factors in extending credit;

- Fair Credit Reporting Act of 1978, governing the use and provision of information to credit reporting agencies;

Fair Debt Collection Act, governing the manner in which consumer debts may be collected by collection agencies; and

Rules and regulations of the various federal agencies charged with the responsibility of implementing such federal laws.

The operations of the Bank also are subject to laws such as the:

Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;

Electronic Funds Transfer Act and Regulation E promulgated thereunder, which govern automatic deposits to and withdrawals from deposit accounts and customers' rights and liabilities arising from the use of automated teller machines and other electronic banking services; and

Check Clearing for the 21st Century Act (also known as "Check 21"), which gives certain check reproductions, such as digital check images and copies made from that image (a "substitute check"), the same legal standing as the original paper check.

FEDERAL AND STATE TAXATION

Federal Taxation

General. The Company and its subsidiaries report their income on a calendar year basis using the accrual method of accounting and are subject to federal income taxation in the same manner as other corporations with some exceptions, including particularly the Bank's reserve for bad debts, as discussed below. The following discussion of tax matters is intended only as a summary and does not purport to be a comprehensive description of the tax rules applicable to the Bank or the Company. The Company and the Bank have not been audited by the Internal Revenue Service in the past five years.

The Company and the Bank have entered into a tax allocation agreement. Because the Company owns 100% of the issued and outstanding capital stock of the Bank, the Company and the Bank are members of an affiliated group within the meaning of Section 1504(a) of the Internal Revenue Code, of which group the Company is the common parent corporation. As a result of this affiliation, the Bank may be included in the filing of a consolidated federal income tax return with the Company and, if a decision to file a consolidated tax return is made, the parties agree to compensate each other for their individual share of the consolidated tax liability and/or any tax benefits provided by them in the filing of the consolidated federal tax return.

Bad Debt Reserve. For taxable years beginning after December 31, 1995, the Bank is entitled to take a bad debt deduction for federal income tax purposes which is based on its current or historic net charge-offs by applying the experience reserve method for banks, as long as the Bank does not meet the definition of a "large bank". Under the Internal Revenue Code, if a bank's average adjusted assets exceeds \$500 million for any tax year it is considered a "large bank" and must utilize the specific charge-off method to compute bad debt deductions. The Bank is expected to

meet the definition of a “large bank” for the tax year ending December 31, 2016 as a result of the acquisition of Peoples. As such, the Bank will be required to use the specific charge-off method to compute bad debt deductions beginning in 2016 and its bad debt reserves calculated using the experience reserve method will be recaptured in taxable income over the four-year period ending December 31, 2019.

Potential Recapture of Base Year Bad Debt Reserve. The Bank's bad debt reserve as of the base year (which is the Bank's last taxable year beginning before January 1, 1988) is not subject to automatic recapture as long as the Bank continues to carry on the business of banking and does not make "non-dividend distributions" as discussed below. If the Bank no longer qualifies as a bank, the balance of the pre-1988 reserves (the base year reserves) are restored to income over a six-year period beginning in the tax year the Bank no longer qualifies as a bank. Such base year bad debt reserve is also subject to recapture to the extent that the Bank makes "non-dividend distributions" that are considered as made from the base year bad debt reserve. To the extent that such reserves exceed the amount that would have been allowed under the experience method ("Excess Distributions"), then an amount based on the amount distributed will be included in the Bank's taxable income. Non-dividend distributions include distributions in excess of the Bank's current and accumulated earnings and profits, distributions in redemption of stock, and distributions in partial or complete liquidation. However, dividends paid out of the Bank's current or accumulated earnings and profits, as calculated for federal income tax purposes, will not be considered to result in a distribution from the Bank's bad debt reserve. Thus, any dividends to the Company that would reduce amounts appropriated to the Bank's bad debt reserve and deducted for federal income tax purposes would create a tax liability for the Bank. The amount of additional taxable income created from an Excess Distribution is an amount that, when reduced by the tax attributable to the income, is equal to the amount of the distribution. If the Bank makes a "non-dividend distribution," then approximately one and one-half times the amount so used would be includable in gross income for federal income tax purposes, assuming a 34% corporate income tax rate (exclusive of state and local taxes). The Bank does not intend to pay dividends that would result in a recapture of any portion of its bad debt reserve.

Corporate Alternative Minimum Tax. The Internal Revenue Code imposes a tax on alternative minimum taxable income ("AMTI") at a rate of 20%. The excess of the bad debt reserve deduction claimed by the Bank over the deduction that would have been allowable under the experience method is treated as a preference item for purposes of computing the AMTI. Only 90% of AMTI can be offset by net operating loss carry-overs, of which the Bank currently has none. AMTI is increased by an amount equal to 75% of the amount by which the Bank's adjusted current earnings exceed its AMTI (determined without regard to this preference and before reduction for net operating losses). In addition, for taxable years beginning after June 30, 1986 and before January 1, 1996, an environmental tax of 0.12% of the excess of AMTI (with certain modifications) over \$2.0 million is imposed on corporations, including the Bank, whether or not an Alternative Minimum Tax ("AMT") is paid. The Bank does not expect to be subject to the AMT.

Dividends Received Deduction and Other Matters. The Company may exclude from its income 100% of dividends received from the Bank as a member of the same affiliated group of corporations. The corporate dividends received deduction is generally 70% in the case of dividends received from unaffiliated corporations with which the Company and the Bank will not file a consolidated tax return, except that if the Company or the Bank own more than 20% of the stock of a corporation distributing a dividend, then 80% of any dividends received may be deducted.

State Taxation

Indiana. Effective July 1, 2013, Indiana amended its tax code to provide for reductions in the franchise tax rate. For the year ended December 31, 2015, Indiana imposed a 7.5% franchise tax based on a financial institution's adjusted gross income as defined by statute. The Indiana franchise tax rate will be reduced to 7.0% and 6.5% for the Company's

tax years ending December 31, 2016 and 2017, respectively, and will remain at 6.5% for the tax year ending December 31, 2018. The Indiana franchise tax rate will then be reduced to 6.25%, 6.00%, 5.50% and 5.00% for the Company's tax years ending December 31, 2019, 2020, 2021 and 2022, respectively. Finally, the franchise tax rate will be reduced to 4.90% for the Company's tax year ending December 31, 2023 and will remain 4.90% thereafter. In computing adjusted gross income, deductions for municipal interest, United States Government interest, the bad debt deduction computed using the reserve method and pre-1990 net operating losses is disallowed. The Company's Indiana state income tax returns have not been audited in the past five years.

Kentucky. With the acquisition of Peoples in December 2015, the Bank is now subject to a tax on the Bank's capital attributable to Kentucky as of January 1 each year beginning January 1, 2016. The capital stock tax on savings banks is imposed on the capital of the institution attributable to Kentucky at a rate of \$1 for each \$1,000 in capital. Taxable capital includes certificates of deposit, savings accounts, demand deposits, undivided profits, surplus and general reserves, less an amount equal to the market value of qualifying U.S. government securities. Because the Bank has business activity both within and without Kentucky, the amount of its capital attributable to Kentucky is determined using a three-factor apportionment formula which considers gross receipts, outstanding loan balances and payroll.

ITEM 1A. RISK FACTORS

Risks Related To Our Business.

Above average interest rate risk associated with fixed-rate loans may have an adverse effect on our financial position or results of operations.

The Bank's loan portfolio includes a significant amount of loans with fixed rates of interest. At December 31, 2015, \$201.6 million, or 54.9% of the Bank's total loans receivable, had fixed interest rates all of which were held for investment. The Bank offers ARM loans and fixed-rate loans. Unlike ARM loans, fixed-rate loans carry the risk that, because they do not reprice to market interest rates, their yield may be insufficient to offset increases in the Bank's cost of funds during a rising interest rate environment. Accordingly, a material and prolonged increase in market interest rates could be expected to have a greater adverse effect on the Bank's net interest income compared to other institutions that hold a materially larger portion of their assets in ARM loans or fixed-rate loans that are originated for committed sale in the secondary market. For a discussion of the Bank's loan portfolio, see "*Item 1. Business— Lending Activities.*"

Higher loan losses could require the Company to increase its allowance for loan losses through a charge to earnings.

When we loan money we incur the risk that our borrowers do not repay their loans. We reserve for loan losses by establishing an allowance through a charge to earnings. The amount of this allowance is based on our assessment of loan losses inherent in our loan portfolio. The process for determining the amount of the allowance is critical to our financial results and condition. It requires subjective and complex judgments about the future, including forecasts of economic or market conditions that might impair the ability of our borrowers to repay their loans. We might underestimate the loan losses inherent in our loan portfolio and have loan losses in excess of the amount reserved. We might increase the allowance because of changing economic conditions. For example, in a rising interest rate environment, borrowers with adjustable-rate loans could see their payments increase. There may be a significant increase in the number of borrowers who are unable or unwilling to repay their loans, resulting in our charging off more loans and increasing our allowance. In addition, when real estate values decline, the potential severity of loss on a real estate-secured loan can increase significantly, especially in the case of loans with high combined loan-to-value ratios. Our allowance for loan losses at any particular date may not be sufficient to cover future loan losses. We may be required to increase our allowance for loan losses, thus reducing earnings.

Commercial business lending may expose the Company to increased lending risks.

At December 31, 2015, the Bank's commercial business loan portfolio amounted to \$23.1 million, or 6.3% of total loans. Subject to market conditions and other factors, the Bank intends to expand its commercial business lending activities within its primary market area. Commercial business lending is inherently riskier than residential mortgage lending. Although commercial business loans are often collateralized by equipment, inventory, accounts receivable or other business assets, the liquidation value of these assets in the event of a borrower default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories and equipment may be obsolete or of limited use, among other things. See "*Item 1. Business—Lending Activities—Commercial Business Loans.*"

Commercial real estate lending may expose the Company to increased lending risks.

At December 31, 2015, the Bank's commercial real estate loan portfolio amounted to \$84.5 million, or 23.0% of total loans. Commercial real estate lending is inherently riskier than residential mortgage lending. Because payments on loans secured by commercial properties often depend upon the successful operation and management of the properties, repayment of such loans may be affected by adverse conditions in the real estate market or the economy, among other things. See "*Item 1. Business—Lending Activities—Commercial Real Estate Loans.*"

Our information systems may experience an interruption or breach in security.

The Bank relies heavily on internal and outsourced digital technologies, communications, and information systems to conduct its business. As our reliance on technology systems increases, the potential risks of technology-related operation interruptions in our customer relationship management, general ledger, deposit, loan, or other systems or the occurrence of cyber incidents also increases. Cyber incidents can result from deliberate attacks or unintentional events including (i) gaining unauthorized access to digital systems for purposes of misappropriating assets or sensitive information, corrupting data, or causing operational disruptions; (ii) causing denial-of-service attacks on websites; or (iii) intelligence gathering and social engineering aimed at obtaining information. The occurrence of operational interruption, cyber incident, or a deficiency in the cyber security of our technology systems (internal or outsourced) could negatively impact our financial condition or results of operations.

We have policies and procedures expressly designed to prevent or limit the effect of a failure, interruption, or security breach of our systems and maintain cyber security insurance. However, such policies, procedures, or insurance may prove insufficient to prevent, repel, or mitigate a cyber incident. Significant interruptions to our business from technology issues could result in expensive remediation efforts and distraction of management. During the year, we experienced certain immaterial cyber-attacks or breaches and continue to invest in security and controls to prevent and mitigate future incidents. Although we have not experienced any material losses related to a technology-related operational interruption or cyber-attack, there can be no assurance that such failures, interruptions, or security breaches will not occur in the future or, if they do occur, that the impact will not be substantial.

The occurrence of any failures, interruptions, or security breaches of our technology systems could damage our reputation, result in a loss of customer business, result in the unauthorized release, gathering, monitoring, misuse, loss, or destruction of proprietary information, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our financial condition, results of operations, or stock price. As cyber threats continue to evolve, we may also be required to spend significant additional resources to continue to modify or enhance our protective measures or to investigate and remediate any information security vulnerabilities.

We depend on outside third parties for processing and handling of our records and data.

The Bank relies on software developed by third party vendors to process various transactions. In some cases, we have contracted with third parties to run their proprietary software on our behalf. These systems include, but are not limited to, general ledger, payroll, employee benefits, and loan and deposit processing, and securities portfolio management. While we perform a review of controls instituted by the vendors over these programs in accordance with industry standards and perform our own testing of user controls, we must rely on the continued maintenance of these controls by the outside party, including safeguards over the security of customer data. In addition, we maintain backups of key processing output daily in the event of a failure on the part of any of these systems. Nonetheless, we may incur a temporary disruption in its ability to conduct our business or process our transactions or incur damage to our reputation if the third party vendor fails to adequately maintain internal controls or institute necessary changes to systems. Such disruption or breach of security may have a material adverse effect on our financial condition and results of operations.

We continually encounter technological change.

The banking and financial services industry continually undergoes technological changes, with frequent introductions of new technology-driven products and services. In addition to better meeting customer needs, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our future success will depend, in part, on our ability to address the needs of our customers by using technology to provide products and services that enhance customer convenience and that create additional efficiencies in our operations. Many of our competitors have greater resources to invest in technological improvements, and we may not effectively implement new technology-driven products and services or do so as quickly as our competitors, which could reduce our ability to effectively compete. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse effect on our business, financial condition, and results of operations.

We may not be able to attract and retain skilled people.

The Bank's success depends on its ability to attract and retain skilled people. Competition for the best people in most activities in which we engage can be intense, and we may not be able to hire people or retain them. The unexpected loss of services of certain of our skilled personnel could have a material adverse impact on our business because of their skills, knowledge of our market, years of industry experience, customer relationships, and the difficulty of promptly finding qualified replacement personnel.

Loss of key employees may disrupt relationships with certain customers.

Our customer relationships are critical to the success of our business, and loss of key employees with significant customer relationships may lead to the loss of business if the customers were to follow that employee to a competitor. While we believe our relationships with its key personnel are strong, we cannot guarantee that all of our key personnel will remain with the organization, which could result in the loss of some of our customers and could have a negative impact on our business, financial condition, and results of operations.

Risks Related to the Banking Industry.

Our business may be adversely affected by conditions in the financial markets and economic conditions generally.

Our financial performance depends to a large extent on the business environment in our geographically concentrated five-county market area, the nearby suburban metropolitan Louisville market, the states of Indiana and Kentucky, and the U.S. as a whole. In particular, the current environment impacts the ability of borrowers to pay interest on and repay principal of outstanding loans as well as the value of collateral securing those loans. A favorable business environment is generally characterized by economic growth, low unemployment, efficient capital markets, low inflation, high business and investor confidence, strong business earnings, and other factors. Unfavorable or uncertain economic and market conditions can be caused by declines in economic growth, business activity, or investor or business confidence; limitations on the availability or increases in the cost of credit and capital; increases in inflation or interest rates; high unemployment; natural disasters; or a combination of these or other factors.

In recent years, our market area, the suburban metropolitan Louisville market, the states of Indiana and Kentucky, and the U.S. as a whole experienced a downward economic cycle. Significant weakness in market conditions adversely impacted all aspects of the economy, including our business. In particular, dramatic declines in the housing market, with decreasing home prices and increasing delinquencies and foreclosures, negatively impacted the credit performance of construction loans, which resulted in significant write-downs of assets by many financial institutions. Business activity across a wide range of industries and regions was greatly reduced, and local governments and many businesses experienced serious difficulty due to the lack of consumer spending and the lack of liquidity in the credit markets. In addition, unemployment increased significantly during that period, which further contributed to the adverse business environment for households and businesses.

While economic conditions have shown signs of improvement through 2015, there can be no assurance that economic recovery will continue, and future deterioration would likely exacerbate the adverse effects of recent difficult market conditions on us and others in the financial institutions industry. Market stress could have a material adverse effect on

the credit quality of our loans, and therefore, our financial condition and results of operations as well as other potential adverse impacts including:

- There could be an increased level of commercial and consumer delinquencies, lack of consumer confidence, increased market volatility, and widespread reduction of business activity generally.
- There could be an increase in write-downs of asset values by financial institutions, such as the Bank.
- There could be the loss of collateral value on commercial and real estate loans that are secured by real estate located in our market area. A further significant decline in real estate values in our market would mean that the collateral for many of our loans would provide less security. As a result, we would be more likely to suffer losses on defaulted loans because our ability to fully recover on defaulted loans by selling the real estate collateral would be diminished.

- Our ability to assess the creditworthiness of customers could be impaired if the models and approaches it uses to select, manage, and underwrite credits become less predictive of future performance.
- The process we use to estimate losses inherent in our loan portfolio requires difficult, subjective, and complex judgments. This process includes analysis of economic conditions and the impact of these economic conditions on borrowers' ability to repay their loans. The process could no longer be capable of accurate estimation and may, in turn, impact its reliability.
- The Bank could be required to pay significantly higher FDIC premiums in the future if losses further deplete the Deposit Insurance Fund.
- We could face increased competition due to intensified consolidation of the financial services industry. If current levels of market disruption and volatility continue or worsen, there can be no assurance that we will not experience an adverse effect, which may be material, on our ability to access capital and on our business, financial condition, and results of operations.

Future economic conditions in our market will depend on factors outside of our control such as political and market conditions, broad trends in industry and finance, legislative and regulatory changes, changes in government, military and fiscal policies and inflation.

Turmoil in the financial markets could result in lower fair values for our investment securities.

Major disruptions in the capital markets experienced in recent years have adversely affected investor demand for all classes of securities, excluding U.S. Treasury securities, and resulted in volatility in the fair values of our investment securities. Significant prolonged reduced investor demand could manifest itself in lower fair values for these securities and may result in recognition of an other-than-temporary impairment ("OTTI"), which could have a material adverse effect on our financial condition and results of operations.

Municipal securities can also be impacted by the business environment of their geographic location. Although this type of security historically experienced extremely low default rates, municipal securities are subject to systemic risk since cash flows generally depend on (i) the ability of the issuing authority to levy and collect taxes or (ii) the ability of the issuer to charge for and collect payment for essential services rendered. If the issuer defaults on its payments, it may result in the recognition of OTTI or total loss, which could have a material adverse effect on our financial condition and results of operations.

Strong competition within the Bank's market area could hurt the Company's profitability and growth.

The Bank faces intense competition both in making loans and attracting deposits. This competition has made it more difficult for it to make new loans and at times has forced it to offer higher deposit rates. Price competition for loans and deposits might result in the Bank earning less on loans and paying more on deposits, which would reduce net interest income. Competition also makes it more difficult to grow loans and deposits. Some of the institutions with which the Bank competes have substantially greater resources and lending limits than it has and may offer services that the Bank does not provide. Future competition will likely increase because of legislative, regulatory and technological changes and the continuing trend of consolidation in the financial services industry. The Company's profitability depends upon the Bank's continued ability to compete successfully in its market area.

We are subject to federal regulations that seek to protect the Deposit Insurance Fund and the depositors and borrowers of the Bank, and our federal regulators may impose restrictions on our operations that are detrimental to holders of the Company's common stock.

We are subject to extensive regulation, supervision and examination by the FRB and the OCC, our primary federal regulators, and the FDIC, as insurer of our deposits. Such regulation and supervision governs the activities in which an institution and its holding company may engage, and are intended primarily for the protection of the insurance fund and the depositors and borrowers of the Bank rather than for holders of the Company's common stock. Our regulators may subject us to supervisory and enforcement actions, such as the imposition of certain restrictions on our operations, the classification of our assets and the determination of the level of our allowance for loan losses, that are aimed at protecting the insurance fund and the depositors and borrowers of the Bank but that are detrimental to holders of the Company's common stock. Any change in our regulation or oversight, whether in the form of regulatory policy, regulations, legislation or supervisory action, may have a material impact on our operations.

Financial regulatory reform may have a material impact on the Company's operations.

The Dodd-Frank Act contains various provisions designed to enhance the regulation of depository institutions and prevent the recurrence of a financial crisis such as occurred in 2008 and 2009. These include provisions strengthening holding company capital requirements, requiring retention of a portion of the risk of securitized loans and regulating debit card interchange fees. The Dodd-Frank Act also created the Consumer Financial Protection Bureau to administer consumer protection and fair lending laws, a function that was formerly performed by the depository institution regulators. The full impact of the Dodd-Frank Act on our business and operations will not be known for years until regulations implementing the statute are written and adopted. However, it is likely that the provisions of the Dodd-Frank Act will have an adverse impact on our operations, particularly through increased regulatory burden and compliance costs.

Additionally, in July 2013, the federal banking agencies issued a final rule to revise their risk-based and leverage capital requirements and their method for calculating risk-weighted assets, to make them consistent with the agreements that were reached by the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. The final rule applies to all depository institutions, top-tier bank holding companies with total consolidated assets of \$500 million or more, and top-tier savings and loan holding companies ("banking organizations"). Among other things, the rule establishes a new common equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets), increases the minimum Tier 1 capital to risk-based assets requirement (from 4% to 6% of risk-weighted assets) and assigns a higher risk weight (150%) to exposures that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance the acquisition, development or construction of real property. The final rule also limits a banking organization's capital distributions and certain discretionary bonus payments if the banking organization does not hold a "capital conservation buffer" consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements. The final rule became effective on January 1, 2015. The capital conservation buffer requirement began phasing in on January 1, 2016 and will end January 1, 2019, when the full capital conservation buffer requirement will be effective.

Compliance with these rules, which are still being analyzed, will impose additional costs on banking entities and their holding companies.

Acquisitions and the addition of branch facilities may not produce revenue enhancements or cost savings at levels or within timeframes originally anticipated and may result in unforeseen integration difficulties and dilution to existing shareholder value.

We acquired Peoples on December 4, 2015. We may have difficulty in integrating Peoples or other acquired companies which may cause us not to realize expected revenue increases, cost savings, increases in geographic or product presence, and/or other projected benefits. The integration could result in higher than expected deposit attrition (run-off), loss of key employees, disruption of our business or the business of the acquired company, or otherwise

adversely affect our ability to maintain relationships with customers and employees or achieve the anticipated benefits of the acquisition. Also, the acquisition of Peoples significantly increases the size of the Company as well as our level of nonperforming assets. The success of the acquisition will depend, in part, to our ability to reduce the level of nonperforming assets and grow the loan portfolio.

We regularly explore opportunities to establish branch facilities and acquire other banks or financial institutions. New or acquired branch facilities and other facilities may not be profitable. We may not be able to correctly identify profitable locations for new branches. The costs to start up new branch facilities or to acquire existing branches, and the additional costs to operate these facilities, may increase our noninterest expense and decrease earnings in the short term. It may be difficult to adequately and profitably manage growth through the establishment of these branches. In addition, we can provide no assurance that these branch sites will successfully attract enough deposits to offset the expenses of operating these branch sites. Any new or acquired branches will be subject to regulatory approval, and there can be no assurance that we will succeed in securing such approvals.

Risks Related to the Company's Stock.

An investment in the Company's Common Stock is not an insured deposit.

The Company's common stock is not a bank deposit and, therefore, is not insured against loss by the FDIC, any other deposit insurance fund, or by any other public or private entity. Investment in the Company's Common Stock is inherently risky for the reasons described in this "Risk Factors" section and elsewhere in this report and is subject to the same market forces that affect the price of common stock in any public company. As a result, if you acquire the Company's common stock, you could lose some or all of your investment.

The price of the Company's common stock may be volatile, which may result in losses for investors.

General market price declines or market volatility in the future could adversely affect the price of the Company's common stock. In addition, the following factors may cause the market price for shares of the Company's common stock to fluctuate:

- announcements of developments related to the Company's business;
- fluctuations in the Company's results of operations;
- sales or purchases of substantial amounts of the Company's securities in the marketplace;
- general conditions in the Company's banking niche or the worldwide economy;
- a shortfall or excess in revenues or earnings compared to securities analysts' expectations;
- changes in analysts' recommendations or projections; and
- the Company's announcement of new acquisitions or other projects.

The trading volume in the Company's common stock is less than that of other larger financial services institutions.

Although the Company's common stock is listed for trading on the NASDAQ Capital Market, the trading volume in its common stock may be less than that of other, larger financial services companies. A public trading market having the desired characteristics of depth, liquidity, and orderliness depends on the presence in the marketplace of willing buyers and sellers of the Company's common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which the Company has no control. During any period of lower trading volume of the Company's common stock, significant sales of shares of the Company's common stock, or the expectation of these sales could cause the Company's common stock price to fall.

The Company's Articles of Incorporation, Indiana law, and certain banking laws may have an anti-takeover effect.

Provisions of the Company's Articles of Incorporation, the Indiana Business Corporation Law and federal banking laws, including regulatory approval requirements, could make it more difficult for a third party to acquire the Company, even if doing so would be perceived to be beneficial by the Company's shareholders. The combination of these provisions could have the effect of inhibiting a non-negotiated merger or other business combination, which, in turn, could adversely affect the market price of the Company's common stock.

The Company may issue additional securities, which could dilute the ownership percentage of holders of the Company's common stock.

The Company may issue additional securities to, among other reasons, raise additional capital or finance acquisitions, and, if it does, the ownership percentage of holders of the Company's common stock could be diluted potentially materially.

We may not be able to pay dividends in the future in accordance with past practice.

The Company has traditionally paid a quarterly dividend to common shareholders. The payment of dividends is subject to legal and regulatory restrictions. Any payment of dividends in the future will depend, in large part, on our earnings, capital requirements, financial condition and other factors considered relevant by the Company's Board of Directors. The Board may, at its discretion, further reduce or eliminate dividends or change its dividend policy in the future.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The following table sets forth certain information regarding the Bank's offices as of December 31, 2015.

<u>Location</u>	Year Opened	Net Book Value ⁽¹⁾ (Dollars in thousands)	Owned/ Leased	Approximate Square Footage
Main Office:				
220 Federal Drive, N.W. Corydon, Indiana 47112	1997	\$ 1,556	Owned	12,000
Branch Offices:				
391 Old Capital Plaza, N.E. Corydon, Indiana 47112	1997	65	Leased ⁽²⁾	425
8095 State Highway 135, N.W. New Salisbury, Indiana 47161	1999	510	Owned	3,500
710 Main Street Palmyra, Indiana 47164	1991	1,294	Owned	6,000
9849 Highway 150 Greenville, Indiana 47124	1986	171	Owned	2,484
5100 State Road 64 (Edwardsville Branch) Georgetown, Indiana 47122	2008	1,178	Owned	4,988
4303 Charlestown Crossing New Albany, Indiana 47150	1999	685	Owned	3,500
3131 Grant Line Road New Albany, Indiana 47150	2003	1,515	Owned	12,200
5609 Williamsburg Station Road Floyds Knobs, Indiana 47119	2003	552	Owned	4,160
2744 Allison Lane Jeffersonville, Indiana 47130	2003	1,089	Owned	4,090
1312 S. Jackson Street Salem, Indiana 47167	2007	848	Owned	3,400

Edgar Filing: FIRST CAPITAL INC - Form 10-K

2420 Barron Avenue NE Lanesville, Indiana 47136	2010	785	Owned	1,450
1612 Highway 44 East Shepherdsville, Kentucky 40165	1980	1,399	Owned	11,892
130 S. Buckman Street Shepherdsville, Kentucky 40165	1962	272	Owned	3,840
550 John Harper Highway Shepherdsville, Kentucky 40165	1999	1,064	Owned	6,648
100 S. Bardstown Road Mount Washington, Kentucky 40047	1991	749	Owned	5,169
140 S. Poplar Street Lebanon Junction, Kentucky 40150	1973	137	Owned	2,795

(1) Represents the net value of land, buildings, furniture, fixtures and equipment owned by the Bank.
(2) Lease expires in April 2020.

ITEM 3. LEGAL PROCEEDINGS

At December 31, 2015, neither the Company nor the Bank was involved in any pending legal proceedings believed by management to be material to the Company's financial condition or results of operations. From time to time, the Bank is involved in legal proceedings occurring in the ordinary course of business. Such routine legal proceedings, in the aggregate, are believed by management to be immaterial to the Company's financial condition, results of operations or cash flows.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The common shares of the Company are traded on the NASDAQ Capital Market under the symbol "FCAP." As of December 31, 2015, the Company had 1,121 stockholders of record and 3,338,603 common shares outstanding. This does not reflect the number of persons whose shares are in nominee or "street" name accounts through brokers. See Note 20 in the accompanying Notes to Consolidated Financial Statements for information regarding dividend restrictions applicable to the Company, which is incorporated herein by reference.

The following table lists quarterly market price and dividend information per common share for the years ended December 31, 2015 and 2014 as reported by NASDAQ.

High	Low		Market
Sale	Sale	Dividends	price end of period

2015

First Quarter	\$24.95	\$22.75	\$ 0.21	\$24.17
Second Quarter	28.25	23.51	0.21	27.07
Third Quarter	27.99	25.44	0.21	26.36
Fourth Quarter	27.37	23.08	0.21	26.10

2014

First Quarter	\$21.50	\$20.20	\$ 0.21	\$20.60
Second Quarter	21.20	20.00	0.21	21.11
Third Quarter	23.50	20.55	0.21	23.45
Fourth Quarter	24.77	23.00	0.21	24.34

Purchases of Equity Securities

On August 19, 2008, the board of directors authorized the repurchase of up to 240,467 shares of the Company's outstanding common stock. The stock repurchase program will expire upon the purchase of the maximum number of shares authorized under the program, unless the board of directors terminates the program earlier. There were no shares purchased under the stock repurchase program during the quarter ended December 31, 2015. The maximum number of shares that may yet be purchased under the plan is 144,671.

Equity Compensation Plan Information as of December 31, 2015

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	-	N/A	204,000
Equity compensation plans not approved by security holders	-	N/A	-
Total	-	N/A	204,000

The Company does not maintain any equity compensation plans that have not been approved by security holders.

ITEM 6. SELECTED FINANCIAL DATA

The consolidated financial data presented below is qualified in its entirety by the more detailed financial data appearing elsewhere in this report, including the Company's audited consolidated financial statements.

FINANCIAL CONDITION DATA:	At December 31,				
	2015	2014	2013	2012	2011
	(In thousands)				
Total assets	\$715,827	\$472,761	\$444,384	\$459,132	\$438,886
Cash and cash equivalents (1)	109,174	33,243	11,136	20,411	18,923
Securities available for sale	186,751	100,226	108,762	122,973	111,440
Interest-bearing time deposits	16,655	8,270	4,425	1,400	0
Net loans	359,166	300,603	288,506	280,407	276,047
Deposits	637,177	412,636	373,830	384,343	364,374
Retail repurchase agreements	0	0	9,310	14,092	9,125
Advances from FHLB	0	0	5,500	5,100	12,350
Stockholders' equity, net of noncontrolling interest in subsidiary	74,396	57,121	53,227	52,824	50,942
	For the Year Ended				
	December 31,				
	2015	2014	2013	2012	2011
	(In thousands)				
Interest income	\$18,713	\$18,399	\$18,411	\$18,800	\$20,273
Interest expense	1,004	1,144	1,653	2,465	3,760
Net interest income	17,709	17,255	16,758	16,335	16,513
Provision for loan losses	50	190	725	1,525	1,825
Net interest income after provision for loan losses	17,659	17,065	16,033	14,810	14,688
Noninterest income	5,124	4,936	4,640	4,537	4,051
Noninterest expense	15,608	14,082	13,331	13,853	13,211
Income before income taxes	7,175	7,919	7,342	5,494	5,528
Income tax expense	1,964	2,312	2,255	1,559	1,543
Net Income	5,211	5,607	5,087	3,935	3,985
Less: net income attributable to noncontrolling interest in subsidiary	13	13	13	13	13
Net Income Attributable to First Capital, Inc.	\$5,198	\$5,594	\$5,074	\$3,922	\$3,972
	PER SHARE DATA (2):				
Net income - basic	\$1.87	\$2.03	\$1.82	\$1.41	\$1.43
Net income - diluted	1.87	2.03	1.82	1.41	1.43
Dividends	0.84	0.84	0.80	0.76	0.76

-
- (1) Includes cash and due from banks, interest-bearing deposits in other depository institutions and federal funds sold.
(2) Per share data excludes net income attributable to noncontrolling interest in subsidiary.

SELECTED FINANCIAL RATIOS:	At or For the Year Ended											
	December 31,		2015		2014		2013		2012		2011	
Performance Ratios:												
Return on assets (1)	1.06	%	1.22	%	1.11	%	0.86	%	0.90	%		
Return on average equity (2)	8.65	%	10.09	%	9.56	%	7.54	%	8.04	%		
Dividend payout ratio (3)	44.92	%	41.38	%	43.96	%	53.90	%	53.15	%		
Average equity to average assets	12.30	%	12.08	%	11.65	%	11.46	%	11.13	%		
Interest rate spread (4)	3.96	%	4.06	%	3.98	%	3.86	%	3.98	%		
Net interest margin (5)	4.03	%	4.14	%	4.07	%	4.00	%	4.14	%		
Noninterest expense to average assets	3.19	%	3.07	%	2.93	%	3.05	%	2.98	%		
Average interest earning assets to average interest bearing liabilities	129.61	%	127.64	%	124.42	%	124.39	%	118.79	%		
Regulatory Capital Ratios (Bank only):												
Tier 1 leverage ratio	12.15	%	10.59	%	10.89	%	10.00	%	10.06	%		
Tier 1 risk-based capital ratio	15.26	%	14.55	%	14.86	%	14.35	%	16.11	%		
Common equity tier 1 capital ratio (6)	15.26	%	N/A		N/A		N/A		N/A			
Total risk-based capital ratio	16.07	%	15.80	%	16.11	%	15.60	%	17.05	%		
Asset Quality Ratios:												
Nonperforming loans as a percent of net loans (7)	1.27	%	1.07	%	1.90	%	2.81	%	2.81	%		
Nonperforming assets as a percent of total assets (8)	1.32	%	0.70	%	1.34	%	1.78	%	1.92	%		
Allowance for loan losses as a percent of gross loans receivable	0.93	%	1.57	%	1.64	%	1.64	%	1.47	%		

(1) Net income attributable to First Capital, Inc. divided by average assets.

(2) Net income attributable to First Capital, Inc. divided by average equity.

(3) Common stock dividends declared per share divided by net income per share.

(4) Difference between weighted average yield on interest-earning assets and weighted average cost of interest-bearing liabilities. Tax exempt income is reported on a tax equivalent basis using a federal marginal tax rate of 34%.

(5) Net interest income as a percentage of average interest-earning assets.

(6) The common equity tier 1 capital ratio became effective January 1, 2015.

(7) Nonperforming loans consist of loans accounted for on a nonaccrual basis and accruing loans 90 days or more past due.

(8) Nonperforming assets consist of nonperforming loans and real estate acquired in settlement of loans.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

General

As the holding company for the Bank, the Company conducts its business primarily through the Bank. The Bank's results of operations depend primarily on net interest income, which is the difference between the income earned on its interest-earning assets, such as loans and investments, and the cost of its interest-bearing liabilities, consisting primarily of deposits, retail repurchase agreements and borrowings from the FHLB. The Bank's net income is also affected by, among other things, fee income, provisions for loan losses, operating expenses and income tax provisions. The Bank's results of operations are also significantly affected by general economic and competitive conditions, particularly changes in market interest rates, government legislation and policies concerning monetary and fiscal affairs, housing and financial institutions and the intended actions of the regulatory authorities.

Management uses various indicators to evaluate the Company's financial condition and results of operations. Many of these indicators were affected by the Peoples acquisition as one-time acquisition expenses associated with the acquisition and integration of Peoples were partially offset by increases in net interest income after provision for loan losses, noninterest income and the effect of purchase accounting adjustments. Indicators include the following:

Net income and earnings per share – Net income attributable to the Company was \$5.2 million, or \$1.87 per diluted share for 2015 compared to \$5.6 million, or \$2.03 per diluted share for 2014. Excluding one-time acquisition-related expenses and the effect of purchase accounting adjustments, the Company would have reported net income of \$6.0 million, or \$2.16 per share for 2015.

Return on average assets and return on average equity – Return on average assets for 2015 was 1.06% compared to 1.22% for 2014, and return on average equity for 2015 was 8.65% compared to 10.09% for 2014.

Efficiency ratio – The Company's efficiency ratio (defined as noninterest expenses divided by net interest income plus noninterest income) was 68.4% for 2015 compared to 63.5% for 2014. This increase was primarily due to one-time costs associated with the acquisition. Excluding one-time acquisition-related expenses and the effect of purchase accounting adjustments, the efficiency ratio would have been 64.2% for 2015.

Asset quality – Net loan charge-offs increased from \$266,000 for 2014 to \$1.5 million for 2015. The increase net charge-offs recognized for 2015 primarily relates to a \$1.2 million charge-off on a commercial loan that had been fully reserved for in prior periods. In addition, total nonperforming assets (consisting of nonperforming loans and foreclosed real estate) increased \$6.2 million from \$3.3 million, or 0.70% of total assets, at December 31, 2014 to \$9.5 million, or 1.32% of total assets, at December 31, 2015. The increase in nonperforming assets for 2015 is wholly attributable to the Peoples acquisition as nonperforming assets acquired from Peoples totaled \$6.3 million at December 31, 2015. The allowance for loan losses was 0.93% of total loans and 74.6% of nonperforming loans at

Edgar Filing: FIRST CAPITAL INC - Form 10-K

December 31, 2015 compared to 1.57% of total loans and 150.3% at December 31, 2014. Again, these ratios were negatively impacted by the Peoples acquisition as the Peoples loans, with a fair value of \$55.7 million, were acquired with no allowance for loan losses in accordance with U.S. GAAP.

Shareholder return – Total shareholder return, including the increase in the Company's stock price from \$24.34 at December 31, 2014 to \$26.10 at December 31, 2015 and dividends of \$0.84 per share, was 10.7% for 2015.

Management's discussion and analysis of financial condition and results of operations is intended to assist in understanding the financial condition and results of operations of the Company and the Bank. The information contained in this section should be read in conjunction with the consolidated financial statements and the accompanying notes to consolidated financial statements included elsewhere in this report.

Operating Strategy

The Company is the parent company of an independent community-oriented financial institution that delivers quality customer service and offers a wide range of deposit, loan and investment products to its customers. The commitment to customer needs, the focus on providing consistent customer service, and community service and support are the keys to the Bank's past and future success. The Company has no other material income other than that generated by the Bank and its subsidiaries.

The Bank's primary business strategy is attracting deposits from the general public and using those funds to originate residential mortgage loans, multi-family residential loans, commercial real estate and business loans and consumer loans. The Bank invests excess liquidity primarily in interest-bearing deposits with the FHLB and other financial institutions, federal funds sold, U.S. government and agency securities, local municipal obligations and mortgage-backed securities.

In recent years, the Company's operating strategy has also included strategies designed to enhance profitability by increasing sources of noninterest income and improving operating efficiency while managing its capital and limiting its credit risk and interest rate risk exposures. To accomplish these objectives, the Company has focused on the following:

Monitoring asset quality and credit risk in the loan and investment portfolios, with an emphasis on reducing nonperforming assets and originating high-quality commercial and consumer loans. As noted above, nonperforming assets acquired with Peoples totaled \$6.3 million at December 31, 2015. A key focus of management in 2016 will be the reduction of nonperforming assets through improved collection efforts and underwriting on nonperforming loans and the sale of foreclosed real estate properties.

Being active in the local community, particularly through our efforts with local schools, to uphold our high standing in our community and marketing to our next generation of customers.

Improving profitability by expanding our product offerings to customers and investing in technology to increase the productivity and efficiency of our staff.

Continuing to emphasize commercial real estate and other commercial business lending as well as consumer lending. The Bank will also continue to focus on increasing secondary market lending as a source of noninterest income. With our acquisition of Peoples in 2015, management intends to focus on growth in the loan portfolio as well as the implementation of a secondary market lending program in the Bullitt County, Kentucky market.

- Growing commercial and personal demand deposit accounts which provide a low-cost funding source.

- Evaluating vendor contracts for potential cost savings and efficiencies.

Continuing our capital management strategy to enhance shareholder value through the repurchase of Company stock and the payment of dividends.

Evaluating growth opportunities to expand the Bank's market area and market share through acquisitions of other financial institutions or branches of other institutions. The acquisition of Peoples in December 2015 expanded our market area into Bullitt County, Kentucky, where Peoples was the leader in deposit account market share among FDIC-insured institutions. Our focus in 2016 will be on the integration of the Peoples customers into our bank and the enhancement and expansion of our customer relationships in this new market.

Ensuring that the Company attracts and retains talented personnel and that an optimal level of performance and customer service is promoted at all levels of the Company.

Critical Accounting Policies and Estimates

The accounting and reporting policies of the Company comply with U.S. GAAP and conform to general practices within the banking industry. The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions. The financial position and results of operations can be affected by these estimates and assumptions, which are integral to understanding reported results. Critical accounting policies are those policies that require management to make assumptions about matters that are highly uncertain at the time an accounting estimate is made; and different estimates that the Company reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the Company's financial condition, changes in financial condition or results of operations. Most accounting policies are not considered by management to be critical accounting policies. Several factors are considered in determining whether or not a policy is critical in the preparation of financial statements. These factors include, among other things, whether the estimates are significant to the financial statements, the nature of the estimates, the ability to readily validate the estimates with other information including third parties or available prices, and sensitivity of the estimates to changes in economic conditions and whether alternative accounting methods may be utilized under U.S. GAAP.

Significant accounting policies, including the impact of recent accounting pronouncements, are discussed in Note 1 of the accompanying Notes to Consolidated Financial Statements, which is incorporated herein by reference. Those policies considered to be critical accounting policies are described below.

Allowances for Loan Losses. The allowance for loan losses is the amount estimated by management as necessary to cover losses inherent in the loan portfolio at the balance sheet date. The allowance is established through the provision for loan losses, which is charged to income. Determining the amount of the allowance for loan losses necessarily involves a high degree of judgment. Among the material estimates required to establish the allowance are: loss exposure at default; the amount and timing of future cash flows on impacted loans; value of collateral; and determination of loss factors to be applied to the various elements of the portfolio. All of these estimates are susceptible to significant change. Management reviews the level of the allowance at least quarterly and establishes the provision for loan losses based upon an evaluation of the portfolio, past loss experience, current economic conditions and other factors related to the collectability of the loan portfolio. Although we believe that we use the best information available to establish the allowance for loan losses, future adjustments to the allowance may be necessary if economic or other conditions differ substantially from the assumptions used in making the evaluation. In addition, the OCC, as an integral part of its examination process, periodically reviews our allowance for loan losses and may require us to recognize adjustments to the allowance based on its judgments about information available to it at the time of its examination. A large loss could deplete the allowance and require increased provisions to replenish the allowance, which would adversely affect earnings. Note 1 and Note 5 of the accompanying Notes to Consolidated Financial Statements, which are incorporated herein by reference, describe the methodology used to determine the allowance for loan losses. The Company has not made any substantive changes to its methodology for determining the allowance for loan losses during the year ended December 31, 2015, and there have been no material changes in the assumptions or estimation techniques compared to the prior year.

Valuation Methodologies. In the ordinary course of business, management applies various valuation methodologies to assets and liabilities that often involve a significant degree of judgment, particularly when active markets do not exist for the items being valued. Generally, in evaluating various assets for potential impairment, management compares the fair value to the carrying value. Quoted market prices are referred to when estimating fair values for certain assets, such as certain investment securities. For investment securities for which quoted market prices are not available, the Company obtains fair value measurements from an independent pricing service. However, for those items for which market-based prices do not exist and an independent pricing service is not readily available, management utilizes significant estimates and assumptions to value such items. Examples of these items include goodwill and other intangible assets, acquired loans and deposits, foreclosed and other repossessed assets, impaired loans, stock-based compensation and certain other financial investments. The use of different assumptions could produce significantly different results, which could have material positive or negative effects on the Company's results of operations. Note 22 and Note 23 of the accompanying Notes to Consolidated Financial Statements, which are incorporated herein by reference, describe the methodologies used to determine the fair value of investment securities, impaired loans, foreclosed real estate and other assets. There were no changes in the valuation techniques and related inputs used during the year ended December 31, 2015.

Results of Operations for the Year Ended December 31, 2015 Compared to the Year Ended December 31, 2014

Net Income. Net income attributable to the Company was \$5.2 million (\$1.87 per share diluted; weighted average common shares outstanding of 2,783,912, as adjusted) for the year ended December 31, 2015 compared to \$5.6 million (\$2.03 per share diluted; weighted average common shares outstanding of 2,755,588, as adjusted) for the year ended December 31, 2014. As previously mentioned in this report, if the one-time acquisition-related expenses and the effect of purchase accounting adjustments are excluded from earnings, the Company would have reported net income of \$6.0 million, or \$2.16 per diluted share, for the year ended December 31, 2015.

Net Interest Income. Net interest income increased \$454,000, or 2.6%, from \$17.3 million for 2014 to \$17.7 million for 2015 primarily due to an increase in the average balance of interest-earning assets partially offset by a decrease in the interest rate spread, the difference between the average tax-equivalent yield on interest-earning assets and the average cost of interest-bearing liabilities.

Total interest income increased \$314,000 for 2015 as compared to 2014. This increase was primarily a result of the average balance of interest-earning assets increasing from \$432.6 million for 2014 to \$454.4 million for 2015 partially offset by the tax-equivalent yield on interest-earning assets decreasing from 4.40% for 2014 to 4.25% for 2015. Interest on loans increased \$276,000 as a result of the average balance of loans increasing from \$301.4 million for 2014 to \$308.5 million for 2015 partially offset by the average tax-equivalent yield on loans decreasing from 5.32% for 2014 to 5.29% for 2015. Interest and dividends on investment securities (including FHLB stock) decreased \$52,000 for 2015 compared to 2014 due to a decrease in the average balance of investment securities from \$108.0 million for 2014 to \$104.8 million for 2015. The average tax-equivalent yield of investment securities remained at 2.69% for 2014 and 2015. Management continued to focus loan origination efforts on commercial and consumer loans during 2015. Market interest rates remained at near historic lows throughout 2015, so as loans and investment securities mature or pay down they are replaced with lower yielding new loan originations and investment purchases. Other interest income increased \$90,000 for 2015 as compared to 2014 primarily due to the average balance of federal funds sold and interest-bearing deposits with banks increasing from \$23.2 million for 2014 to \$41.2 million for 2015.

Total interest expense decreased \$140,000, from \$1.1 million for 2014 to \$1.0 million for 2015, due to a decrease in the average cost of funds from 0.34% for 2014 to 0.29% for 2015, which was more than enough to offset an increase in the average balance of interest-bearing liabilities from \$338.9 million for 2014 to \$350.6 million for 2015. Interest expense on deposits decreased 11.3% from \$1.1 million for 2014 to \$1.0 million for 2015 as a result of a decrease in the average cost of interest-bearing deposits, which decreased from 0.34% for 2014 to 0.29% for 2015 partially offset by an increase in the average balance of interest-bearing deposits from \$333.2 million for 2014 to \$350.2 million for 2015. For further information, see “Average Balances and Yields” below. The changes in interest income and interest expense resulting from changes in volume and changes in rates for 2015 and 2014 are shown in the schedule captioned “Rate/Volume Analysis” included herein.

Provision for Loan Losses. The provision for loan losses was \$50,000 for 2015 compared to \$190,000 for 2014. The consistent application of management’s allowance methodology resulted in a decrease in the provision for loan losses

for 2015. Net charge-offs increased when comparing the two periods, from \$266,000 for 2014 to \$1.5 million for 2015. As mentioned previously in this report, net charge-offs recognized in 2015 primarily related to a \$1.2 million charge-off on a commercial loan that had been fully reserved for in prior periods. The provisions were recorded to bring the allowance to the level determined in applying the allowance methodology after reduction for net charge-offs during the year.

Provisions for loan losses are charges to earnings to maintain the total allowance for loan losses at a level considered reasonable by management to provide for probable known and inherent loan losses based on management's evaluation of the collectability of the loan portfolio, including the nature of the portfolio, credit concentrations, trends in historical loss experience, specified impaired loans and economic conditions. Although management uses the best information available, future adjustments to the allowance may be necessary due to changes in economic, operating, regulatory and other conditions that may be beyond the Bank's control. While the Bank maintains the allowance for loan losses at a level that it considers adequate to provide for estimated losses, there can be no assurance that further additions will not be made to the allowance for loan losses and that actual losses will not exceed the estimated amounts.

Noninterest income. Noninterest income increased \$188,000 to \$5.1 million for 2015 compared to \$4.9 million for 2014. Service charges on deposit accounts and gains on the sale of loans increased by \$251,000 and \$130,000, respectively, when comparing the two periods. The increase in the gains on the sale of loans was primarily due to an increase in the Bank's sales activity of commercial Small Business Administration loans during 2015. Commission income decreased \$132,000 for 2015 compared to the prior year primarily due to lower commissions on investment advisory services.

Noninterest expense. Noninterest expense increased \$1.5 million, or 10.8%, to \$15.6 million for 2015 compared to \$14.1 million for 2014. The increase was primarily due to \$1.0 million in costs related to the acquisition and subsequent integration of Peoples. In addition, compensation and benefits increased \$260,000 and data processing expenses increased \$142,000 for 2015 compared to 2014. The increase in compensation and benefits is primarily due to increased staff from the Peoples locations for December and normal increases in salaries and benefits.

Income tax expense. The Company recognized income tax expense of \$2.0 million for 2015 compared to \$2.3 million for 2014. The effective tax rate decreased from 29.2% for 2014 to 27.4% for 2015 primarily due to the tax benefit provided by the captive insurance subsidiary which was organized in September 2014.

Average Balances and Yields. The following table sets forth certain information for the periods indicated regarding average balances of assets and liabilities, as well as the total dollar amounts of interest income from average interest-earnings assets and interest expense on average interest-bearing liabilities and average yields and costs. Such yields and costs for the periods indicated are derived by dividing income or expense by the average historical cost balances of assets or liabilities, respectively, for the periods presented and do not give effect to changes in fair value that are included as a separate component of stockholders' equity. Average balances are derived from daily balances. Tax-exempt income on loans and investment securities has been adjusted to a tax equivalent basis using the federal marginal tax rate of 34%.

(Dollars in thousands)	Year Ended December 31,									
	2015			2014			2013			
	Average Balance	Interest	Average Yield/ Cost		Average Balance	Interest	Average Yield/ Cost	Average Balance	Interest	Average Yield/ Cost
Interest-earning assets:										
Loans (1) (2):										
Taxable	\$303,455	\$16,006	5.27 %	\$296,560	\$15,741	5.31 %	\$286,514	\$15,748	5.50 %	
Tax-exempt	5,012	313	6.25 %	4,875	296	6.07 %	2,382	129	5.42 %	
Total loans	308,467	16,319	5.29 %	301,435	16,037	5.32 %	288,896	15,877	5.50 %	
Investment securities:										
Taxable (3)	73,405	1,310	1.78 %	76,136	1,299	1.71 %	83,876	1,392	1.66 %	
Tax-exempt	31,397	1,507	4.80 %	31,872	1,603	5.03 %	32,654	1,689	5.17 %	
Total investment securities	104,802	2,817	2.69 %	108,008	2,902	2.69 %	116,530	3,081	2.64 %	
Other interest-earning assets (4)	41,155	195	0.47 %	23,155	105	0.45 %	21,198	72	0.34 %	
Total interest-earning assets	454,424	19,331	4.25 %	432,598	19,044	4.40 %	426,624	19,030	4.46 %	
Noninterest-earning assets	34,155			26,370			28,959			
Total assets	\$488,579			\$458,968			\$455,583			
Interest-bearing liabilities:										
Interest-bearing demand deposits										
Interest-bearing demand deposits	\$193,350	\$456	0.24 %	\$178,632	\$403	0.23 %	\$168,774	\$412	0.24 %	
Savings accounts	85,676	117	0.14 %	73,670	73	0.10 %	65,587	65	0.10 %	
Time deposits	71,194	427	0.60 %	80,890	651	0.80 %	93,375	997	1.07 %	
Total deposits	350,220	1,000	0.29 %	333,192	1,127	0.34 %	327,736	1,474	0.45 %	
Retail repurchase agreements	0	0	0.00 %	4,601	12	0.26 %	11,015	28	0.25 %	
Borrowed funds	401	4	1.00 %	1,137	5	0.44 %	4,135	151	3.65 %	
Total interest-bearing liabilities	350,621	1,004	0.29 %	338,930	1,144	0.34 %	342,886	1,653	0.48 %	
Noninterest-bearing liabilities:										
Noninterest-bearing deposits	75,368			64,344			58,167			
Other liabilities	2,483			262			1,462			

Edgar Filing: FIRST CAPITAL INC - Form 10-K

Total liabilities	428,472		403,536		402,515	
Stockholders' equity (5)	60,107		55,432		53,068	
Total liabilities and stockholders' equity	\$488,579		\$458,968		\$455,583	
Net interest income		\$18,327		\$17,900		\$17,377
Interest rate spread		3.96 %		4.06 %		3.98 %
Net interest margin		4.03 %		4.14 %		4.07 %
Ratio of average interest – earning assets to average interest-bearing liabilities		129.61 %		127.64 %		124.42 %

(1) Interest income on loans includes fee income of \$756,000, \$707,000 and \$754,000 for the years ended December 31, 2015, 2014, and 2013, respectively.

(2) Average loan balances include loans held for sale and nonperforming loans.

(3) Includes taxable debt and equity securities and FHLB stock.

(4) Includes interest-bearing deposits with banks, federal funds sold and interest-bearing time deposits.

(5) Stockholders' equity attributable to First Capital, Inc.

Rate/Volume Analysis. The following table sets forth the effects of changing rates and volumes on net interest income and interest expense computed on a tax-equivalent basis. Information is provided with respect to (i) effects on interest income attributable to changes in volume (changes in volume multiplied by prior rate); (ii) effects attributable to changes in rate (changes in rate multiplied by prior volume); and (iii) effects attributable to changes in rate and volume (change in rate multiplied by changes in volume). Tax exempt income on loans and investment securities has been adjusted to a tax-equivalent basis using the federal marginal tax rate of 34%.

	2015 Compared to 2014				2014 Compared to 2013			
	Increase (Decrease) Due to				Increase (Decrease) Due to			
	Rate/		Volume Net		Rate/		Volume Net	
	Rate	Volume	Volume	Net	Rate	Volume	Volume	Net
	(In thousands)							
Interest-earning assets:								
Loans:								
Taxable	\$(111)	\$ 379	\$ (3)	\$265	\$(543)	\$ 555	\$(19)	\$(7)
Tax-exempt	9	8	0	17	15	136	16	167
Total loans	(102)	387	(3)	282	(528)	691	(3)	160
Investment securities:								
Taxable	57	(44)	(2)	11	41	(130)	(4)	(93)
Tax-exempt	(73)	(24)	1	(96)	(47)	(40)	1	(86)
Total investment securities	(16)	(68)	(1)	(85)	(6)	(170)	(3)	(179)
Other interest-earning assets								
Total net change in income on interest-earning assets	(113)	400	0	287	(510)	528	(4)	14
Interest-bearing liabilities:								
Interest-bearing deposits	(173)	55	(9)	(127)	(365)	24	(6)	(347)
Retail repurchase agreements	(12)	(12)	12	(12)	1	(16)	(1)	(16)
Borrowed funds	6	(3)	(4)	(1)	(133)	(109)	96	(146)
Total net change in expense on interest-bearing liabilities	(179)	40	(1)	(140)	(497)	(101)	89	(509)
Net change in net interest income	\$66	\$ 360	\$ 1	\$427	\$(13)	\$629	\$(93)	\$523

Comparison of Financial Condition at December 31, 2015 and 2014

Total assets increased from \$472.8 million at December 31, 2014 to \$715.8 million at December 31, 2015. As part of the Peoples acquisition, the Company acquired total assets with a fair value of \$240.5 million and assumed liabilities with a fair value of \$210.9 million. In accounting for the acquisition, \$1.4 million was assigned to a core deposit intangible and the excess of cost over the fair value of the acquired net assets of \$1.1 million was recorded as goodwill.

Net loans increased from \$300.6 million at December 31, 2014 to \$359.2 million at December 31, 2015, including loans acquired from Peoples with a recorded investment of \$54.8 million. The primary contributing factor to the increase in net loans was an increase of \$41.3 million in residential mortgage loans, of which \$35.6 million was acquired from Peoples. The Bank also increased commercial real estate loans, residential construction loans and consumer loans by \$6.2 million, \$6.0 million and \$8.8 million, respectively, during 2015, including Peoples loans of \$10.7 million, \$3.1 million and \$3.8 million, respectively. Excluding the loans acquired from Peoples, the Bank still reported a modest increase in residential mortgage loans despite continuing to sell the majority of newly originated residential mortgage loans in the secondary market. The Bank originated \$31.5 million in new residential mortgages for sale in the secondary market during 2015 compared to \$29.1 million in 2014. These loans were originated and funded by the Bank and sold in the secondary market. Of this total, \$6.0 million paid off existing loans in the Bank's portfolio. Originating mortgage loans for sale in the secondary market allows the Bank to better manage its interest rate risk, while offering a full line of mortgage products to prospective customers.

Securities available for sale, at fair value, consisting primarily of U.S. agency mortgage-backed obligations, U. S. agency notes and bonds, and municipal obligations, increased from \$100.2 million at December 31, 2014 to \$186.8 million at December 31, 2015. Securities acquired from Peoples totaled \$132.0 million and purchases of securities available for sale totaled \$34.0 million in 2015. These were offset by sales of \$45.4 million, maturities of \$19.4 million and principal repayments of \$13.5 million in 2015. The Bank invests excess cash in securities that provide safety, liquidity and yield. Accordingly, we purchase mortgage-backed securities to provide cash flow for loan demand and deposit changes, we purchase federal agency notes for short-term yield and low risk, and municipals are purchased to improve our tax equivalent yield focusing on longer term profitability.

Cash and cash equivalents increased from \$33.2 million at December 31, 2014 to \$109.2 million at December 31, 2015. The increase is due primarily to cash equivalents acquired from Peoples and proceeds from the sale of securities also acquired from Peoples in December 2015. Management intends to invest this excess liquidity in high-quality loans and investment securities in 2016 in order to improve interest income.

Foreclosed real estate increased from \$78,000 at December 31, 2014 to \$4.9 million at December 31, 2015. The increase is due primarily to foreclosed real estate acquired from Peoples which totaled \$4.3 million at the acquisition date. This amount includes the Contingent Assets identified in Note 2 in the accompanying Notes to Consolidated Financial Statements, which is incorporated herein by reference. See Note 2 for the potential impact the sale of this property could have on the total cash consideration paid as part of the Peoples acquisition.

Total deposits increased \$224.6 million from \$412.6 million at December 31, 2014 to \$637.2 million at December 31, 2015, including deposits with a fair value of \$209.5 million acquired from Peoples. During 2015, interest-bearing demand deposit accounts increased \$85.2 million, savings accounts increased \$66.4 million and noninterest-bearing demand deposits increased \$52.0 million, with each of the increases due primarily to the Peoples acquisition. Excluding certificates of deposit acquired from Peoples totaling \$34.2 million, the balance of certificates of deposit would have decreased \$13.3 million during 2015. This continues a trend of decreasing certificate of deposit balances as some customers are unwilling to lock into long-term commitments while interest rates remain at their current low levels.

Total stockholders' equity attributable to the Company increased \$17.3 million from \$57.1 million at December 31, 2014 to \$74.4 million at December 31, 2015. This increase is primarily due to the issuance of common stock in relation to the Peoples acquisition of \$14.8 million and retained net income of \$2.8 million. This was partially offset by a net unrealized loss on available for sale securities of \$303,000. As of December 31, 2015, the Company had repurchased 95,796 shares of the 240,467 shares authorized by the Board of Directors under the current stock repurchase program which was announced in August 2008 and 424,330 shares since the original repurchase program began in 2001.

Off-Balance-Sheet Arrangements

The Company is a party to financial instruments with off-balance-sheet risk including commitments to extend credit under existing lines of credit and commitments to originate loans. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated financial statements.

Off-balance-sheet financial instruments whose contract amounts represent credit and interest rate risk are summarized as follows:

	At December 31,	
	2015	2014
	(In thousands)	
Commitments to originate new loans	\$7,861	\$7,413
Undisbursed portion of construction loans	4,869	3,325
Unfunded commitments to extend credit under existing commercial and personal lines of credit	60,698	48,328
Standby letters of credit	1,287	693

The Company does not have any special purpose entities, derivative financial instruments or other forms of off-balance-sheet financing arrangements.

Commitments to originate new loans or to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Most equity line commitments are for a term of five to 10 years and commercial lines of credit are generally renewable on an annual basis. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amounts of collateral obtained, if deemed necessary by the Company upon extension of credit, are based on management's credit evaluation of the borrower.

Contractual Obligations

The following table summarizes information regarding the Company's contractual obligations as of December 31, 2015:

	Payments due by period				
	Total	Less than 1 Year	1 – 3 Years	3 – 5 Years	More than 5 Years
	(In thousands)				
Deposits	\$637,177	\$589,315	\$37,595	\$10,267	\$ 0
Operating lease obligations	81	19	38	24	0
Total contractual obligations	\$637,258	\$589,334	\$37,633	\$10,291	\$ 0

Liquidity and Capital Resources

Liquidity refers to the ability of a financial institution to generate sufficient cash flow to fund current loan demand, meet deposit withdrawals and pay operating expenses. The Bank's primary sources of funds are new deposits, proceeds from loan repayments and prepayments and proceeds from the maturity of securities. The Bank may also borrow from the FHLB. While loan repayments and maturities of securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by market interest rates, general economic conditions and competition. At December 31, 2015, the Bank had cash and interest-bearing deposits with banks (including interest-bearing time deposits) of \$125.8 million and securities available for sale with a fair value of \$186.8 million. If the Bank requires funds beyond its ability to generate them internally, it has additional borrowing capacity with the FHLB, collateral eligible for repurchase agreements and an unsecured federal funds purchased line of credit with another financial institution.

The Bank must maintain an adequate level of liquidity to ensure the availability of sufficient funds to support loan growth and deposit withdrawals, to satisfy financial commitments and to take advantage of investment opportunities. At December 31, 2015, the Bank had total commitments to extend credit of \$74.7 million. See Note 18 in the accompanying Notes to Consolidated Financial Statements, which is incorporated herein by reference. At December 31, 2015, the Bank had certificates of deposit scheduled to mature within one year of \$48.8 million. Historically, the Bank has been able to retain a significant amount of its deposits as they mature.

The Company is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, the Company requires funds to pay any dividends to its shareholders and to repurchase any shares of its common stock. The Company's primary source of income is dividends received from the Bank. The amount of dividends the Bank may declare and pay to the Company in any calendar year, without the receipt of prior approval from the OCC but with prior notice to the OCC, cannot exceed net income for that year to date plus retained net income (as defined) for the preceding two calendar years. At December 31, 2015, the Company (on an unconsolidated basis) had liquid assets of \$461,000. If the Company requires funds beyond its ability to generate them internally or if the Bank is unable to make dividend payments, it has a \$1.0 million revolving line of credit with another financial institution.

The Bank is required to maintain specific amounts of capital pursuant to OCC regulations. As of December 31, 2015 the Bank was in compliance with all regulatory capital requirements which were effective as of such date with Tier 1 capital to average assets, Tier 1 capital to risk-weighted assets, common equity Tier 1 capital to risk-weighted assets and total risk-based capital to risk-weighted assets ratios of 12.2%, 15.3%, 15.3% and 16.1%, respectively. See Note 21 in the accompanying Notes to Consolidated Financial Statements, which is incorporated herein by reference.

Effect of Inflation and Changing Prices

The consolidated financial statements and related financial data presented in this report have been prepared in accordance with U.S. GAAP, which generally require the measurement of financial position and operating results in terms of historical dollars, without considering the changes in relative purchasing power of money over time due to inflation. The primary impact of inflation is reflected in the increased cost of the Bank's operations. Unlike most industrial companies, virtually all the assets and liabilities of the financial institution are monetary in nature. As a result, interest rates generally have a more significant impact on the financial institution's performance than do general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

Market Risk Analysis

Qualitative Aspects of Market Risk. Market risk is the risk that the estimated fair value of our assets and liabilities will decline as a result of changes in interest rates or financial market volatility, or that our net income will be significantly reduced by interest rate changes.

The Company's principal financial objective is to achieve long-term profitability while reducing its exposure to fluctuating market interest rates by operating within acceptable limits established for interest rate risk and maintaining adequate levels of funding and liquidity. The Company has sought to reduce the exposure of its earnings to changes in market interest rates by attempting to manage the mismatch between asset and liability maturities and interest rates. In order to reduce the exposure to interest rate fluctuations, the Company has developed strategies to manage its liquidity, shorten its effective maturities of certain interest-earning assets and decrease the interest rate sensitivity of its asset base. Management has sought to decrease the average maturity of its assets by emphasizing the origination of short-term commercial and consumer loans, all of which are retained by the Company for its portfolio. The Company relies on retail deposits as its primary source of funds. Management believes the use of retail deposits, compared to brokered deposits, reduces the effects of interest rate fluctuations because they generally represent a more stable source of funds.

Quantitative Aspects of Market Risk. The Company does not maintain a trading account for any class of financial instrument nor does the Company engage in hedging activities or purchase high-risk derivative instruments. Furthermore, the Company is not subject to foreign currency exchange rate risk or commodity price risk.

Potential cash flows, sales, or replacement value of many of our assets and liabilities, especially those that earn or pay interest, are sensitive to changes in the general level of interest rates. This interest rate risk arises primarily from our normal business activities of gathering deposits, extending loans and investing in investment securities. Many factors affect the Company's exposure to changes in interest rates, such as general economic and financial conditions, customer preferences, historical pricing relationships, and re-pricing characteristics of financial instruments. The Company's earnings can also be affected by the monetary and fiscal policies of the U.S. Government and its agencies, particularly the FRB.

An element in the Company's ongoing process is to measure and monitor interest rate risk using a Net Interest Income at Risk simulation to model the interest rate sensitivity of the balance sheet and to quantify the impact of changing interest rates on the Company. The model quantifies the effects of various possible interest rate scenarios on projected net interest income over a one-year horizon. The model assumes a semi-static balance sheet and measures the impact on net interest income relative to a base case scenario of hypothetical changes in interest rates over twelve months and provides no effect given to any steps that management might take to counter the effect of the interest rate movements. The scenarios include prepayment assumptions, changes in the level of interest rates, the shape of the yield curve, and spreads between market interest rates in order to capture the impact from re-pricing, yield curve, option, and basis risks.

Results of the Company's simulation modeling, which assumes an immediate and sustained parallel shift in market interest rates, project that the Company's net interest income could change as follows over a one-year horizon, relative to our base case scenario, based on December 31, 2015 and 2014 financial information.

At December 31,	At December 31,
2015	2014

Edgar Filing: FIRST CAPITAL INC - Form 10-K

Immediate Change in the Level of Interest Rates	One Year Horizon		One Year Horizon	
	Dollar Change (Dollars in thousands)	Percent Change	Dollar Change	Dollar Change
300bp	\$903	3.79 %	\$(193)	(1.08)%
200bp	756	3.18	192	1.08
100bp	442	1.86	241	1.35
Static	-	-	-	-
(100)bp	(1,296)	(5.44)	(367)	(2.05)

At December 31, 2015, the Company's simulated exposure to an increase in interest rates shows that an immediate and sustained increase in rates of 1.00% would increase the Company's net interest income by \$442,000, or 1.86%, over a one year horizon compared to a flat interest rate scenario. Furthermore, a rate increase of 2.00% or 3.00% would cause net interest income to increase by 3.18% and 3.79%, respectively. Alternatively, an immediate and sustained decrease in rates of 1.00% would decrease the Company's net interest income by 5.44% over a one year horizon compared to a flat interest rate scenario.

The Company also has longer term interest rate risk exposure, which may not be appropriately measured by Net Interest Income at Risk modeling. Therefore, the Company also uses an Economic Value of Equity ("EVE") interest rate sensitivity analysis in order to evaluate the impact of its interest rate risk on earnings and capital. This is measured by computing the changes in net EVE for its cash flows from assets, liabilities and off-balance sheet items in the event of a range of assumed changes in market interest rates. EVE modeling involves discounting present values of all cash flows for on and off balance sheet items under different interest rate scenarios and provides no effect given to any steps that management might take to counter the effect of the interest rate movements. The discounted present value of all cash flows represents the Company's EVE and is equal to the market value of assets minus the market value of liabilities, with adjustments made for off-balance sheet items. The amount of base case EVE and its sensitivity to shifts in interest rates provide a measure of the longer term re-pricing and option risk in the balance sheet.

Results of the Company's simulation modeling, which assumes an immediate and sustained parallel shift in market interest rates, project that the Company's EVE could change as follows, relative to the Company's base case scenario, based on December 31, 2015 and 2014 financial information.

At December 31, 2015						
Immediate Change in the Level of Interest Rates	Economic Value of Equity			Economic Value of Equity as a Percent of Present Value of Assets		
	Dollar Amount	Dollar Change	Percent Change	EVE Ratio	Change	
	(Dollars in thousands)					
300bp	\$84,935	\$(16,474)	(16.25)%	12.72 %	(151)bp	
200bp	95,621	(5,788)	(5.71)	14.01	(22)bp	
100bp	102,349	940	0.93	14.67	44 bp	
Static	101,409	-	-	14.23	- bp	
(100)bp	98,469	(2,940)	(2.90)	13.55	(68)bp	

At December 31, 2014						
Immediate Change in the Level of Interest Rates	Economic Value of Equity			Economic Value of Equity as a Percent of Present Value of Assets		
	Dollar Amount	Dollar Change	Percent Change	EVE Ratio	Change	

Edgar Filing: FIRST CAPITAL INC - Form 10-K

	(Dollars in thousands)				
300bp	\$59,328	\$(13,398)	(18.42)%	13.52%	(192)bp
200bp	67,860	(4,866)	(6.69)	15.10	(34)bp
100bp	73,971	1,245	1.71	16.07	63 bp
Static	72,726	-	-	15.44	- bp
(100)bp	70,498	(2,228)	(3.06)	14.58	(86)bp

The previous table indicates that at December 31, 2015, the Company would expect a decrease in its EVE in the event of a sudden and sustained 200 to 300 basis point increase or a 100 basis point decrease in prevailing interest rates, and would expect an increase in its EVE in the event of a sudden and sustained 100 basis point increase in prevailing interest rates.

The models are driven by expected behavior in various interest rate scenarios and many factors besides market interest rates affect the Company's net interest income and EVE. For this reason, the Company models many different combinations of interest rates and balance sheet assumptions to understand its overall sensitivity to market interest rate changes. Therefore, as with any method of measuring interest rate risk, certain shortcomings are inherent in the method of analysis presented in the foregoing tables and it is recognized that the model outputs are not guarantees of actual results. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets, such as adjustable-rate mortgage loans, have features that restrict changes in interest rates on a short-term basis and over the life of the asset. Further, in the event of a change in interest rates, expected rates of prepayments on loans and early withdrawals from certificates of deposit could deviate significantly from those assumed in the modeling scenarios.

Impact of Recent Accounting Pronouncements

For a discussion of the impact of recent accounting pronouncements, see Note 1 of the accompanying Notes to Consolidated Financial Statements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information required by this item is incorporated herein by reference to the section captioned "Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations – Market Risk Analysis*" in this Annual Report on Form 10-K.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements required by this item are listed in Part IV, Item 15(a)(1) and are filed as part of this Annual Report on Form 10-K and incorporated herein by reference.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

The Company's management, including the Company's principal executive officer and principal financial officer, have evaluated the effectiveness of the Company's "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective for the purpose of ensuring that the information required to be disclosed in the reports that the Company files or submits under the Exchange Act with the Securities and Exchange Commission (the "SEC"): (1) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (2) is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

Internal Control over Financial Reporting

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The internal control process has been designed under our supervision to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's financial statements for external reporting purposes in accordance with U.S. GAAP.

Management conducted an assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2015, utilizing the framework established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 2013. Based on this assessment, management has determined that the Company's internal control over financial reporting as of December 31, 2015 is effective.

Our internal control over financial reporting includes policies and procedures that pertain to the maintenance of records that accurately and fairly reflect, in reasonable detail, transactions and dispositions of assets; and provide reasonable assurances that: (1) transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. GAAP; (2) receipts and expenditures are being made only in accordance with authorizations of management and the directors of the Company; and (3) unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the Company's financial statements are prevented or timely detected.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to rules of the SEC that permit the Company to provide only management's report in this annual report.

Changes to Internal Control over Financial Reporting

There have been no changes in the Company's internal control over financial reporting during the quarter ended December 31, 2015 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

Not applicable.

55

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS, AND CORPORATE GOVERNANCE

The information required in response to this item will be contained in the Company's Proxy Statement for the 2016 Annual Meeting of Shareholders and is incorporated herein by reference.

Executive Officers Who Are Not Directors

Name	Age ⁽¹⁾	Position
M. Chris Frederick	48	Executive Vice President, Chief Financial Officer and Treasurer
Dennis L. Thomas	59	Senior Vice President- Lending
Jill Keinsley	48	Senior Vice President, Human Resources Director

(1) As of December 31, 2015.

Biographical Information

M. Chris Frederick has been affiliated with the Bank since June 1990 and has served in his present position since 2013. Prior to that time, Mr. Frederick served as Senior Vice President, Chief Financial Officer and Treasurer since 1997.

Dennis L. Thomas has been affiliated with the Bank since January 2000. He was employed by Harrison County Bank from 1981 until its merger with the Bank.

Jill Keinsley has been affiliated with the Bank and served in her present position since August 2006.

Code of Ethics

The Company maintains a Code of Ethics and Business Conduct that applies to all directors, officers and employees of the Company and its affiliates. The Code of Ethics and Business Conduct is posted on the Company's Internet website, www.firstharrison.com.

ITEM 11. EXECUTIVE COMPENSATION

The information required in response to this item will be contained in the Company's Proxy Statement for the 2016 Annual Meeting of Shareholders and is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required in response to this item will be contained in the Company's Proxy Statement for the 2016 Annual Meeting of Shareholders and is incorporated herein by reference.

(a) Security Ownership of Certain Beneficial Owners.

The information required in response to this item will be contained in the Company's Proxy Statement for the 2016 Annual Meeting of Shareholders and is incorporated herein by reference.

(b) Security Ownership of Management

The information required in response to this item will be contained in the Company's Proxy Statement for the 2016 Annual Meeting of Shareholders and is incorporated herein by reference.

(c) Changes in Control

Management of the Company knows of no arrangements, including any pledge by any person of securities of the Company, the operation of which may at a subsequent date result in a change in control of the registrant.

(d) Equity Compensation Plan Information

See Part II, Item 5 for information about securities authorized for issuance under the Company's equity compensation plan.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTORS INDEPENDENCE

The information required in response to this item will be contained in the Company's Proxy Statement for the 2016 Annual Meeting of Shareholders and is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required in response to this item will be contained in the Company's Proxy Statement for the 2016 Annual Meeting of Shareholders and is incorporated herein by reference.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a)(1) Financial Statements.

The following consolidated financial statements of the Company and its subsidiaries are included in this Annual Report on Form 10-K:

	Page Reference
<u>Report of Independent Registered Public Accounting Firm</u>	<u>F- 1</u>
<u>Consolidated Balance Sheets at December 31, 2015 and 2014</u>	<u>F- 2</u>
<u>Consolidated Statements of Income for the years ended December 31, 2015 and 2014</u>	<u>F- 3</u>
<u>Consolidated Statements of Comprehensive Income for the years ended December 31, 2015 and 2014</u>	<u>F- 4</u>
<u>Consolidated Statements of Changes in Stockholders' Equity for the years ended December 31, 2015 and 2014</u>	<u>F- 5</u>
<u>Consolidated Statements of Cash Flows for the years ended December 31, 2015 and 2014</u>	<u>F- 6</u>
<u>Notes to Consolidated Financial Statements</u>	<u>F- 7</u>

Financial Statement Schedules. All financial statement schedules are omitted as the required information either (a)(2) is not required or applicable, or the required information is contained in the consolidated financial statements or related notes.

a)(3)Exhibits

- 3.1 Articles of Incorporation of First Capital, Inc. (1)
- 3.2 Fifth Amended and Restated Bylaws of First Capital, Inc. (2)
- 10.1 *Change in Control Agreement between First Capital, Inc., First Harrison Bank and William W. Harrod (3)
- 10.2 * Change in Control Agreement between First Capital, Inc., First Harrison Bank
- 10.3 * Change in Control Agreement between First Capital, Inc., First Harrison Bank and M. Chris Frederick (3)
- 10.4 * Change in Control Agreement between First Capital, Inc., First Harrison Bank and Dennis Thomas (3)
- 10.4 and Jill Keinsley (4)
- 10.4 *First Capital, Inc. 2009 Equity Incentive Plan (5)
- 10.9 *Director Deferred Compensation Agreement between First Federal Savings & Loan Association and James Pendleton (6)
- 10.1 *Director Deferred Compensation Agreement between First Federal Savings & Loan Association and Gerald Uhl (6)
- 10.11 *Director Deferred Compensation Agreement between First Federal Savings & Loan Association and Mark Shireman (6)
- 11 Statement Re: Computation of Per Share Earnings (incorporated by reference to Item 8, “*Financial Statements and Supplementary Data*” of this Form 10-K)
- 21 Subsidiaries of the Registrant (incorporated by reference to Part I, “*Business—Subsidiary Activities*” of this Form 10-K)
- 23 Consent of Monroe Shine and Co., Inc.
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
- 32 Section 1350 Certification of Chief Executive Officer & Chief Financial Officer
- 101.0 The following materials from the Company’s Annual Report on Form 10-K for the year ended December 31, 2015, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statement of Changes in Stockholders’ Equity, (iv) the Consolidated Statements of Cash Flows and (v) the Notes to the Consolidated Financial Statements.

* Management contract or compensatory plan, contract or arrangement.

- (1) Incorporated by reference to Exhibit 3.1 filed with the Registration Statement on Form SB-2 on September 16, 1998, and any amendments thereto, Registration No. 333-63515.
- (2) Incorporated by reference to Exhibit 3.2 to the Current Report on Form 8-K filed with the Securities and Exchange Commission on June 18, 2013.
- (3) Incorporated by reference to Exhibits 10.1, 10.2 and 10.3, respectively, filed with the Annual Report on Form 10-K for the year ended December 31, 2014.
- (4) Incorporated by reference to Exhibit 10.3 of the Annual Report on Form 10-K for the year ended December 31, 2012.
- (5) Incorporated by reference to Appendix A to the Definitive Proxy Statement on Schedule 14A filed with the Securities and Exchange Commission on April 9, 2009.

(6) Incorporated by reference to Exhibits 10.9, 10.10 and 10.11, respectively, filed with the Annual Report on Form 10-K for the year ended December 31, 2008 (Commission File No. 0-25023).

Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders

First Capital, Inc.

Corydon, Indiana

We have audited the accompanying consolidated balance sheets of **First Capital, Inc.** (the “Company”) as of December 31, 2015 and 2014, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the years then ended. The Company's management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of **First Capital, Inc.** as of December 31, 2015 and 2014, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States

of America.

New Albany, Indiana

March 29, 2016

F-1

Monroe Shine & Co., Inc. " Certified Public Accountants and Business Consultants

FIRST CAPITAL, INC.

CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 2015 AND 2014

(In thousands, except share and per share data)	2015	2014
ASSETS		
Cash and due from banks	\$14,756	\$13,653
Interest-bearing deposits with banks	3,635	865
Federal funds sold	90,783	18,725
Total cash and cash equivalents	109,174	33,243
Interest-bearing time deposits	16,655	8,270
Securities available for sale, at fair value	186,751	100,226
Securities-held to maturity	4	6
Loans, net	359,166	300,603
Loans held for sale	3,081	1,608
Federal Home Loan Bank and other stock, at cost	1,650	2,241
Foreclosed real estate	4,890	78
Premises and equipment	13,936	10,208
Accrued interest receivable	2,244	1,580
Cash value of life insurance	6,899	6,161
Goodwill	6,472	5,386
Core deposit intangible	1,406	-
Other assets	3,499	3,151
Total Assets	\$715,827	\$472,761
LIABILITIES		
Deposits:		
Noninterest-bearing	\$125,059	\$73,042
Interest-bearing	512,118	339,594
Total deposits	637,177	412,636
Accrued interest payable	167	127
Accrued expenses and other liabilities	3,975	2,765
Total liabilities	641,319	415,528
Commitments and Contingencies		
EQUITY		
Preferred stock of \$.01 par value per share		
Authorized 1,000,000 shares; none issued	-	-
Common stock of \$.01 par value per share		
Authorized 5,000,000 shares; issued 3,762,933 shares, (3,164,416 in 2014); outstanding 3,338,603 shares (2,740,502 shares in 2014)	38	32

Edgar Filing: FIRST CAPITAL INC - Form 10-K

Additional paid-in capital	39,515	24,313
Retained earnings-substantially restricted	42,991	40,229
Unearned stock compensation	(382)	-
Accumulated other comprehensive income	497	800
Less treasury stock, at cost - 424,330 shares (423,914 shares in 2014)	(8,263)	(8,253)
Total First Capital, Inc. stockholders' equity	74,396	57,121
Noncontrolling interest in subsidiary	112	112
Total equity	74,508	57,233
Total Liabilities and Equity	\$715,827	\$472,761

See notes to consolidated financial statements.

F-2

FIRST CAPITAL, INC.

CONSOLIDATED STATEMENTS OF INCOME

YEARS ENDED DECEMBER 31, 2015 AND 2014

(In thousands, except per share data)	2015	2014
INTEREST INCOME		
Loans, including fees	\$16,213	\$15,937
Securities:		
Taxable	1,203	1,185
Tax-exempt	995	1,058
Dividends	107	114
Other interest income	195	105
Total interest income	18,713	18,399
INTEREST EXPENSE		
Deposits	1,000	1,127
Retail repurchase agreements	-	12
Advances from Federal Home Loan Bank	2	5
Other borrowings	2	-
Total interest expense	1,004	1,144
Net interest income	17,709	17,255
Provision for loan losses	50	190
Net interest income after provision for loan losses	17,659	17,065
NONINTEREST INCOME		
Service charges on deposit accounts	3,440	3,189
Commission and fee income	414	546
Gain on sale of securities	-	54
Gain on sale of loans	843	713
Mortgage brokerage fee income	63	45
Increase in cash value of life insurance	135	150
Other income	229	239
Total noninterest income	5,124	4,936
NONINTEREST EXPENSE		
Compensation and benefits	7,921	7,661
Occupancy and equipment	1,287	1,198
Data processing	1,733	1,591
Professional fees	628	721
Acquisition expense	1,002	-
Advertising	317	288
Other expenses	2,720	2,623
Total noninterest expense	15,608	14,082

Edgar Filing: FIRST CAPITAL INC - Form 10-K

Income before income taxes	7,175	7,919
Income tax expense	1,964	2,312
Net Income	5,211	5,607
Less net income attributable to the noncontrolling interest in subsidiary	13	13
Net Income Attributable to First Capital, Inc.	\$5,198	\$5,594
Earnings per common share attributable to First Capital, Inc.:		
Basic	\$1.87	\$2.03
Diluted	\$1.87	\$2.03
Dividends per share on common shares	\$0.84	\$0.84

See notes to consolidated financial statements.

F-3

FIRST CAPITAL, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

YEARS ENDED DECEMBER 31, 2015 AND 2014

(In thousands)	2015	2014
Net Income	\$5,211	\$5,607
OTHER COMPREHENSIVE INCOME (LOSS)		
Unrealized gains (losses) on securities available for sale:		
Unrealized holding gains (losses) arising during the period	(476)	2,453
Income tax (expense) benefit	173	(897)
Net of tax amount	(303)	1,556
Less: reclassification adjustment for realized gains included in net income	-	(54)
Income tax expense	-	18
Net of tax amount	-	(36)
Other Comprehensive Income (Loss), net of tax	(303)	1,520
Total Comprehensive Income	4,908	7,127
Less: comprehensive income attributable to the noncontrolling interest in subsidiary	13	13
Comprehensive Income Attributable to First Capital, Inc.	\$4,895	\$7,114

See notes to consolidated financial statements.

F-4

FIRST CAPITAL, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

YEARS ENDED DECEMBER 31, 2015 AND 2014

(In thousands, except share data)	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Unearned Stock Compensation	Treasury Stock	Noncontrolling Interest	Total
Balances at January 1, 2014	\$ 32	\$ 24,313	\$ 36,947	\$ (720)	\$ -	\$ (7,345)	\$ 112	\$ 53,339
Net income	-	-	5,594	-	-	-	13	5,607
Other comprehensive income	-	-	-	1,520	-	-	-	1,520
Cash dividends	-	-	(2,312)	-	-	-	(13)	(2,325)
Purchase of 43,586 treasury shares	-	-	-	-	-	(908)	-	(908)
Balances at December 31, 2014	32	24,313	40,229	800	-	(8,253)	112	57,233
Net income	-	-	5,198	-	-	-	13	5,211
Other comprehensive loss	-	-	-	(303)	-	-	-	(303)
Cash dividends	-	-	(2,436)	-	-	-	(13)	(2,449)
Restricted stock grants, net of forfeitures	-	453	-	-	(453)	-	-	-
Stock compensation expense	-	-	-	-	71	-	-	71
Purchase of 416 treasury shares	-	-	-	-	-	(10)	-	(10)
Issuance of common stock in acquisition - 580,017 shares	6	14,749	-	-	-	-	-	14,755
Balances at December 31, 2015	\$ 38	\$ 39,515	\$ 42,991	\$ 497	\$ (382)	\$ (8,263)	\$ 112	\$ 74,508

See notes to consolidated financial statements.

F-5

FIRST CAPITAL, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

YEARS ENDED DECEMBER 31, 2015 AND 2014

(In thousands)	2015	2014
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$5,211	\$5,607
Adjustments to reconcile net income to net cash and cash equivalents		
Adjustments to reconcile net income to net cash and cash equivalents provided by operating activities:		
Amortization of premium and accretion of discount on securities, net	693	699
Depreciation and amortization expense	756	698
Deferred income taxes	672	285
Stock compensation expense	71	-
Increase in cash value of life insurance	(135)	(150)
Gain on life insurance	(110)	(129)
Gain on sale of securities	-	(54)
Provision for loan losses	50	190
Proceeds from sale of loans	32,916	29,814
Loans originated for sale	(33,547)	(29,098)
Gain on sale of loans	(843)	(713)
Net (gain) loss on sale of foreclosed real estate	115	(39)
Net loss on sale of premises and equipment	61	-
Decrease in accrued interest receivable	467	136
Decrease in accrued interest payable	(367)	(65)
Net change in other assets/liabilities	(4)	(272)
Net Cash Provided By Operating Activities	6,006	6,909
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment in interest-bearing time deposits	(5,075)	(4,820)
Proceeds from maturities and sales of interest-bearing time deposits	1,670	975
Purchase of securities available for sale	(34,028)	(27,644)
Proceeds from maturities of securities available for sale	19,395	21,442
Proceeds from sales of securities available for sale	45,444	5,669
Principal collected on mortgage-backed obligations	13,457	10,824
Net increase in loans receivable	(3,694)	(12,363)
Proceeds from redemption of Federal Home Loan Bank stock	1,886	579
Proceeds from sale of foreclosed real estate	230	503
Purchase of premises and equipment	(1,105)	(559)
Proceeds from sale of premises and equipment	37	-
Cost method equity investment	-	(171)
Net cash and cash equivalents received in acquisition	18,710	-
Net Cash Used In Investing Activities	56,927	(5,565)
CASH FLOWS FROM FINANCING ACTIVITIES		

Edgar Filing: FIRST CAPITAL INC - Form 10-K

Net increase in deposits	15,457	38,806
Net decrease in retail repurchase agreements	-	(9,310)
Advances from Federal Home Loan Bank	15,500	10,000
Repayment of advances from Federal Home Loan Bank	(15,500)	(15,500)
Advances on line of credit	500	-
Repayment of advances on line of credit	(500)	-
Purchase of treasury stock	(10)	(908)
Dividends paid	(2,449)	(2,325)
Net Cash Provided By Financing Activities	12,998	20,763
Net Increase in Cash and Cash Equivalents	75,931	22,107
Cash and cash equivalents at beginning of year	33,243	11,136
Cash and Cash Equivalents at End of Year	\$109,174	\$33,243

See notes to consolidated financial statements.

F-6

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

First Capital, Inc. (the “Company”) is the savings and loan holding company of First Harrison Bank (the “Bank”), a wholly-owned subsidiary. The Bank is a federally-chartered savings bank which provides a variety of banking services to individuals and business customers through seventeen locations in Indiana and Kentucky. The Bank’s primary source of revenue is real estate mortgage loans. The Bank originates mortgage loans for sale in the secondary market and also sells non-deposit investment products through a financial services division. First Harrison Investments, Inc. and First Harrison Holdings, Inc. are wholly-owned Nevada corporate subsidiaries of the Bank that jointly own First Harrison, LLC, a Nevada limited liability company that holds and manages an investment securities portfolio. First Harrison REIT, Inc. is a wholly-owned subsidiary of First Harrison Holdings, Inc. which holds a portion of the Bank’s real estate mortgage loan portfolio. Heritage Hill, LLC is a wholly-owned subsidiary of the Bank that holds and operates certain foreclosed real estate properties. On September 23, 2014, the Company formed FHB Risk Mitigation Services, Inc. (the “Captive”). The Captive is a wholly-owned insurance subsidiary of the Company that provides property and casualty insurance coverage to the Company, the Bank and the Bank’s subsidiaries, and reinsurance to eight other third party insurance captives, for which insurance may not be currently available or economically feasible in the insurance marketplace.

Basis of Consolidation and Reclassifications

The consolidated financial statements include the accounts of the Company and its subsidiaries and have been prepared in accordance with generally accepted accounting principles in the United States of America and conform to general practices in the banking industry. Intercompany balances and transactions have been eliminated. Certain prior year amounts have been reclassified to conform to the current year presentation. The reclassifications had no effect on net income or stockholders’ equity.

Statements of Cash Flows

For purposes of the statements of cash flows, the Company has defined cash and cash equivalents as cash on hand, amounts due from banks (including cash items in process of clearing), interest-bearing deposits with other banks with

an original maturity of 90 days or less, and federal funds sold.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans. In connection with the determination of the allowance for loan losses and foreclosed real estate, management obtains independent appraisals for significant properties.

A majority of the Bank's loan portfolio consists of single-family residential and commercial real estate loans in the Louisville, Kentucky metropolitan area. Accordingly, the ultimate collectability of a substantial portion of the Bank's loan portfolio and the recovery of the carrying amount of foreclosed real estate are susceptible to changes in local market conditions.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(1 - continued)

Use of Estimates – continued

While management uses available information to recognize losses on loans and foreclosed real estate, further reductions in the carrying amounts of loans and foreclosed real estate may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the estimated losses on loans and foreclosed real estate. Such agencies may require the Bank to recognize additional losses based on their judgments about information available to them at the time of their examination. Because of these factors, it is reasonably possible that the estimated losses on loans and foreclosed real estate may change materially in the near term. However, the amount of the change that is reasonably possible cannot be estimated.

Investment Securities

Securities Available for Sale: Securities available for sale consist primarily of mortgage-backed and other debt securities and are stated at fair value. The Company holds mortgage-backed securities and other debt securities issued by the Government National Mortgage Association (“GNMA”), a U.S. government agency, and the Federal National Mortgage Association (“FNMA”), the Federal Home Loan Mortgage Corporation (“FHLMC”), and the Federal Home Loan Bank (“FHLB”), government-sponsored enterprises (collectively referred to as government agencies), as well as collateralized mortgage obligations (“CMOs”) and other mortgage-backed securities. Mortgage-backed securities represent participating interests in pools of long-term first mortgage loans originated and serviced by the issuers of the securities. CMOs are complex mortgage-backed securities that restructure the cash flows and risks of the underlying mortgage collateral. The Company also holds debt securities issued by municipalities and political subdivisions of state and local governments.

Amortization of premiums and accretion of discounts are recognized in interest income using methods approximating the interest method over the period to maturity, adjusted for anticipated prepayments. Unrealized gains and losses, net of tax, on securities available for sale are included in other comprehensive income and the accumulated unrealized holding gains and losses are reported as a separate component of equity until realized. Realized gains and losses on the sale of securities available for sale are determined using the specific identification method and are included in other noninterest income and, when applicable, are reported as a reclassification adjustment, net of tax, in other

comprehensive income.

Securities Held to Maturity: Debt securities for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts that are recognized in interest income using methods approximating the interest method over the period to maturity, adjusted for anticipated prepayments. The Company classifies certain mortgage-backed securities as held to maturity.

Declines in the fair value of individual available for sale and held to maturity securities below their amortized cost that are other than temporary result in write-downs of the individual securities to their fair value. The related write-downs are included in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than amortized cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment for a period of time sufficient to allow for any anticipated recovery in fair value.

Investments in non-marketable equity securities such as FHLB stock and companies in which the Company has less than a 20% interest are carried at cost. Dividends received from these investments are included in dividend income, and dividends received in excess of the Company's proportionate share of accumulated earnings are applied as a reduction of the cost of the investment. Impairment testing on these investments is based on applicable accounting guidance and the cost basis is reduced when impairment is deemed to be other-than-temporary.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(1 - continued)

Loans and Allowance for Loan Losses

Loans Held for Investment

Loans are stated at unpaid principal balances, less net deferred loan fees and the allowance for loan losses. The Company grants real estate mortgage, commercial business and consumer loans. A substantial portion of the loan portfolio is represented by mortgage loans to customers in southern Indiana. The ability of the Company's customers to honor their contracts is dependent upon the real estate and general economic conditions in this area.

Loan origination and commitment fees, as well as certain direct costs of underwriting and closing loans, are deferred and amortized as a yield adjustment to interest income over the lives of the related loans using the interest method. Amortization of net deferred loan fees is discontinued when a loan is placed on nonaccrual status.

Nonaccrual Loans

The recognition of income on a loan is discontinued and previously accrued interest is reversed when interest or principal payments become 90 days past due unless, in the opinion of management, the outstanding interest remains collectible. Past due status is determined based on contractual terms. Generally, by applying the cash receipts method, interest income is subsequently recognized only as received until the loan is returned to accrual status. The cash receipts method is used when the likelihood of further loss on the loan is remote. Otherwise, the Company applies the cost recovery method and applies all payments as a reduction of the unpaid principal balance until the loan qualifies for return to accrual status. Interest income on impaired loans is recognized using the cost recovery method, unless the likelihood of further loss on the loan is remote.

A loan is restored to accrual status when all principal and interest payments are brought current and the borrower has demonstrated the ability to make future payments of principal and interest as scheduled, which generally requires that

the borrower demonstrate a period of performance of at least six consecutive months.

Impaired Loans

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(1 - continued)

Loans and Allowance for Loan Losses – continued

Values for collateral dependent loans are generally based on appraisals obtained from independent licensed real estate appraisers, with adjustments applied for estimated costs to sell the property, costs to complete unfinished or repair damaged property and other factors. New appraisals are generally obtained for all significant properties when a loan is identified as impaired, and a property is considered significant if the value of the property is estimated to exceed \$200,000. Subsequent appraisals are obtained as needed or if management believes there has been a significant change in the market value of a collateral property securing a collateral dependent impaired loan. In instances where it is not deemed necessary to obtain a new appraisal, management bases its impairment and allowance for loan loss analysis on the original appraisal with adjustments for current conditions based on management's assessment of market factors and management's inspection of the property.

Troubled Debt Restructurings

Modification of a loan is considered to be a troubled debt restructuring ("TDR") if the debtor is experiencing financial difficulties and the Company grants a concession to the debtor that it would not otherwise consider. By granting the concession, the Company expects to obtain more cash or other value from the debtor, or to increase the probability of receipt, than would be expected by not granting the concession. The concession may include, but is not limited to, reduction of the stated interest rate of the loan, reduction of accrued interest, extension of the maturity date or reduction of the face amount of the debt. A concession will be granted when, as a result of the restructuring, the Company does not expect to collect all amounts due, including interest at the original stated rate. A concession may also be granted if the debtor is not able to access funds elsewhere at a market rate for debt with similar risk characteristics as the restructured debt. The Company's determination of whether a loan modification is a TDR considers the individual facts and circumstances surrounding each modification.

A TDR can involve loans remaining on nonaccrual, moving to nonaccrual, or continuing on accrual status, depending on the individual facts and circumstances of the borrower. A TDR on nonaccrual status is restored to accrual status when the borrower has demonstrated the ability to make future payments in accordance with the restructured terms, which generally requires that the borrower demonstrate a period of performance of at least six consecutive months in accordance with the restructured terms including consistent and timely payments.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The Company uses a disciplined process and methodology to evaluate the allowance for loan losses on at least a quarterly basis that is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific and general components. The specific component relates to loans that are individually evaluated for impairment or loans otherwise classified as doubtful, substandard, or special mention. For such loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(1 - continued)

Loans and Allowance for Loan Losses – continued

The general component covers non-classified loans and classified loans that are found, upon individual evaluation, to not be impaired. Such loans are pooled by segment and losses are modeled using annualized historical loss experience adjusted for qualitative factors. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by the Company over the prior five years unless the historical loss experience is not considered indicative of the level of risk in the remaining balance of a particular portfolio segment, in which case an adjustment is determined by management. The Company's historical loss experience is then adjusted by an overall loss factor weighting adjustment based on a qualitative analysis prepared by management and reviewed on a quarterly basis. The overall loss factor considers changes in underwriting standards, economic conditions, changes and trends in past due and classified loans and other internal and external factors.

Management also applies additional loss factor multiples to loans classified as watch, special mention and substandard that are not individually evaluated for impairment. The loss factor multiples for classified loans are based on management's assessment of historical trends regarding losses experienced on classified loans in prior periods. See Note 5 for additional discussion of the qualitative factors utilized in management's allowance for loan losses methodology at December 31, 2015 and 2014.

Management exercises significant judgment in evaluating the relevant historical loss experience and the qualitative factors. Management also monitors the differences between estimated and actual incurred loan losses for loans considered impaired in order to evaluate the effectiveness of the estimation process and make any changes in the methodology as necessary.

The following portfolio segments are considered in the allowance for loan loss analysis: residential real estate, land, construction, commercial real estate, commercial business, home equity and second mortgage, and other consumer loans.

Residential real estate loans primarily consist of loans to individuals for the purchase or refinance of their primary residence, with a smaller portion of the segment secured by non-owner-occupied residential investment properties and multi-family residential investment properties. The risks associated with residential real estate loans are closely correlated to the local housing market and general economic conditions, as repayment of the loans is primarily dependent on the borrowers' or tenants' personal cash flow and employment status.

Land loans primarily consist of loans secured by farmland and vacant land held for investment purposes. The risks associated with land loans are related to the market value of the property taken as collateral and the underlying cash flows for loans secured by farmland, and general economic conditions.

The Company's construction loan portfolio consists of single-family residential properties, multi-family properties and commercial projects, and includes both owner-occupied and speculative investment properties. Risks inherent in construction lending are related to the market value of the property held as collateral, the cost and timing of constructing or improving a property, the borrower's ability to use funds generated by a project to service a loan until a project is completed, movements in interest rates and the real estate market during the construction phase, and the ability of the borrower to obtain permanent financing.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(1 - continued)

Loans and Allowance for Loan Losses – continued

Commercial real estate loans are comprised of loans secured by various types of collateral including office buildings, warehouses, retail space and mixed use buildings located in the Company's primary lending area. Risks related to commercial real estate lending are related to the market value of the property taken as collateral, the underlying cash flows and general economic condition of the local real estate market. Repayment of these loans is generally dependent on the ability of the borrower to attract tenants at lease rates that provide for adequate debt service and can be impacted by local economic conditions which impact vacancy rates. The Company generally obtains loan guarantees from financially capable parties for commercial real estate loans.

Commercial business loans includes lines of credit to businesses, term loans and letters of credit secured by business assets such as equipment, accounts receivable, inventory, or other assets excluding real estate and are generally made to finance capital expenditures or fund operations. Commercial loans contain risks related to the value of the collateral securing the loan and the repayment is primarily dependent upon the financial success and viability of the borrower. As with commercial real estate loans, the Company generally obtains loan guarantees from financially capable parties for commercial business loans.

Home equity and second mortgage loans and other consumer loans consist primarily of home equity lines of credit and other loans secured by junior liens on the borrower's personal residence, home improvement loans, automobile and truck loans, boat loans, mobile home loans, loans secured by savings deposits, credit cards and other personal loans. The risk associated with these loans is related to the local housing market and local economic conditions including the unemployment level.

Loan Charge-Offs

For portfolio segments other than consumer loans, the Company's practice is to charge-off any loan or portion of a loan when the loan is determined by management to be uncollectible due to the borrower's failure to meet repayment terms, the borrower's deteriorating or deteriorated financial condition, the depreciation of the underlying collateral, the

loan's classification as a loss by regulatory examiners, or for other reasons. A partial charge-off is recorded on a loan when the uncollectibility of a portion of the loan has been confirmed, such as when a loan is discharged in bankruptcy, the collateral is liquidated, a loan is restructured at a reduced principal balance, or other identifiable events that lead management to determine the full principal balance of the loan will not be repaid. A specific reserve is recognized as a component of the allowance for estimated losses on loans individually evaluated for impairment. Partial charge-offs on nonperforming and impaired loans are included in the Company's historical loss experience used to estimate the general component of the allowance for loan losses as discussed above. Specific reserves are not considered charge-offs in management's evaluation of the general component of the allowance for loan losses because they are estimates and the outcome of the loan relationship is undetermined.

During 2015 the Company recognized no partial charge-offs, while during 2014 partial charge-offs totaling \$67,000 were recognized. At December 31, 2015, the Company had 10 loans with an aggregate recorded investment of \$646,000 and an aggregate unpaid principal balance of \$1.2 million on which partial charge-offs of \$410,000 had been recorded. At December 31, 2014, the Company had 12 loans with an aggregate recorded investment of \$757,000 and an aggregate unpaid principal balance of \$1.4 million on which partial charge-offs of \$472,000 had been recorded.

Consumer loans not secured by real estate are typically charged off at 90 days past due, or earlier if deemed uncollectible, unless the loans are in the process of collection. Overdrafts are charged off after 45 days past due. Charge-offs are typically recorded on loans secured by real estate when the property is foreclosed upon.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(1 - continued)

Foreclosed Real Estate

Foreclosed real estate includes formally foreclosed property held for sale. At the time of foreclosure, foreclosed real estate is recorded at fair value less estimated costs to sell, which becomes the property's new basis. Any write-downs based on the property's fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, valuations are periodically performed by management and property held for sale is carried at the lower of the new cost basis or fair value less cost to sell. Costs incurred in maintaining foreclosed real estate and subsequent impairment adjustments to the carrying amount of a property, if any, are included in other noninterest expense.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. The Company uses the straight line method of computing depreciation at rates adequate to amortize the cost of the applicable assets over their estimated useful lives. Maintenance and repairs are expensed as incurred. The cost and related accumulated depreciation of assets sold, or otherwise disposed of, are removed from the related accounts and any gain or loss is included in earnings.

Goodwill and Other Intangibles

Goodwill recognized in a business combination represents the excess of the cost of the acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed. Goodwill is carried at its implied fair value and is evaluated for possible impairment at least annually or more frequently upon the occurrence of an event or change in circumstances that would more likely than not reduce the fair value of the reporting unit below its carrying amount. Such circumstances could include, but are not limited to: (1) a significant adverse change in legal factors or in business climate, (2) unanticipated competition, or (3) an adverse action or assessment by a regulator. If the carrying amount of the goodwill exceeds its implied fair value, an impairment loss is recognized in earnings equal to that excess amount. The loss recognized cannot exceed the carrying amount of goodwill. After a goodwill impairment loss is recognized, the adjusted carrying amount of goodwill is its new accounting basis.

Other intangible assets consist of acquired core deposit intangibles. Core deposit intangibles are amortized over the estimated economic lives of the acquired core deposits. The carrying amount of core deposit intangibles and the remaining estimated economic life are evaluated annually or whenever events or circumstances indicate the carrying amount may not be recoverable or the remaining period of amortization requires revision. After an impairment loss is recognized, the adjusted carrying amount of the intangible asset is its new accounting basis.

Securities Lending and Financing Arrangements

Securities purchased under agreements to resell (reverse repurchase agreements) and securities sold under agreements to repurchase (repurchase agreements) are treated as collateralized lending and borrowing transactions, respectively, and are carried at the amounts at which the securities were initially acquired or sold.

F-13

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(1 - continued)

Mortgage Banking Activities

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or market value. Aggregate market value is determined based on the quoted prices under a “best efforts” sales agreement with a third party. Net unrealized losses are recognized through a valuation allowance by charges to income. Realized gains on sales of mortgage loans are included in noninterest income. Mortgage loans are sold with servicing released.

Commitments to originate mortgage loans held for sale are considered derivative financial instruments to be accounted for at fair value. The Bank’s mortgage loan commitments subject to derivative accounting are fixed-rate mortgage loan commitments at market rates when initiated. At December 31, 2015, the Bank had commitments to originate \$589,000 in fixed-rate mortgage loans intended for sale in the secondary market after the loans are closed. Fair value is estimated based on fees that would be charged on commitments with similar terms.

Cash Surrender Value of Life Insurance

The Bank has purchased life insurance policies on certain directors, officers and key employees to offset costs associated with the Bank’s compensation and benefit programs. Bank-owned life insurance is recorded at the amount that can be realized under the insurance contracts at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

Stock-Based Compensation

The Company has adopted the fair value based method of accounting for stock-based compensation prescribed in Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 718 for its stock plans.

Advertising Costs

Advertising costs are charged to operations when incurred.

Income Taxes

When income tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while other positions are subject to some degree of uncertainty regarding the merits of the position taken or the amount of the position that would be sustained. The Company recognizes the benefits of a tax position in the consolidated financial statements of the period during which, based on all available evidence, management believes it is more-likely-than-not (more than 50 percent probable) that the tax position would be sustained upon examination. Income tax positions that meet the more-likely-than-not threshold are measured as the largest amount of income tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with the income tax positions claimed on income tax returns that exceeds the amount measured as described above is reflected as a liability for unrecognized income tax benefits in the consolidated balance sheets, along with any associated interest and penalties that would be payable to the taxing authorities, if there were an examination. Interest and penalties associated with unrecognized income tax benefits are classified as additional income taxes in the consolidated statements of income.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(1 - continued)

Income Taxes – continued

Income taxes are provided for the tax effects of the transactions reported in the financial statements and consist of taxes currently due plus deferred income taxes. Income tax reporting and financial statement reporting rules differ in many respects. As a result, there will often be a difference between the carrying amount of an asset or liability as presented in the accompanying consolidated balance sheets and the amount that would be recognized as the tax basis of the same asset or liability computed based on the effects of tax positions recognized, as described in the preceding paragraph. These differences are referred to as temporary differences because they are expected to reverse in future years. Deferred income tax assets are recognized for temporary differences where their future reversal will result in future tax benefits. Deferred income tax assets are also recognized for the future tax benefits expected to be realized from net operating loss or tax credit carryforwards. Deferred income tax liabilities are recognized for temporary differences where their future reversal will result in the payment of future income taxes. Deferred income tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred income tax assets will not be realized. Deferred tax assets and liabilities are reflected at income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

Earnings per Common Share

Basic earnings per common share is computed by dividing net income available to common shareholders by the weighted average number of shares of common stock outstanding during the periods presented. Diluted earnings per common share include the dilutive effect of additional potential common shares issuable under stock options, restricted stock and other potentially dilutive securities outstanding. Earnings and dividends per share are restated for stock splits and dividends through the date of issuance of the financial statements.

Comprehensive Income

Comprehensive income consists of reported net income and other comprehensive income. Other comprehensive income refers to revenue, expenses, gains and losses that are recorded as an element of equity but are excluded from reported net income. Other comprehensive income includes changes in the unrealized gains and losses on securities available for sale.

Amounts reclassified out of unrealized gains or losses on securities available for sale included in accumulated other comprehensive income or loss are included in the net gain on sale of securities line item on the consolidated statements of income.

Loss Contingencies

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(1 - continued)

Recent Accounting Pronouncements

The following are summaries of recently issued or adopted accounting pronouncements that impact the accounting and reporting practices of the Company:

In January 2014, the FASB issued Accounting Standards Update (“ASU”) No. 2014-04, *Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40), Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*. The objective of the amendments in this update is to reduce diversity in practice by clarifying when an in-substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The amendments in the update clarify that an in-substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure, or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor, and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in the update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The adoption of this update did not have a material impact on the Company’s consolidated financial position or results of operations.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The update provides a five-step revenue recognition model for all revenue arising from contracts with customer and affects all entities that enter into contracts to provide goods or services to their customers (unless the contracts are included in the scope of other standards). The guidance requires an entity to recognize the revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. For public entities, the guidance was originally effective for annual reporting periods beginning after December 15, 2016, including interim periods within those reporting periods. However, with the issuance of ASU No. 2015-14 in August 2015, the FASB deferred the effective date of ASU No. 2014-09 by one year for all entities, making the amendments effective for public entities for annual reporting periods

beginning after December 15, 2017, including interim periods within those reporting periods. Companies have the option to apply ASU No. 2014-09 as of the original effective date. Management is evaluating the new guidance, but does not expect the adoption of this guidance to have a material impact on the Company's consolidated financial position or results of operations.

In August 2014, the FASB issued ASU No. 2014-14, *Receivables – Trouble Debt Restructurings by Creditors (Subtopic 310-40), Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure*. The objective of the amendments in this update is to reduce the diversity in how creditors classify government-guaranteed mortgage loans, including FHA and VA guaranteed loans, upon foreclosure by addressing the classification of certain foreclosed mortgage loans held by creditors that are either fully or partially guaranteed under government programs. The amendments in the update are effective for public entities for annual reporting periods, and interim periods within those annual periods, beginning after December 15, 2014. The adoption of this update did not have a material impact on the Company's consolidated financial position or results of operations.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(1 - continued)

Recent Accounting Pronouncements – continued

In September 2015, the FASB issued ASU No. 2015-16, *Business Combinations (Topic 805) – Simplifying the Accounting for Measurement-Period Adjustments*. The guidance eliminates the requirement for an acquirer in a business combination to retrospectively account for measurement-period adjustments. Instead, acquirers must recognize measurement-period adjustments during the reporting period in which the adjustment amounts are determined, and the effect of the adjustments on the income statement must be calculated as if the accounting had been completed at the acquisition date. In addition, the update requires an entity to present separately on the face of the income statement or in the notes to the financial statements the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. For public entities, the guidance is effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. The guidance should be applied prospectively to adjustments to provisional amounts that occur after the effective date, with earlier application permitted for financial statements that have not been issued. The adoption of this update is not expected to have a material impact on the Company's consolidated financial position or results of operations.

In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments – Overall (Subtopic 825-10) – Recognition and Measurement of Financial Assets and Financial Liabilities*. The guidance addresses certain aspects of recognition, measurement, presentation and disclosure of financial instruments. In particular, the guidance revises an entity's accounting related to (1) the classification and measurement of investments in equity securities and (2) the presentation of certain fair value changes for financial liabilities measured at fair value. The guidance also amends certain disclosure requirements associated with fair value of financial instruments. For public business entities, the guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Entities should apply the amendments by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The adoption of this update is not expected to have a material impact on the Company's consolidated financial position or results of operations.

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)*. The guidance supersedes existing guidance on accounting for leases with the main difference being that operating leases are to be recorded in the statement of financial position as right-of-use assets and lease liabilities, initially measured at the present value of the lease payments. For operating leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election not to recognize lease assets and liabilities. For public business entities, the guidance is effective for

fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application of the guidance is permitted. In transition, entities are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. Management is evaluating the new guidance, but does not expect the adoption of this guidance to have a material impact on the Company's consolidated financial position or results of operations.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(2) ACQUISITION OF PEOPLES BANCORP, INC. OF BULLITT COUNTY

On December 4, 2015, the Company acquired 100% of the outstanding common shares of Peoples Bancorp, Inc. of Bullitt County (“Peoples”), the bank holding company for The Peoples Bank of Bullitt County (“Peoples Bank”), headquartered in Shepherdsville, Kentucky, pursuant to an Agreement and Plan of Merger dated June 4, 2015 (the “Merger Agreement”). Under the Merger Agreement, Peoples merged with and into the Company, with the Company as the surviving corporation, and Peoples Bank merged with and into the Bank, with the Bank as the surviving corporation. The acquisition expanded the Company’s presence into Bullitt County, Kentucky and expanded its overall presence in the greater Louisville, Kentucky metropolitan market. The Company expects to benefit from growth in this new market area as well as from expansion of the banking services provided to the existing customers of Peoples Bank. Cost savings are also expected for the combined bank through economies of scale and the consolidation of business operations.

Pursuant to the terms of the Merger Agreement, shareholders of Peoples had the right to elect to receive either 382.83 shares of Company common stock or \$9,475 in cash for each share of Peoples common stock owned, subject to certain adjustments and proration provisions specified in the Merger Agreement that provided for a targeted aggregate mix of total consideration of 50% common stock and 50% cash. Due to such adjustments, at the effective time of the merger, Peoples shareholders had the right to elect to receive either 377.637 shares of Company common stock or \$9,607.08 in cash for each share of Peoples common stock owned. The Company paid cash consideration of \$14.7 million in the transaction and issued 580,017 shares of Company common stock, with a total fair value of \$14.8 million based on the \$25.44 per share average closing price of the Company’s common stock for the 20 days ended November 27, 2015, to the former Peoples shareholders. Acquisition-related costs totaling \$1.0 million were expensed as incurred and reported in noninterest expense in the accompanying consolidated statement of income for the year ended December 31, 2015.

As part of the merger, the Company acquired foreclosed real estate with an estimated fair value of \$3.75 million (the “Contingent Assets”). Under the terms of the Merger Agreement, if the Company sells the Contingent Assets within 24 months after the effective date of the merger or has entered into a written contract for the sale of the Contingent Assets which are then sold within 60 days after the expiration of that 24-month period, the Company will distribute additional cash consideration of 50% of the sale proceeds in excess of \$3.75 million on a pro rata basis to the former shareholders of Peoples. At December 31, 2015, there was no written contract for the sale of the Contingent Assets and no contingent consideration is anticipated.

The transaction was accounted for using the acquisition method of accounting. Accordingly, the results of operations of Peoples have been included in the Company’s results of operations since the date of acquisition.

Under the acquisition method of accounting, the purchase price is assigned to the assets acquired and liabilities assumed based on their estimated fair values, net of applicable income tax effects. The excess of cost over the fair value of the acquired net assets of \$1.1 million has been recorded as goodwill. The goodwill arising from the acquisition consists largely of the synergies and economies of scale expected from combining the operations of the Company and Peoples. No amount of the goodwill arising in the acquisition is deductible for income tax purposes.

F-18

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(2 - continued)

Following is a summary of the assets acquired and the liabilities assumed recognized at the date of acquisition:

	(In thousands)
Cash and cash equivalents	\$ 33,458
Interest-bearing time deposits	4,980
Investment securities	131,959
Loans	55,727
FHLB and other stock	1,295
Foreclosed real estate	4,349
Premises and equipment	3,465
Cash value of life insurance	828
Goodwill	1,085
Core deposit intangible	1,418
Other assets	1,886
Total assets acquired	240,450
Deposit accounts	209,084
Net deferred tax liability	17
Other liabilities	1,846
Total liabilities assumed	210,947
Total consideration	\$ 29,503

In accounting for the acquisition, \$1.4 million was assigned to a core deposit intangible which is amortized over a weighted-average estimated economic life of 9.67 years. It is not anticipated that the core deposit intangible will have a significant residual value.

ASC 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*, applies to loans with evidence of deterioration of credit quality since origination, acquired by completion of a transfer for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable (referred to as purchased credit impaired loans or PCI loans). See Note 5 for additional disclosures related to the Company's PCI

loans. Following is a summary of the acquired loans at the date of acquisition:

<i>(In thousands)</i>	Fair Value	Gross Contractual Amounts Receivable	Estimated Contractual Cash Flows Not Expected to be Collected
Acquired loans subject to ASC 310-30	\$1,570	\$ 2,934	\$ 1,033
Acquired loans not subject to ASC 310-30	54,157	60,013	1,927
Total acquired loans	\$55,727	\$ 62,947	\$ 2,960

F-19

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(2 - continued)

For the period from December 4, 2015 to December 31, 2015, Peoples contributed \$291,000 in loan interest income and \$94,000 in deposit interest expense to the Company's operations. Total contributed revenues and net income of Peoples for the period from December 4, 2015 to December 31, 2015 is not available as separate information on all revenues and expenses is not maintained.

The following unaudited pro forma combined results of operations assumes that the acquisition was consummated on January 1, 2014:

	Year Ended December 31,	
	2015	2014
(In thousands, except per share data)		
Interest income	\$25,639	\$26,843
Interest expense	2,160	2,460
Net interest income	23,479	24,383
Provision for loan losses	50	190
Net interest income after provision for loan losses	23,429	24,193
Noninterest income	7,016	7,921
Noninterest expenses	22,102	21,562
Income before income taxes	8,343	10,552
Income tax expense	2,059	3,094
Net income	\$6,284	\$7,458
Net income attributable to the Company	\$6,271	\$7,445
Net income per common share, basic	\$1.89	\$2.23
Net income per common share, diluted	\$1.89	\$2.23

In addition to combining the historical results of operations, the pro forma calculations consider the purchase accounting adjustments and nonrecurring charges directly related to the acquisition and the related tax effects. The pro

forma calculations do not include any anticipated cost savings as a result of the acquisition. The pro forma results of operations are not necessarily indicative of the actual results of operations that would have occurred had the acquisition actually been consummated on January 1, 2014, or results that may occur in the future.

(3) RESTRICTION ON CASH AND DUE FROM BANKS

The Bank is required to maintain reserve balances on hand and with the Federal Reserve Bank which are noninterest bearing and unavailable for investment. The average amount of those reserve balances for the years ended December 31, 2015 and 2014 was approximately \$886,000 and \$805,000, respectively.

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED****(4) INVESTMENT SECURITIES**

Debt and equity securities have been classified in the consolidated balance sheets according to management's intent. Investment securities at December 31, 2015 and 2014 are summarized as follows:

(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2015:				
Securities available for sale:				
Agency mortgage-backed securities	\$42,158	\$ 123	\$ 271	\$42,010
Agency CMO	9,391	41	101	9,331
Other debt securities:				
Agency notes and bonds	84,797	11	355	84,453
Municipal obligations	49,527	1,372	60	50,839
Subtotal – debt securities	185,873	1,547	787	186,633
Mutual funds	118	0	0	118
Total securities available for sale	\$ 185,991	\$ 1,547	\$ 787	\$ 186,751
Securities held to maturity:				
Agency mortgage-backed securities	\$ 4	\$ 0	\$ 0	\$ 4
Total securities held to maturity	\$ 4	\$ 0	\$ 0	\$ 4
December 31, 2014:				
Securities available for sale:				
Agency mortgage-backed securities	\$32,135	\$ 240	\$ 79	\$32,296
Agency CMO	14,461	74	150	14,385
Other debt securities:				
Agency notes and bonds	18,136	32	48	18,120
Municipal obligations	32,178	1,242	78	33,342
Subtotal – debt securities	96,910	1,588	355	98,143
Mutual funds	2,083	0	0	2,083
Total securities available for sale	\$98,993	\$ 1,588	\$ 355	\$ 100,226

Securities held to maturity:

Agency mortgage-backed securities	\$6	\$ 0	\$ 0	\$6
-----------------------------------	-----	------	------	-----

Total securities held to maturity	\$6	\$ 0	\$ 0	\$6
-----------------------------------	-----	------	------	-----

F-21

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(4 - continued)

The amortized cost and fair value of debt securities as of December 31, 2015, by contractual maturity, are shown below. Expected maturities of mortgage-backed securities and CMO may differ from contractual maturities because the mortgages underlying the obligations may be prepaid without penalty.

	Securities Available for Sale		Securities Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
(In thousands)				
Due in one year or less	\$2,521	\$2,522	\$ 0	\$ 0
Due after one year through five years	55,801	55,704	0	0
Due after five years through ten years	45,938	46,217	0	0
Due after ten years	30,064	30,849	0	0
	134,324	135,292	0	0
Mortgage-backed securities and CMO	51,549	51,341	4	4
	\$185,873	\$186,633	\$ 4	\$ 4

At December 31, 2015, certain securities available for sale with an amortized cost of \$44.6 million and a fair value of \$44.4 million were pledged to secure public fund deposits.

Information pertaining to investment securities available for sale with gross unrealized losses at December 31, 2015, aggregated by investment category and the length of time that individual investment securities have been in a continuous loss position, follows. At December 31, 2015, the Company did not have any securities held to maturity with an unrealized loss.

(Dollars in thousands)	Number of Investment Positions	Fair Value	Gross Unrealized Losses
------------------------	--------------------------------------	---------------	-------------------------------

Continuous loss position less than twelve months:			
Agency mortgage-backed securities	33	\$30,602	\$ 229
Agency CMO	3	514	2
Agency notes and bonds	24	78,692	355
Municipal obligations	4	3,193	34
Total less than twelve months	64	113,001	620
Continuous loss position more than twelve months:			
Agency mortgage-backed securities	4	2,284	42
Agency CMO	9	5,860	99
Municipal obligations	3	1,554	26
Total more than twelve months	16	9,698	167
Total securities available for sale	80	\$122,699	\$ 787

Management evaluates securities for other-than-temporary impairment at least quarterly, and more frequently when economic or market 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 and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – CONTINUED

(4 - continued)

At December 31, 2015, the municipal obligations and U.S. government agency debt securities, including agency mortgage-backed securities, agency CMOs, and agency notes and bonds, in a loss position had depreciated approximately 0.6% from the amortized cost basis. All of the U.S. government agency securities and municipal securities are issued by U.S. government agencies, government-sponsored enterprises, or municipal governments, and are secured by first mortgage loans and municipal project revenues. These unrealized losses related principally to current interest rates for similar types of securities. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government, its agencies or other governments, whether downgrades by bond rating agencies have occurred, and the results of reviews of the issuer's financial condition. As the Company has the ability to hold the U.S. government agency debt securities and municipal securities in an unrealized loss position until maturity, no declines are deemed to be other-than-temporary.

While management does not anticipate any credit-related impairment losses at December 31, 2015, additional deterioration in market and economic conditions may have an adverse impact on the credit quality in the future.

During the year ended December 31, 2015, the Company realized no gains or losses on the sale of securities. Securities acquired from Peoples with a fair value of \$45.4 million were sold within a short period of time following the merger, resulting in no gain or loss for financial reporting purposes. During the year ended December 31, 2014, the Company realized gross gains on sales of available for sale municipal obligations and U.S. government agency mortgage-backed securities of \$98,000 and \$7,000, respectively, and gross losses on the sale of municipal obligations, U.S. government agency mortgage-backed securities and mutual funds of \$31,000, \$3,000 and \$17,000, respectively.

In June 2014, the Company acquired 31,750 shares of common stock in another financial institution, in addition to the 100,000 shares acquired in 2013, representing approximately 9% of the outstanding common stock of the entity, for a total investment of \$711,000. The investment is accounted for using the cost method of accounting and is included in other assets in the consolidated balance sheet.

(5) LOANS AND ALLOWANCE FOR LOAN LOSSES

Loans at December 31, 2015 and 2014 consisted of the following:

(In thousands)	2015	2014
Real estate mortgage loans:		
Residential	\$ 147,933	\$ 106,679
Land	12,962	11,028
Residential construction	16,391	10,347
Commercial real estate	84,493	78,314
Commercial real estate construction	1,090	1,422
Commercial business loans	23,095	28,282
Consumer loans:		
Home equity and second mortgage loans	38,476	37,513
Automobile loans	28,828	25,274
Loans secured by savings accounts	2,096	1,018
Unsecured loans	4,350	3,316
Other consumer loans	7,210	5,075
Gross loans	366,924	308,268
Less undisbursed portion of loans in process	(4,926)	(3,325)
Principal loan balance	361,998	304,943
Deferred loan origination fees, net	583	506
Allowance for loan losses	(3,415)	(4,846)
Loans, net	\$ 359,166	\$ 300,603

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(5 - continued)

At December 31, 2015, the net unaccreted discount on loans acquired from Peoples, excluding PCI loans, was \$590,000.

At December 31, 2015, residential mortgage loans secured by residential properties without private mortgage insurance or government guarantee and with loan-to-value ratios exceeding 90% amounted to approximately \$2.5 million.

Mortgage loans serviced for the benefit of others amounted to \$156,000 and \$169,000 at December 31, 2015 and 2014, respectively.

The Bank has entered into loan transactions with certain directors, officers and their affiliates (i.e., related parties). In the opinion of management, such indebtedness was incurred in the ordinary course of business on substantially the same terms, including interest rate and collateral, as those prevailing at the time for comparable transactions with unrelated persons.

The following table represents the aggregate activity for related party loans during the year ended December 31, 2015. The beginning balance has been adjusted to reflect new directors and officers, as well as directors and officers that are no longer with the Company.

(In thousands)

Beginning balance	\$8,609
New loans	7,790
Payments	(8,224)
Ending balance	\$8,175

A director of the Company and the Bank is a shareholder of a farm implement dealership that contracts with the Bank to provide sales financing to the dealership's customers. In the opinion of management, these transactions were made in the ordinary course of business on substantially the same terms, including interest rate and collateral, as those prevailing at the time for comparable transactions with unrelated parties. During the year ended December 31, 2015, the Bank purchased approximately \$862,000 of loans to customers of the corporation and the aggregate outstanding balance of all loans purchased from the corporation was approximately \$1.3 million and \$1.2 million at December 31, 2015 and 2014, respectively.

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(5 - continued)

The following table provides the components of the Company's recorded investment in loans at December 31, 2015 and 2014:

	Residential Real Estate	Land	Construct	Real Estate	Commercial Business	Home Equity and Second Mortgage	Other Consumer	Total
	<i>(In thousands)</i>							
December 31, 2015:								
Principal loan balance	\$147,933	\$12,962	\$12,555	\$84,493	\$23,095	\$38,476	\$42,484	\$361,9
Accrued interest receivable	584	70	61	281	64	130	171	1,361
Net deferred loan origination fees and costs	58	6	0	(46)	(6)	571	0	583
Recorded investment in loans	\$148,575	\$13,038	\$12,616	\$84,728	\$23,153	\$39,177	\$42,655	\$363,9
December 31, 2014:								
Principal loan balance	\$106,679	\$11,028	\$8,444	\$78,314	\$28,282	\$37,513	\$34,683	\$304,9
Accrued interest receivable	368	48	20	186	131	131	152	1,036
Net deferred loan origination fees and costs	49	4	(1)	(20)	(7)	481	0	506
Recorded investment in loans	\$107,096	\$11,080	\$8,463	\$78,480	\$28,406	\$38,125	\$34,835	\$306,4

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(5 - continued)

An analysis of the allowance for loan losses and recorded investment in loans as of and for the year ended December 31, 2015 is as follows:

	Residential Real Estate	Land	Construct	Real Estate	Commercial Business	Home Equity and Second Mortgage	Other Consumer	To
	<i>(In thousands)</i>							
Allowance for Loan Losses:								
Beginning balance	\$609	\$201	\$60	\$1,501	\$1,480	\$720	\$275	\$4,000
Provisions	35	(44)	(13)	6	(23)	(49)	138	500
Charge-offs	(128)	0	0	0	(1,205)	(78)	(268)	(1,000)
Recoveries	11	0	0	34	9	33	111	100
Ending balance	\$527	\$157	\$47	\$1,541	\$261	\$626	\$256	\$3,000
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	\$6	\$0	\$0	\$49	\$100	\$11	\$0	\$1,000
Collectively evaluated for impairment	521	157	47	1,492	161	615	256	3,000
Acquired with deteriorated credit quality	0	0	0	0	0	0	0	0
Ending balance	\$527	\$157	\$47	\$1,541	\$261	\$626	\$256	\$3,000
Recorded Investment in Loans:								
Individually evaluated for impairment	\$1,996	\$24	\$0	\$3,623	\$167	\$136	\$0	\$5,000
Collectively evaluated for impairment	145,695	13,014	12,616	80,639	22,986	39,041	42,655	3,000
Acquired with deteriorated credit quality	884	0	0	466	0	0	0	1,000
Ending balance	\$148,575	\$13,038	\$12,616	\$84,728	\$23,153	\$39,177	\$42,655	\$3,000

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(5 - continued)

An analysis of the allowance for loan losses and recorded investment in loans as of and for the year ended December 31, 2014 is as follows:

	Residential Real Estate	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity and Second Mortgage	Other Consumer	Total
	<i>(In thousands)</i>							
Allowance for Loan Losses:								
Beginning balance	\$811	\$152	\$63	\$1,284	\$1,446	\$877	\$289	\$4,922
Provisions	(69)	49	(3)	211	23	(195)	174	190
Charge-offs	(140)	0	0	0	(6)	(154)	(320)	(620)
Recoveries	7	0	0	6	17	192	132	354
Ending balance	\$609	\$201	\$60	\$1,501	\$1,480	\$720	\$275	\$4,867
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	\$47	\$0	\$0	\$11	\$1,293	\$0	\$0	\$1,350
Collectively evaluated for impairment	562	201	60	1,490	187	720	275	3,415
Ending balance	\$609	\$201	\$60	\$1,501	\$1,480	\$720	\$275	\$4,867
Recorded Investment in Loans:								
Individually evaluated for impairment	\$1,411	\$16	\$0	\$1,819	\$1,642	\$151	\$0	\$5,029
Collectively evaluated for impairment	105,685	11,064	8,463	76,661	26,764	37,974	34,835	300,442
Ending balance	\$107,096	\$11,080	\$8,463	\$78,480	\$28,406	\$38,125	\$34,835	\$300,419

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(5 - continued)

At December 31, 2015 and 2014, management applied specific qualitative factor adjustments to the residential real estate, construction, commercial real estate, commercial business, vacant land, and home equity and second mortgage portfolio segments as they determined that the historical loss experience was not indicative of the level of risk in the remaining balance of those portfolio segments. These adjustments increased the loss factors by 0.25% to 20% for certain loan groups, and increased the estimated allowance for loan losses related to those portfolio segments by approximately \$1.4 million and \$1.6 million, respectively. These changes were made to reflect management's estimates of inherent losses in these portfolio segments at December 31, 2015 and 2014.

At December 31, 2015 and 2014, for each loan portfolio segment management applied an overall qualitative factor of 1.18 to the Company's historical loss factors. The overall qualitative factor is derived from management's analysis of changes and trends in the following qualitative factors:

Underwriting Standards – Management reviews the findings of periodic internal audit loan reviews, independent outsourced loan reviews and loan reviews performed by the banking regulators to evaluate the risk associated with changes in underwriting standards. At December 31, 2015 and 2014, management assessed the risk associated with this component as neutral, requiring no adjustment to the historical loss factors.

Economic Conditions – Management analyzes trends in housing and unemployment data in the Louisville, Kentucky metropolitan area, the Company's primary market area, to evaluate the risk associated with economic conditions. Due to a decrease in new home construction and an increase in unemployment in the Company's primary market area, management assigned a risk factor of 1.20 for this component at December 31, 2015 and 2014.

Past Due Loans – Management analyzes trends in past due loans for the Company to evaluate the risk associated with delinquent loans. In general, past due loan ratios have remained at elevated levels compared to historical amounts since 2007, and management assigned a risk factor of 1.20 for this component at December 31, 2015 and 2014.

Other Internal and External Factors – This component includes management's consideration of other qualitative factors such as loan portfolio composition. The Company has focused on the origination of commercial business and real estate loans in an effort to convert the Company's balance sheet from that of a traditional thrift institution to a commercial bank. In addition, the Company has increased its investment in mortgage loans in which it does not hold a first lien position. Commercial loans and second mortgage loans generally entail greater credit risk than residential

mortgage loans secured by a first lien. As a result of changes in the loan portfolio composition and other factors, management has maintained the elevated risk factor of 1.30 for this component at December 31, 2015 and 2014.

Each of the four factors above was assigned an equal weight to arrive at an average for the overall qualitative factor of 1.18 at December 31, 2015 and 2014. The effect of the overall qualitative factor was to increase the estimated allowance for loan losses by \$457,000 and \$520,000 at December 31, 2015 and 2014, respectively.

Management also adjusts the historical loss factors for loans classified as watch, special mention and substandard that are not individually evaluated for impairment. The adjustments consider the increased likelihood of loss on classified loans based on the Company's separate historical experience for classified loans. The effect of the adjustments for classified loans was to increase the estimated allowance for loan losses by \$410,000 and \$664,000 at December 31, 2015 and 2014, respectively.

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(5 - continued)

The following table summarizes the Company's impaired loans as of and for the year ended December 31, 2015. The Company did not recognize any interest income on impaired loans using the cash receipts method of accounting for the year ended December 31, 2015.

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<i>(In thousands)</i>					
Loans with no related allowance recorded:					
Residential real estate	\$1,938	\$2,330	\$0	\$1,356	\$19
Land	24	27	0	20	0
Construction	0	0	0	0	0
Commercial real estate	3,389	3,706	0	2,092	76
Commercial business	67	67	0	19	0
Home equity and second mortgage	56	65	0	64	2
Other consumer	0	0	0	0	0
	\$5,474	\$6,195	\$0	\$3,551	\$97
Loans with an allowance recorded:					
Residential real estate	\$58	\$62	\$6	\$190	\$0
Land	0	0	0	0	0
Construction	0	0	0	0	0
Commercial real estate	234	260	49	78	0
Commercial business	100	100	100	355	0
Home equity and second mortgage	80	81	11	80	0
Other consumer	0	0	0	0	0
	\$472	\$503	\$166	\$703	\$0
Total:					
Residential real estate	\$1,996	\$2,392	\$6	\$1,546	\$19
Land 24	27	0	20	0	
Construction	0	0	0	0	0
Commercial real estate	3,623	3,966	49	2,170	76

Edgar Filing: FIRST CAPITAL INC - Form 10-K

Commercial business	167	167	100	374	0
Home equity and second mortgage	136	146	11	144	2
Other consumer	0	0	0	0	0
	\$5,946	\$ 6,698	\$ 166	\$ 4,254	\$ 97

F-29

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(5 - continued)

The following table summarizes the Company's impaired loans as of and for the year ended December 31, 2014. The Company did not recognize any interest income on impaired loans using the cash receipts method of accounting for the year ended December 31, 2014.

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<i>(In thousands)</i>					
Loans with no related allowance recorded:					
Residential real estate	\$1,141	\$ 1,446	\$ 0	\$ 1,293	\$ 26
Land	16	18	0	96	0
Construction	0	0	0	52	0
Commercial real estate	1,777	1,808	0	1,626	70
Commercial business	0	0	0	113	0
Home equity and second mortgage	71	87	0	147	2
Other consumer	0	0	0	0	0
	\$3,005	\$ 3,359	\$ 0	\$ 3,327	\$ 98
Loans with an allowance recorded:					
Residential real estate	\$270	\$ 304	\$ 47	\$ 369	\$ 0
Land	0	0	0	1	0
Construction	0	0	0	0	0
Commercial real estate	42	65	11	656	0
Commercial business	1,642	1,909	1,293	1,696	0
Home equity and second mortgage	80	98	0	46	0
Other consumer	0	0	0	0	0
	\$2,034	\$ 2,376	\$ 1,351	\$ 2,768	\$ 0
Total:					
Residential real estate	\$1,411	\$ 1,750	\$ 47	\$ 1,662	\$ 26
Land 16	18	0	97	0	
Construction	0	0	0	52	0
Commercial real estate	1,819	1,873	11	2,282	70

Edgar Filing: FIRST CAPITAL INC - Form 10-K

Commercial business	1,642	1,909	1,293	1,809	0
Home equity and second mortgage	151	185	0	193	2
Other consumer	0	0	0	0	0
	\$5,039	\$ 5,735	\$ 1,351	\$ 6,095	\$ 98

F-30

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(5 - continued)

Nonperforming loans consists of nonaccrual loans and loans over 90 days past due and still accruing interest. The following table presents the recorded investment in nonperforming loans at December 31, 2015 and 2014:

	December 31, 2015			December 31, 2014		
	Loans Nonaccrual Loans	90+ Days Past Due Still Accruing	Total Nonperforming Loans	Loans Nonaccrual Loans	90+ Days Past Due Still Accruing	Total Nonperforming Loans
	(In thousands)					
Residential real estate	\$1,648	\$ 271	\$ 1,919	\$919	\$ 68	\$ 987
Land	24	75	99	16	0	16
Construction	0	0	0	0	0	0
Commercial real estate	2,267	0	2,267	433	0	433
Commercial business	167	0	167	1,642	0	1,642
Home equity and second mortgage	116	0	116	129	14	143
Other consumer	0	9	9	0	3	3
Total	\$4,222	\$ 355	\$ 4,577	\$3,139	\$ 85	\$ 3,224

The following table presents the aging of the recorded investment in loans at December 31, 2015:

30-59 Days	60-89 Days	Over 90 Days	Total	Current	Purchased Credit Impaired Loans	Total Loans
Past Due	Past Due	Past Due	Past Due			
(In thousands)						

Edgar Filing: FIRST CAPITAL INC - Form 10-K

Residential real estate	\$3,078	\$786	\$1,256	\$5,120	\$142,571	\$ 884	\$148,575
Land	55	26	99	180	12,858	0	13,038
Construction	71	0	0	71	12,545	0	12,616
Commercial real estate	435	773	396	1,604	82,658	466	84,728
Commercial business	0	100	67	167	22,986	0	23,153
Home equity and second mortgage	365	6	80	451	38,726	0	39,177
Other consumer	464	13	9	486	42,169	0	42,655
Total	\$4,468	\$1,704	\$1,907	\$8,079	\$354,513	\$ 1,350	\$363,942

F-31

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(5 - continued)

The following table presents the aging of the recorded investment in loans at December 31, 2014:

	30-59 Days	60-89 Days	Over 90 Days	Total		Total
	Past Due	Past Due	Past Due	Past Due	Current	Loans
	(In thousands)					
Residential real estate	\$3,070	\$551	\$308	\$3,929	\$103,167	\$107,096
Land	24	124	0	148	10,932	11,080
Construction	0	0	0	0	8,463	8,463
Commercial real estate	54	133	42	229	78,251	78,480
Commercial business	0	0	0	0	28,406	28,406
Home equity and second mortgage	153	23	97	273	37,852	38,125
Other consumer	263	26	3	292	34,543	34,835
Total	\$3,564	\$857	\$450	\$4,871	\$301,614	\$306,485

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, public information, historical payment experience, credit documentation, and current economic trends, among other factors. The Company classifies loans based on credit risk at least quarterly. The Company uses the following regulatory definitions for risk ratings:

Special Mention: Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the Company's credit position at some future date.

Substandard: Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful: Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loss: Loans classified as loss are considered uncollectible and of such little value that their continuance on the Company's books as an asset is not warranted.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans.

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(5 - continued)

The following table presents the recorded investment in loans by risk category as of the date indicated:

	Residential			Commercial		Home Equity and Second Mortgage	Other Consumer	Total
	Real Estate	Land	Construction	Real Estate	Business			
	<i>(In thousands)</i>							
<u>December 31, 2015:</u>								
Pass	\$ 140,438	\$ 10,077	\$ 12,286	\$ 76,389	\$ 22,365	\$ 38,956	\$ 42,553	\$ 343,064
Special mention	3,657	125	330	4,446	471	0	53	9,082
Substandard	1,948	2,812	0	1,195	150	105	49	6,259
Doubtful	2,532	24	0	2,698	167	116	0	5,537
Loss	0	0	0	0	0	0	0	0
Total	\$ 148,575	\$ 13,038	\$ 12,616	\$ 84,728	\$ 23,153	\$ 39,177	\$ 42,655	\$ 363,942
<u>December 31, 2014:</u>								
Pass	\$ 104,780	\$ 7,969	\$ 7,722	\$ 73,204	\$ 26,137	\$ 37,860	\$ 34,770	\$ 292,442
Special mention	105	94	741	2,648	298	2	49	3,937
Substandard	1,292	3,001	0	2,195	329	134	16	6,967
Doubtful	919	16	0	433	1,642	129	0	3,139
Loss	0	0	0	0	0	0	0	0
Total	\$ 107,096	\$ 11,080	\$ 8,463	\$ 78,480	\$ 28,406	\$ 38,125	\$ 34,835	\$ 306,485

F-33

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(5 - continued)

Troubled Debt Restructurings

The following table summarizes the Company's TDRs by accrual status as of December 31, 2015 and 2014:

	December 31, 2015				December 31, 2014			
	Accruing	Nonaccrual	Total	Related Allowance for Loan Losses	Accruing	Nonaccrual	Total	Related Allowance for Loan Losses
	(In thousands)							
Residential real estate	\$342	\$ 315	\$657	\$ 0	\$492	\$ 166	\$658	\$ 6
Commercial real estate	1,348	294	1,642	0	1,386	338	1,724	0
Commercial business	0	0	0	0	0	1,642	1,642	1,292
Home equity and second mortgage	20	0	20	0	22	0	22	0
Total	\$1,710	\$ 609	\$2,319	\$ 0	\$1,900	\$ 2,146	\$4,046	\$ 1,298

At December 31, 2015 and 2014, there were no commitments to lend additional funds to debtors whose loan terms have been modified in a TDR.

There were no TDRs that were restructured during the year ended December 31, 2015. The following table summarizes information in regard to TDRs that were restructured during the year ended December 31, 2014:

Edgar Filing: FIRST CAPITAL INC - Form 10-K

		Pre-Modification Outstanding Number of Contracts (In thousands)	Balance	Post-Modification Outstanding Balance
Commercial real estate	5	\$ 641		\$ 641
Total	5	\$ 641		\$ 641

For the TDRs listed above, the terms of modification included temporary interest-only payment periods and a temporary decrease in the borrowers' monthly payments. There were no principal charge-offs recorded as a result of TDRs during 2014 and there was no specific allowance for loan losses related to TDRs modified during 2014 at December 31, 2014.

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(5 - continued)

The Company had payment defaults (defined as the loan becoming more than 90 days past due, being moved to nonaccrual status, or the collateral being foreclosed upon) on two TDRs to the same borrower totaling \$187,000 during the year ended December 31, 2015. There were no such defaults during the year ended December 31, 2014. In the event that a TDR subsequently defaults, the Company evaluates the restructuring for possible impairment. As a result, the related allowance for loan losses may be increased or charge-offs may be taken to reduce the carrying amount of the loan. The Company did not recognize any provisions for loan losses or net charge-offs as a result of defaulted TDRs for the years ended December 31, 2015 and 2014.

Purchased Credit Impaired ("PCI") Loans

Purchased loans acquired in a business combination are recorded at estimated fair value on their purchase date with no carryover of the related allowance for loan and lease losses. Such loans are accounted for individually or aggregated into pools of loans based on common risk characteristics such as credit score, loan type and date of origination. In determining the estimated fair value of purchased loans or pools, management considers a number of factors including the remaining life, estimated prepayments, estimated loss ratios, estimated value of the underlying collateral, and net present value of cash flows expected to be received, among others. Purchased loans are accounted for in accordance with guidance for certain loans acquired in a transfer (ASC 310-30), when the loans have evidence of credit deterioration since origination and it is probable at the date of acquisition that the acquirer will not collect all contractually required principal and interest payments. The difference between contractually required payments and the cash flows expected to be collected at acquisition is referred to as the nonaccretable difference. The difference between the expected cash flows and the fair value at acquisition is recorded as interest income over the remaining life of the loan or pool of loans and is referred to as the accretable yield. Subsequent decreases to the expected cash flows will generally result in a provision for loan and lease losses. Subsequent increases in expected cash flows will result in a reversal of the provision for loan losses to the extent of prior charges and then an adjustment to accretable yield, which is recognized as future interest income.

The following table presents the carrying amount of PCI loans accounted for under ASC 310-30 at December 31, 2015:

(In thousands)

Residential real estate \$884
 Commercial real estate 466

\$1,350

There was no allowance for loan losses related to PCI loans at December 31, 2015 or 2014. In addition, there were no losses recognized or reductions of the allowance for loan losses on PCI loans for the years ended December 31, 2015 and 2014.

Accretable yield, or income expected to be collected, is as follows for the year ended December 31, 2015:

(In thousands)

Balance at January 1	\$-
New loans purchased	331
Accretion to income	(12)
Disposals of loans	-
Reclassification (to) from nonaccretable difference	-
Balance at December 31	\$319

F-35

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED****(6) PREMISES AND EQUIPMENT**

Premises and equipment as of December 31 consisted of the following:

(In thousands)	2015	2014
Land and land improvements	\$4,771	\$3,256
Leasehold improvements	56	56
Office buildings	12,632	10,605
Furniture, fixtures and equipment	5,662	4,867
	23,121	18,784
Less accumulated depreciation	9,185	8,576
Totals	\$13,936	\$10,208

Depreciation expense was \$744,000 and \$698,000 for the years ended December 31, 2015 and 2014, respectively.

(7) FORECLOSED REAL ESTATE

At December 31, 2015 and 2014, the Bank had foreclosed real estate held for sale of \$4.9 million and \$78,000, respectively. During the years ended December 31, 2015 and 2014, foreclosure losses in the amount of \$1.2 million and \$187,000, respectively, were charged off to the allowance for loan losses. Losses on subsequent write-downs of foreclosed real estate were \$100,000 for 2015. There were no losses on subsequent write-downs of foreclosed real estate for 2014. Net realized losses from the sale of foreclosed real estate amounted to \$15,000 for 2015 and net realized gains from the sale of foreclosed real estate amounted to \$39,000 for 2014. The net gain or loss on foreclosed real estate is reported in other noninterest expense. Net expenses of holding foreclosed real estate are included in other noninterest expenses and amounted to \$50,000 and \$19,000 in 2015 and 2014, respectively. Realized gains from the sale of foreclosed real estate are deferred when the sales are financed by the Bank and do not qualify for recognition under U.S. GAAP. There were no realized gains from the sale of foreclosed real estate deferred for 2015 or 2014. At December 31, 2015 and 2014, deferred gains on the sale of foreclosed real estate financed by the Bank amounted to \$10,000 and \$16,000, respectively.

At December 31, 2015, the recorded investment in consumer mortgage loans collateralized by residential real estate property in the process of foreclosure was \$313,000.

F-36

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED****(8)GOODWILL AND OTHER INTANGIBLES**

The Company acquired goodwill of \$1.1 million in the acquisition of Peoples in addition to acquiring goodwill of \$5.4 million in the acquisition of Hometown Bancshares, Inc. (“Hometown”) during 2003. Goodwill is evaluated for impairment at least annually or more frequently upon the occurrence of an event or when circumstances indicate that the carrying amount is greater than its fair value. No impairment of goodwill was recognized during 2015 or 2014.

The Company acquired a core deposit intangible of \$1.4 million in the acquisition of Peoples. All of the Company’s previously acquired core deposit intangibles had been fully amortized prior to 2014. Core deposit intangible amortization expense totaled \$12,000 for 2015. Estimated amortization expense for the core deposit intangible for each of the ensuing five years and in the aggregate is as follows:

Years ending December 31:	(In thousands)
2016	\$ 147
2017	147
2018	147
2019	147
2020	147
2021 and thereafter	671
Total	\$ 1,406

(9)DEPOSITS

The aggregate amount of time deposit accounts with balances that met or exceeded the FDIC insurance limit of \$250,000 was approximately \$3.5 million and \$2.7 million at December 31, 2015 and 2014, respectively.

At December 31, 2015, scheduled maturities of time deposits were as follows:

Year ending December 31:	(In thousands)
2016	\$ 48,826
2017	24,578
2018	13,017
2019	6,634
2020 and thereafter	3,633
Total	\$ 96,688

The Bank held deposits of approximately \$11.4 million and \$6.1 million for related parties at December 31, 2015 and 2014, respectively. Approximately \$4.7 million of related party deposits at December 31, 2015 are a result of the Peoples acquisition.

(10) RETAIL REPURCHASE AGREEMENTS

Retail repurchase agreements represent overnight borrowings from deposit customers and the debt securities sold under the repurchase agreements are under the control of the Bank. There were no retail repurchase agreements outstanding at December 31, 2015 and 2014, as all such borrowings were paid converted to deposit accounts during 2014. The average balance and maximum month-end balance of retain repurchase agreements for 2014 was \$4.6 million and \$10.6 million, respectively, and the weighted average interest rate on retail repurchase agreements for 2014 was 0.26%.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(11) LINES OF CREDIT

In connection with the acquisition of Peoples Bank, the Bank obtained an unsecured federal funds purchased line of credit through The Bankers' Bank of Kentucky with a maximum borrowing amount of \$5.0 million. At December 31, 2015, the Bank had no outstanding federal funds purchased under the line of credit.

On July 31, 2015, the Company entered into a \$1.0 million revolving line of credit with Stock Yards Bank & Trust Company secured by the stock of the Bank held by the Company. The interest rate charged under the line of credit is the prime rate less 0.25%. At December 31, 2015, the Company had no outstanding borrowings under the line of credit.

(12) ADVANCES FROM FEDERAL HOME LOAN BANK

There were no outstanding advances from the FHLB at December 31, 2015 or 2014. Advances are secured under a blanket collateral agreement with the FHLB. At December 31, 2015, the carrying value of residential mortgage loans pledged as security for potential future advances was \$75.5 million.

(13) LEASE COMMITMENTS

During 2015, the Bank extended a noncancelable lease agreement for branch office space which expires in March 2020 with annual lease payments of \$19,000. At December 31, 2015, minimum lease payments under the lease were \$19,000 for each year ending December 31, 2016 through 2019 and \$5,000 for the year ending December 31, 2020, for an aggregate total of \$81,000.

The Bank's subsidiary companies headquartered in Nevada lease office space under sublease agreements that automatically renew for one year periods each October.

Total rental expense for all operating leases for each of the years ended December 31, 2015 and 2014 was \$30,000 and \$28,000, respectively.

(14) INCOME TAXES

The components of income tax expense for the years ended December 31, 2015 and 2014 were as follows:

(In thousands)	2015	2014
Current	\$1,292	\$2,027
Deferred	672	285
Totals	\$1,964	\$2,312

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(14 - continued)

The reconciliation of income tax expense for the years ended December 31, 2015 and 2014, with the amount which would have been provided at the federal statutory rate of 34% follows:

(In thousands)	2015	2014
Provision at federal statutory tax rate	\$2,440	\$2,692
State income tax-net of federal tax benefit	107	170
Change in state statutory tax rate	(4)	15
Tax-exempt interest income	(405)	(422)
Bank-owned life insurance income	(83)	(95)
Captive insurance net premiums	(322)	(57)
Nondeductible acquisition expense	219	0
Other	12	9
Totals	\$1,964	\$2,312
Effective tax rate	27.4 %	29.2 %

Tax laws enacted in 2013 and 2014 decreased the Indiana financial institutions franchise tax rate beginning in 2014 and ending in 2023. Deferred taxes have been adjusted to reflect the newly enacted rates and the period in which temporary differences are expected to reverse.

Significant components of the deferred tax assets and liabilities as of December 31, 2015 and 2014 were as follows:

(In thousands)	2015	2014
Deferred tax assets (liabilities):		
Deferred compensation plans	\$205	\$92
Allowance for loan losses	872	1,679
Accrued expenses	155	18

Edgar Filing: FIRST CAPITAL INC - Form 10-K

Other	351	157
Deferred tax assets	1,583	1,946
Depreciation	(550)	(647)
Deferred loan fees and costs	(186)	(171)
FHLB stock dividends	(262)	(98)
Prepaid expenses	(258)	(231)
Acquisition purchase accounting adjustments	(181)	0
Unrealized gain on securities available for sale	(261)	(434)
Deferred tax liabilities	(1,698)	(1,581)
Net deferred tax asset (liability)	\$(115)	\$365

At December 31, 2015 and 2014, the Company had no liability for unrecognized income tax benefits related to uncertain tax positions and does not anticipate any increase in the liability for unrecognized tax benefits during the next twelve months. The Company believes that its income tax positions would be sustained upon examination and does not anticipate any adjustments that would result in a material change to its financial position or results of operations. The Company files consolidated U.S. federal income tax returns and Indiana state income tax returns. Returns filed in these jurisdictions for tax years ended on or after December 31, 2012 are subject to examination by the relevant taxing authorities. Each entity included in the consolidated federal and Indiana state income tax returns filed by the Company are charged or given credit for the applicable tax as though separate returns were filed.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(14 - continued)

Retained earnings of the Bank at December 31, 2015 and 2014 include approximately \$1.0 million for which no deferred federal income tax liability has been recognized. This amount represents an allocation of income to bad debt deductions as of December 31, 1987 for tax purposes only. Reduction of such allocated amounts for purposes other than tax bad debt losses, including redemption of bank stock, excess dividends or loss of “bank” status, would create income for tax purposes only, subject to the then-current corporate income tax rate. The unrecorded deferred liability on these amounts was approximately \$354,000 at December 31, 2015 and 2014.

(15)EMPLOYEE BENEFIT PLANS

Defined Contribution Plan:

The Bank has a qualified contributory defined contribution plan available to all eligible employees. The plan allows participating employees to make tax-deferred contributions under Internal Revenue Code Section 401(k). The Bank contributed \$362,000 and \$344,000 to the plan for the years ended December 31, 2015 and 2014, respectively.

Employee Stock Ownership Plan:

On December 31, 1998, the Bank established a leveraged employee stock ownership plan (“ESOP”) covering substantially all employees. The Bank accounts for the ESOP in accordance with FASB ASC 718-40, *Employee Stock Ownership Plans*. The ESOP trust acquired 61,501 shares of Company common stock financed by a loan with the Company with a ten year term. The employer loan and the related interest income are not recognized in the consolidated financial statements as the debt is serviced from Bank contributions. Dividends payable on allocated shares are charged to retained earnings and are satisfied by the allocation of cash dividends to participant accounts. Dividends payable on unallocated shares are not considered dividends for financial reporting purposes. Shares held by the ESOP trust are allocated to participant accounts based on the ratio of the current year principal and interest payments to the total of the current year and future year’s principal and interest to be paid on the employer loan. The employer loan was fully paid in 2008 and all shares of the Company common stock have been allocated to participant

accounts.

Compensation expense is recognized based on the average fair value of shares released for allocation to participant accounts during the year with a corresponding credit to stockholders' equity. No compensation expense was recognized for the years ended December 31, 2015 and 2014 as all shares were allocated during 2008.

At December 31, 2015, the ESOP trust holds 54,204 shares of Company stock, including shares acquired on the open market, all of which have been allocated to participant accounts.

F-40

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(16) DEFERRED COMPENSATION PLANS

The Bank has a deferred compensation plan whereby certain officers will be provided specific amounts of income for a period of fifteen years following normal retirement. The benefits under the agreements are fully vested and will be paid in varying amounts through 2022. As part of the acquisition of Peoples in December 2015, the Bank assumed a non-qualified deferred compensation plan for three key employees of Peoples, which provides for specific amounts of income for a period of ten years following retirement. The benefits under the Peoples plan are fully vested and, assuming normal retirement, will be paid in varying amounts through 2026. The Bank is the owner and beneficiary of insurance policies on the lives of these officers which may provide funds for a portion of the required payments. The agreements also provide for payment of benefits in the event of disability, early retirement, termination of employment or death. The Bank accrues the present value of the benefits under these plans so the amounts required will be provided at the normal retirement dates and thereafter. The balance of the accrued benefit for the plans was \$370,000 and \$66,000 at December 31, 2015 and 2014, respectively. Deferred compensation expense for the Bank's deferred compensation plans for employees was \$8,000 for both of the years ended December 31, 2015 and 2014, respectively.

The Bank also has a directors' deferred compensation plan whereby a director defers into a retirement account a portion of his/her monthly director fees for a specified period to provide a specified amount of income for a period of fifteen years following normal retirement. Assuming normal retirement, the benefits under the plan will be paid in varying amounts through 2036. The agreements also provide for payment of benefits in the event of disability, early retirement, termination of service or death. The Bank accrues the interest cost on the deferred obligation so the amounts required will be provided at the normal retirement dates and thereafter. The balance of the accrued benefit for the director plan was \$164,000 and \$167,000 at December 31, 2015 and 2014, respectively. Deferred compensation expense for the director plan was \$19,000 for both of the years ended December 31, 2015 and 2014.

(17) STOCK-BASED COMPENSATION PLAN

On May 20, 2009, the Company adopted the 2009 Equity Incentive Plan (the "Plan"). The Plan provides for the award of stock options, restricted stock, performance shares and stock appreciation rights. The aggregate number of shares of the Company's common stock available for issuance under the Plan may not exceed 223,000 shares. The Company may grant both non-statutory and statutory stock options which may not have a term exceeding ten years. In the case of incentive stock options, the aggregate fair value of the stock (determined at the time the incentive stock option is granted) for which any optionee may be granted incentive options which are first exercisable during any calendar year shall not exceed \$100,000. Option prices may not be less than the fair market value of the underlying stock at the date

of the grant. An award of a performance share is a grant of a right to receive shares of the Company's common stock which is contingent upon the achievement of specific performance criteria or other objectives set at the grant date. Stock appreciation rights are equity or cash settled share-based compensation arrangements whereby the number of shares that will ultimately be issued or the cash payment is based upon the appreciation of the Company's common stock. Awards granted under the Plan may be granted either alone, in addition to, or in tandem with, any other award granted under the Plan.

The fair market value of stock options granted is estimated at the date of grant using an option pricing model. Expected volatilities are based on historical volatility of the Company's stock. The expected term of options granted represents the period of time that options are expected to be outstanding and is based on historical trends. The risk free rate for the expected life of the options is based on the U.S. Treasury yield curve in effect at the time of grant. As of December 31, 2015, no stock options had been granted under the Plan.

F-41

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(17 - continued)

On February 17, 2015, the Company granted 19,500 restricted stock shares to directors, officers and key employees at a grant-date price of \$24.50 per share for a total of \$478,000. The restricted stock generally vests over a five-year period. Compensation expense is measured based on the fair market value of the restricted stock at the grant date and is recognized ratably over the period during which the shares are earned (the vesting period). Compensation expense related to restricted stock recognized for the year ended December 31, 2015 was \$71,000. A summary of the Company's nonvested restricted shares for the year ended December 31, 2015 is as follows:

	Number of Shares	Weighted Average Grant-Date Fair Value
Nonvested at beginning of year	-	\$ -
Granted	19,500	24.50
Vested	(500)	24.50
Forfeited	(1,000)	24.50
Nonvested at end of year	18,000	\$ 24.50

The total fair value of restricted shares that vested during the year ended December 31, 2015 was \$13,000. At December 31, 2015, unrecognized compensation expense related to nonvested restricted shares was \$382,000. The compensation expense is expected to be recognized over the remaining vesting period of 4.4 years.

(18) COMMITMENTS AND CONTINGENCIES

In the normal course of business, there are outstanding various commitments and contingent liabilities, such as commitments to extend credit and legal claims, which are not reflected in the consolidated financial statements.

Edgar Filing: FIRST CAPITAL INC - Form 10-K

Commitments under outstanding standby letters of credit totaled \$1.3 million and \$693,000 at December 31, 2015 and 2014, respectively.

The following is a summary of the commitments to extend credit at December 31, 2015 and 2014:

(In thousands)	2015	2014
Loan commitments:		
Fixed rate	\$4,007	\$351
Adjustable rate	3,854	7,062
Unused lines of credit on credit cards	4,429	4,732
Undisbursed commercial and personal lines of credit	29,359	19,390
Undisbursed portion of construction loans in process	4,869	3,325
Undisbursed portion of home equity lines of credit	26,910	24,206
Total commitments to extend credit	\$73,428	\$59,066

At December 31, 2015, the Company had a commitment of approximately \$543,000, net of a \$20,000 deposit previously paid, to acquire land for a future branch site. The transaction is expected to be completed in 2016.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(19) FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the balance sheet.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments (see Note 18). The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount and type of collateral obtained, if deemed necessary by the Bank upon extension of credit, varies and is based on management's credit evaluation of the counterparty.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Standby letters of credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank's policy for obtaining collateral, and the nature of such collateral, is essentially the same as that involved in making commitments to extend credit.

The Bank has not been required to perform on any financial guarantees and did not incur any losses on its commitments in 2015 or 2014.

(20) DIVIDEND RESTRICTION

As an Indiana corporation, the Company is subject to Indiana law with respect to the payment of dividends. Under Indiana law, the Company may pay dividends so long as it is able to pay its debts as they become due in the usual course of business and its assets exceed the sum of its total liabilities, plus the amount that would be needed if the Company were to be dissolved at the time of the dividend to satisfy any rights that are preferential to the rights of the persons receiving the dividend. The ability of the Company to pay dividends depends primarily on the ability of the Bank to pay dividends to the Company.

The payment of dividends by the Bank is subject to regulation by the Office of the Comptroller of the Currency ("OCC"). The Bank may not declare or pay a cash dividend or repurchase any of its capital stock if the effect thereof would cause the regulatory capital of the Bank to be reduced below regulatory capital requirements imposed by the OCC or below the amount of the liquidation account established upon completion of the conversion of the Bank's former mutual holding company (First Capital, Inc., MHC) from mutual to stock form on December 31, 1998.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(21) REGULATORY MATTERS

The Bank is subject to various regulatory capital requirements administered by the OCC. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Bank and the consolidated financial statements. Under the regulatory capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines involving quantitative measures of the Bank's assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification under the prompt corrective action guidelines are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and Tier 1 capital (as defined) to average assets (as defined). Effective January 1, 2015, new capital regulations created an additional minimum capital ratio of common equity Tier 1 capital (as defined) to risk-weighted assets (as defined). Management believes that the Bank met all capital adequacy requirements to which it was subject as of December 31, 2015 and 2014.

As of December 31, 2015, the most recent notification from the OCC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based, common equity Tier 1 risk-based and Tier I leverage ratios as set forth in the table below. There are no conditions or events since that notification that management believes have changed the Bank's category.

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(21 - continued)

The Bank's actual capital amounts and ratios are presented in the following table. No amounts were deducted from capital for interest-rate risk in either year.

(Dollars in thousands)	Actual		Minimum for Capital Adequacy Purposes:		Minimum to be Well Capitalized under Prompt Corrective Action Provisions:	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2015:						
Total capital (to risk weighted assets)	\$67,540	16.07%	\$33,624	8.00%	\$42,030	10.00%
Tier I capital (to risk weighted assets)	\$64,125	15.26%	\$25,218	6.00%	\$33,624	8.00%
Common equity Tier I capital (to risk weighted assets)	\$64,125	15.26%	\$18,913	4.50%	\$27,319	6.50%
Tier I capital (to average assets)	\$64,125	12.15%	\$21,110	4.00%	\$26,387	5.00%
As of December 31, 2014:						
Total capital (to risk weighted assets)	\$53,545	15.80%	\$27,105	8.00%	\$33,881	10.00%
Tier I capital (to risk weighted assets)	\$49,302	14.55%	N/A		\$20,329	6.00%
Tier I capital (to adjusted total assets)	\$49,302	10.59%	\$18,624	4.00%	\$23,280	5.00%
Tangible capital (to adjusted total assets)	\$49,302	10.59%	\$6,984	1.50%	N/A	

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED****(22) DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS**

The following table summarizes the carrying value and estimated fair value of financial instruments and the level within the fair value hierarchy (see Note 23) in which the fair value measurements fall at December 31, 2015 and 2014:

<i>(In thousands)</i>	Carrying Value	<u>Fair Value Measurements Using</u>			
		Fair Value Level 1	Level 2	Level 3	
December 31, 2015:					
Financial assets:					
Cash and cash equivalents	\$109,174	\$109,174	\$109,174	\$0	\$0
Interest-bearing time deposits	16,655	16,696	0	16,696	0
Securities available for sale	186,751	186,751	118	186,633	0
Securities held to maturity	4	4	0	4	0
Loans held for sale	3,081	3,145	0	3,145	0
Loans, net	359,166	359,784	0	0	359,784
FHLB and other stock	1,650	1,650	0	1,650	0
Accrued interest receivable	2,244	2,244	0	2,244	0
Cost method investment (included in other assets)	711	711	0	711	0
Financial liabilities:					
Deposits	637,177	636,406	0	0	636,406
Accrued interest payable	167	167	0	167	0
December 31, 2014:					
Financial assets:					
Cash and cash equivalents	\$33,243	\$33,243	\$33,243	\$0	\$0
Interest-bearing time deposits	8,270	8,370	0	8,370	0
Securities available for sale	100,226	100,226	2,083	98,143	0
Securities held to maturity	6	6	0	6	0
Loans held for sale	1,608	1,641	0	1,641	0
Loans, net	300,603	301,864	0	0	301,864
FHLB and other stock	2,241	2,241	0	2,241	0
Accrued interest receivable	1,580	1,580	0	1,580	0
Cost method investment (included in other assets)	711	711	0	711	0

Edgar Filing: FIRST CAPITAL INC - Form 10-K

Financial liabilities:

Deposits	412,636	412,282	0	0	412,282
Accrued interest payable	127	127	0	127	0

F-46

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(22 - continued)

The carrying amounts in the preceding table are included in the consolidated balance sheets under the applicable captions. The contractual or notional amounts of financial instruments with off-balance-sheet risk are disclosed in Note 18, and the fair value of these instruments is considered immaterial.

The following methods and assumptions were used to estimate the fair value of each class of financial instrument for which it is practicable to estimate that value:

Cash and Cash Equivalents

For cash and short-term instruments, including cash and due from banks, interest-bearing deposits with banks, and federal funds sold, the carrying amount is a reasonable estimate of fair value.

Investment Securities and Interest-Bearing Time Deposits

For marketable equity securities, the fair values are based on quoted market prices. For debt securities and interest-bearing time deposits, the Company obtains fair value measurements from an independent pricing service and the fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, U.S. government and agency yield curves, live trading levels, trade execution data, market consensus prepayment speeds, credit information, and the security's terms and conditions, among other factors. For FHLB stock and other restricted equity securities, the carrying amount is a reasonable estimate of fair value because the stock is not marketable. For other cost method investments where a quoted market value is not available, the carrying amount is a reasonable estimate of fair value.

Loans

The fair value of loans, excluding loans held for sale, is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and terms. Impaired loans are valued at the lower of their carrying value or fair value. The carrying amount of accrued interest receivable approximates its fair value.

The fair value of loans held for sale is based on specific prices of underlying contracts for sales to investors.

Deposits

The fair value of demand deposits, savings accounts, money market deposit accounts and other transaction accounts is the amount payable on demand at the balance sheet date. The fair value of fixed-maturity certificates of deposit is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities. The carrying amount of accrued interest payable approximates its fair value.

Borrowed Funds

The carrying amount of retail repurchase agreements and other short-term borrowings approximates its fair value. The fair value of advances from FHLB is estimated by discounting the future cash flows using the current rates at which similar loans with the same remaining maturities could be obtained.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(23) FAIR VALUE MEASUREMENTS

FASB ASC Topic 820, *Fair Value Measurements*, provides the framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under FASB ASC Topic 820 are described as follows:

Level 1: Inputs to the valuation methodology are quoted prices, unadjusted, for identical assets or liabilities in active markets. A quoted market price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.

Level 2: Inputs to the valuation methodology include quoted market prices for similar assets or liabilities in active markets; quoted market prices for identical or similar assets or liabilities in markets that are not active; or inputs that are derived principally from or can be corroborated by observable market data by correlation or other means.

Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement. Level 3 assets and liabilities include financial instruments whose value is determined using discounted cash flow methodologies, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

Fair value is based upon quoted market prices, where available. If quoted market prices are not available, fair value is based on internally developed models or obtained from independent third parties that primarily use, as inputs, observable market-based parameters or a matrix pricing model that employs the Bond Market Association's standard calculations for cash flow and price/yield analysis and observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value, or the lower of cost or fair value. These adjustments may include unobservable parameters. Any such valuation adjustments have been applied consistently over time. The Company's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below. These valuation methodologies were applied to all of the Company's financial and nonfinancial assets carried at fair value or the lower of cost or fair value.

F-48

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(23 - continued)

The table below presents the balances of assets measured at fair value on a recurring and nonrecurring basis as of December 31, 2015. The Company had no liabilities measured at fair value as of December 31, 2015.

	Carrying Value			
	Level 1	Level 2	Level 3	Total
	(In thousands)			
<u>December 31, 2015:</u>				
<i>Assets Measured on a Recurring Basis</i>				
Securities available for sale:				
Agency mortgage-backed securities	\$0	\$42,010	\$0	\$42,010
Agency CMO	0	9,331	0	9,331
Agency notes and bonds	0	84,453	0	84,453
Municipal obligations	0	50,839	0	50,839
Mutual funds	118	0	0	118
Total securities available for sale	\$118	\$186,633	\$0	\$186,751
<i>Assets Measured on a Nonrecurring Basis</i>				
Impaired loans:				
Residential real estate	\$0	\$0	\$1,990	\$1,990
Land	0	0	24	24
Commercial real estate	0	0	3,574	3,574
Commercial business	0	0	67	67
Home equity and second mortgage	0	0	125	125
Total impaired loans	\$0	\$0	\$5,780	\$5,780
Loans held for sale	\$0	\$3,081	\$0	\$3,081
Foreclosed real estate:				
Residential real estate	\$0	\$0	\$557	\$557
Land	0	0	203	203
Commercial real estate	0	0	4,130	4,130
Total foreclosed real estate	\$0	\$0	\$4,890	\$4,890

F-49

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(23 - continued)

The table below presents the balances of assets measured at fair value on a recurring and nonrecurring basis as of December 31, 2014. The Company had no liabilities measured at fair value as of December 31, 2014.

	Carrying Value			
	Level 1	Level 2	Level 3	Total
	(In thousands)			
December 31, 2014:				
<i>Assets Measured on a Recurring Basis</i>				
Securities available for sale:				
Agency mortgage-backed securities	\$0	\$32,296	\$0	\$32,296
Agency CMO	0	14,385	0	14,385
Agency notes and bonds	0	18,120	0	18,120
Municipal obligations	0	33,342	0	33,342
Mutual funds	2,083	0	0	2,083
Total securities available for sale	\$2,083	\$98,143	\$0	\$100,226
<i>Assets Measured on a Nonrecurring Basis</i>				
Impaired loans:				
Residential real estate	\$0	\$0	\$1,364	\$1,364
Land	0	0	16	16
Commercial real estate	0	0	1,808	1,808
Commercial business	0	0	349	349
Home equity and second mortgage	0	0	151	151
Total impaired loans	\$0	\$0	\$3,688	\$3,688
Loans held for sale	\$0	\$1,608	\$0	\$1,608
Foreclosed real estate:				
Residential real estate	\$0	\$0	\$78	\$78
Total foreclosed real estate	\$0	\$0	\$78	\$78

Securities Available for Sale. Securities classified as available for sale are reported at fair value on a recurring basis. These securities are classified as Level 1 of the valuation hierarchy where quoted market prices from reputable third-party brokers are available in an active market. If quoted market prices are not available, the Company obtains fair value measurements from an independent pricing service. These securities are reported using Level 2 inputs and the fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, U.S. government and agency yield curves, live trading levels, trade execution data, market consensus prepayment speeds, credit information, and the security's terms and conditions, among other factors. Changes in fair value of securities available for sale are recorded in other comprehensive income, net of income tax effect.

F-50

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

(23 - continued)

Impaired Loans. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly. The fair value of impaired loans is classified as Level 3 in the fair value hierarchy.

Impaired loans are measured at the present value of estimated future cash flows using the loan's effective interest rate or the fair value of collateral less estimated costs to sell if the loan is collateral dependent. At December 31, 2015 and 2014, all impaired loans were considered to be collateral dependent for the purpose of determining fair value. Collateral may be real estate and/or business assets, including equipment, inventory and/or accounts receivable. The fair value of the collateral is generally determined based on real estate appraisals or other independent evaluations by qualified professionals, which are then discounted to reflect management's estimate of the fair value of the collateral given the current market conditions and the condition of the collateral.

At December 31, 2015, the significant unobservable inputs used in the fair value measurement of impaired loans included a discount from appraised value for estimates of changes in market conditions, the condition of the collateral, and estimated costs to sell the collateral ranging from 10% to 59%, with a weighted average discount of 16%. At December 31, 2014, the significant unobservable inputs used in the fair value measurement of impaired loans included a discount from appraised value for estimates of changes in market conditions, the condition of the collateral, and estimated costs to sell the collateral ranging from 10% to 48%.

The Company recognized provisions for loan losses of \$154,000 and \$49,000 for the years ended December 31, 2015 and 2014, respectively, for impaired loans.

Loans Held for Sale. Loans held for sale are carried at the lower of cost or market value. The portfolio comprised of residential real estate loans and fair value is based on specific prices of underlying contracts for sales to investors. These measurements are carried at Level 2 in the fair value hierarchy.

Foreclosed Real Estate. Foreclosed real estate is reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly. The fair value of foreclosed real estate is classified as Level 3 in the fair value hierarchy.

Foreclosed real estate is reported at fair value less estimated costs to dispose of the property. The fair values are determined by real estate appraisals which are then discounted to reflect management's estimate of the fair value of the property given current market conditions and the condition of the collateral.

At December 31, 2015, the significant unobservable inputs used in the fair value measurement of foreclosed real estate included a discount from appraised value for estimates of changes in market conditions, the condition of the collateral, and estimated costs to sell the property ranging from 9% to 43%, with a weighted average of 30%. At December 31, 2014, the discount from appraised value ranged from 10% to 60%, with a weighted average of 40%.

The Company recognized charges of \$100,000 to write down foreclosed real estate to fair value for the year ended December 31, 2015. The Company did not recognize any charges to write down foreclosed real estate to fair value for the year ended December 31, 2014.

Transfers between Categories. There have been no changes in the valuation techniques and related inputs used for assets measured at fair value on a recurring and nonrecurring basis during the years ended December 31, 2015 and 2014. There were no transfers in or out of the Company's Level 3 financial assets for the years ended December 31, 2015 and 2014. In addition, there were no transfers into or out of Levels 1 and 2 of the fair value hierarchy during the years ended December 31, 2015 and 2014.

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED****(24) PARENT COMPANY CONDENSED FINANCIAL INFORMATION**

Condensed financial information for the Company (parent company only) follows:

Balance Sheets

(In thousands)

	As of December 31,	
	2015	2014
Assets:		
Cash and cash equivalents	\$461	\$309
Other assets	971	911
Investment in subsidiaries	73,027	55,906
	\$74,459	\$57,126
Liabilities and Equity:		
Accrued expenses	\$63	\$5
Stockholders' equity	74,396	57,121
	\$74,459	\$57,126

Statements of Income

(In thousands)

Years Ended
December 31,
2015 2014

Edgar Filing: FIRST CAPITAL INC - Form 10-K

Dividend income from subsidiary	\$18,200	\$4,114
Other income	9	6
Other operating expenses	(1,116)	(376)
Income before income taxes and equity in undistributed net income of subsidiaries	17,093	3,744
Income tax benefit	179	145
Income before equity in undistributed net income of subsidiaries	17,272	3,889
Equity in undistributed net income of subsidiaries	(12,074)	1,705
Net income	\$5,198	\$5,594

F-52

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(24 - continued)

Statements of Cash Flows*(In thousands)*

	Years Ended December 31,	
	2014	2014
Operating Activities:		
Net income	\$5,198	\$5,594
Adjustments to reconcile net income to cash and cash equivalents provided by operating activities:		
Equity in undistributed net income of subsidiaries	12,074	(1,705)
Net change in other assets and liabilities	74	(71)
Net cash provided by operating activities	17,346	3,818
Investing Activities:		
Investment in captive insurance subsidiary	0	(250)
Cost method equity investment	0	(171)
Net cash paid in acquisition of Peoples	(14,748)	0
Net cash used in investing activities	(14,748)	(421)
Financing Activities:		
Advances on line of credit	500	0
Repayment of advances on line of credit	(500)	0
Purchase of treasury stock	(10)	(908)
Cash dividends paid	(2,436)	(2,312)
Net cash used in financing activities	(2,446)	(3,220)
Net increase in cash and cash equivalents	152	177
Cash and cash equivalents at beginning of year	309	132
Cash and cash equivalents at end of year	\$461	\$309

(25) SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

Edgar Filing: FIRST CAPITAL INC - Form 10-K

(In thousands)	Years Ended	
	December 31, 2015	2014
Cash payments for:		
Interest	\$978	\$1,209
Income taxes	1,040	2,464
Noncash investing activities:		
Transfers from loans to real estate acquired through foreclosure	\$809	\$262
Proceeds from sales of foreclosed real estate financed through loans	0	177
Noncash financing activity:		
Issuance of common stock in Peoples acquisition	\$14,755	\$0

F-53

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED****(26) SUPPLEMENTAL DISCLOSURE FOR EARNINGS PER SHARE**

Basic earnings per common share is computed by dividing net income available to common shareholders by the weighted average number of shares of common stock outstanding during the periods presented. Diluted earnings per common share include the dilutive effect of additional potential common shares issuable under stock options, restricted stock and other potentially dilutive securities outstanding. Earnings and dividends per share are restated for stock splits and dividends through the date of issuance of the financial statements. Earnings per share information is presented below for the years ended December 31, 2015 and 2014.

(In thousands, except share and per share data)	Years Ended December	
	31, 2015	2014
Basic:		
Net income attributable to First Capital, Inc.	\$5,198	\$5,594
Shares:		
Weighted average common shares outstanding	2,783,508	2,755,588
Net income per common share attributable to First Capital, Inc., basic	\$1.87	\$2.03
Diluted:		
Net income attributable to First Capital, Inc.	\$5,198	\$5,594
Shares:		
Weighted average common shares outstanding	2,783,508	2,755,588
Add: Dilutive effect of restricted stock	404	0
Weighted average common shares outstanding, as adjusted	2,783,912	2,755,588
Net income per common share attributable to First Capital, Inc., diluted	\$1.87	\$2.03

Nonvested restricted stock shares are not considered as outstanding for purposes of computing weighted average common shares outstanding.

FIRST CAPITAL, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED****(27) SELECTED QUARTERLY FINANCIAL INFORMATION
(UNAUDITED)**

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(In thousands, except per share data)			
2015				
Interest income	\$4,496	\$4,555	\$4,553	\$5,109
Interest expense	243	239	220	302
Net interest income	4,253	4,316	4,333	4,807
Provision for loan losses	0	50	0	0
Net interest income after provision for loan losses	4,253	4,266	4,333	4,807
Noninterest income	1,364	1,214	1,226	1,320
Noninterest expenses	3,679	3,761	3,651	4,517
Income before income taxes	1,938	1,719	1,908	1,610
Income tax expense	469	487	507	501
Net income	1,469	1,232	1,401	1,109
Less: net income attributable to noncontrolling interest in subsidiary	3	4	3	3
Net income attributable to First Capital, Inc.	\$1,466	\$1,228	\$1,398	\$1,106
Earnings per common share attributable to First Capital, Inc.:				
Basic	\$0.53	\$0.45	\$0.51	\$0.38
Diluted	\$0.53	\$0.45	\$0.51	\$0.38
2014				
Interest income	\$4,502	\$4,663	\$4,646	\$4,588
Interest expense	298	297	280	269
Net interest income	4,204	4,366	4,366	4,319
Provision for loan losses	25	90	75	0
Net interest income after provision for loan losses	4,179	4,276	4,291	4,319
Noninterest income	979	1,287	1,438	1,232
Noninterest expenses	3,299	3,349	3,591	3,843
Income before income taxes	1,859	2,214	2,138	1,708
Income tax expense	559	692	611	450

Edgar Filing: FIRST CAPITAL INC - Form 10-K

Net income	1,300	1,522	1,527	1,258
Less: net income attributable to noncontrolling interest in subsidiary	3	4	3	3
Net income attributable to First Capital, Inc.	\$1,297	\$1,518	\$1,524	\$1,255
Earnings per common share attributable to First Capital, Inc.:				
Basic	\$0.47	\$0.55	\$0.56	\$0.45
Diluted	\$0.47	\$0.55	\$0.56	\$0.45

F-55

SIGNATURES

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

FIRST CAPITAL, INC.

Date: March 29, 2016 /s/ William W. Harrod
 William W. Harrod
 President, Chief Executive Officer and a Director

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

<u>Name</u>	<u>Title</u>	<u>Date</u>
/s/ William W. Harrod William W. Harrod	President, Chief Executive Officer and Director (principal executive officer)	March 29, 2016
/s/ Gerald L. Uhl Gerald L. Uhl	Chairman	March 29, 2016
/s/ Michael C. Frederick Michael C. Frederick	Executive Vice President, Chief Financial Officer and Treasurer (principal accounting and financial officer)	March 29, 2016
/s/ Samuel E. Uhl Samuel E. Uhl	Director	March 29, 2016
/s/ Mark D. Shireman Mark D. Shireman	Director	March 29, 2016
/s/ Kenneth R. Saulman Kenneth R. Saulman	Director	March 29, 2016

/s/ Michael L. Shireman Director March 29, 2016
Michael L. Shireman

/s/ Kathryn W. Ernstberger Director March 29, 2016
Kathryn W. Ernstberger

/s/ William I. Orwick, Sr. Director March 29, 2016
William I. Orwick, Sr.

/s/ Carolyn E. Wallace Director March 29, 2016
Carolyn E. Wallace

/s/ Pamela G. Kraft Director March 29, 2016
Pamela G. Kraft

/s/ Christopher L. Byrd Director March 29, 2016
Christopher L. Byrd

/s/ Dana L. Huber Director March 29, 2016
Dana L. Huber