

FIRST CAPITAL INC
Form 10-Q
November 14, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2016

OR

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

For the transition period from _____ to _____

Commission File No. 0-25023

First Capital, Inc.

(Exact name of registrant as specified in its charter)

Indiana **35-2056949**
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification Number)

220 Federal Drive NW, Corydon, Indiana 47112

(Address of principal executive offices) (Zip Code)

Registrant's telephone number including area code 1-812-738-2198

Not applicable

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a small reporting company. See definition 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 Exchange Act). Yes No

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 3,337,552 shares of common stock were outstanding as of October 28, 2016.

FIRST CAPITAL, INC.

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PART I - FINANCIAL INFORMATION

FIRST CAPITAL, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Unaudited)

	<u>September</u> <u>30,</u> <u>2016</u>	<u>December</u> <u>31,</u> <u>2015</u>
	(In thousands)	
ASSETS		
Cash and due from banks	\$ 16,255	\$ 14,756
Interest bearing deposits with banks	1,382	3,635
Federal funds sold	52,744	90,783
Total cash and cash equivalents	70,381	109,174
Interest-bearing time deposits	15,540	16,655
Securities available for sale, at fair value	247,250	186,751
Securities-held to maturity	3	4
Loans, net	366,367	359,166
Loans held for sale	2,553	3,081
Federal Home Loan Bank and other stock, at cost	1,650	1,650
Foreclosed real estate	4,254	4,890
Premises and equipment	14,554	13,936
Accrued interest receivable	2,361	2,244
Cash value of life insurance	7,041	6,899
Goodwill	6,472	6,472
Core deposit intangible	1,296	1,406
Other assets	2,355	3,499
Total Assets	\$ 742,077	\$ 715,827
LIABILITIES		
Deposits:		
Noninterest-bearing	\$ 124,205	\$ 125,059
Interest-bearing	534,542	512,118
Total deposits	658,747	637,177
Accrued interest payable	137	167
Accrued expenses and other liabilities	4,487	3,975
Total liabilities	663,371	641,319
EQUITY		
Preferred stock of \$.01 par value per share Authorized 1,000,000 shares; none issued	0	0
Common stock of \$.01 par value per share Authorized 5,000,000 shares; issued 3,762,933 shares; outstanding 3,337,552 shares (3,338,603 in 2015)	38	38

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Additional paid-in capital	39,515	39,515
Retained earnings-substantially restricted	46,012	42,991
Unearned stock compensation	(322)	(382)
Accumulated other comprehensive income	1,652	497
Less treasury stock, at cost -425,381 shares (424,330 in 2015)	(8,297)	(8,263)
Total First Capital, Inc. stockholders' equity	78,598	74,396
Noncontrolling interest in subsidiary	108	112
Total equity	78,706	74,508
Total Liabilities and Equity	\$742,077	\$715,827

See accompanying notes to consolidated financial statements.

PART I - FINANCIAL INFORMATION

FIRST CAPITAL, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended <u>September 30,</u>		Nine Months Ended <u>September 30,</u>	
	<u>2016</u>	<u>2015</u>	<u>2016</u>	<u>2015</u>
INTEREST INCOME	(In thousands, except per share data)			
Loans, including fees	\$4,940	\$3,983	\$15,106	\$11,876
Securities:				
Taxable	861	267	2,424	797
Tax-exempt	279	243	862	733
Federal Home Loan Bank dividends	16	20	49	72
Federal funds sold and interest bearing deposits with banks	119	40	409	126
Total interest income	6,215	4,553	18,850	13,604
INTEREST EXPENSE				
Deposits	414	220	1,370	702
Total interest expense	414	220	1,370	702
Net interest income	5,801	4,333	17,480	12,902
Provision for loan losses	200	0	425	50
Net interest income after provision for loan losses	5,601	4,333	17,055	12,852
NONINTEREST INCOME				
Service charges on deposit accounts	1,046	897	2,968	2,527
Commission income	112	121	306	305
Gain on sale of securities	0	0	176	0
Gain on sale of loans	371	131	889	617
Mortgage brokerage fees	0	15	0	61
Increase in cash surrender value of life insurance	40	34	143	101
Other income	181	28	251	193
Total noninterest income	1,750	1,226	4,733	3,804
NONINTEREST EXPENSE				
Compensation and benefits	2,681	1,885	8,018	5,866
Occupancy and equipment	447	317	1,222	940
Data processing	650	441	1,784	1,271
Professional fees	189	258	626	839
Advertising	74	92	249	240
Other operating expenses	883	658	2,859	1,935
Total noninterest expense	4,924	3,651	14,758	11,091
Income before income taxes	2,427	1,908	7,030	5,565
Income tax expense	666	507	1,897	1,463
Net Income	1,761	1,401	5,133	4,102
Less: net income attributable to noncontrolling interest in subsidiary	3	3	10	10

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Net Income Attributable to First Capital, Inc.	\$1,758	\$1,398	\$5,123	\$4,092
Earnings per common share attributable to First Capital, Inc.				
Basic	\$0.53	\$0.51	\$1.53	\$1.49
Diluted	\$0.53	\$0.51	\$1.53	\$1.49
Dividends per share	\$0.21	\$0.21	\$0.63	\$0.63

See accompanying notes to consolidated financial statements.

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PART I - FINANCIAL INFORMATION

FIRST CAPITAL, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended <u>September 30,</u> <u>2016</u>		Nine Months Ended <u>September 30,</u> <u>2016</u>	
	<u>2015</u>		<u>2015</u>	
	(In thousands)			
Net Income	\$1,761	\$1,401	\$5,133	\$4,102
OTHER COMPREHENSIVE INCOME (LOSS)				
Unrealized gains (losses) on securities available for sale:				
Unrealized holding gains (losses) arising during the period	(637)	588	2,082	(49)
Income tax (expense) benefit	248	(229)	(811)	19
Net of tax amount	(389)	359	1,271	(30)
Less:reclassification adjustment for realized gains included in net income	0	0	(176)	0
Income tax expense	0	0	60	0
Net of tax amount	0	0	(116)	0
Other Comprehensive Income (Loss), net of tax	(389)	359	1,155	(30)
Comprehensive Income	1,372	1,760	6,288	4,072
Less:comprehensive income attributable to the noncontrolling interest in subsidiary	3	3	10	10
Comprehensive Income Attributable to First Capital, Inc.	\$1,369	\$1,757	\$6,278	\$4,062

See accompanying notes to consolidated financial statements.

PART I - FINANCIAL INFORMATION

FIRST CAPITAL, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

(Unaudited)

(In thousands, except share and per share data)	Common Stock	Additional Paid-in Capital	Retained Earnings	Unearned Stock Compensation	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Noncontrolling Interest	Total
Balances at January 1, 2015	\$32	\$24,313	\$40,229	\$0	\$800	\$(8,253)	\$112	\$57,233
Net income	0	0	4,092	0	0	0	10	4,102
Other comprehensive loss	0	0	0	0	(30)	0	0	(30)
Cash dividends	0	0	(1,734)	0	0	0	(14)	(1,748)
Restricted stock grants, net of forfeitures	0	453	0	(453)	0	0	0	0
Stock compensation expense	0	0	0	53	0	0	0	53
Purchase of treasury shares	0	0	0	0	0	(10)	0	(10)
Balances at September 30, 2015	\$32	\$24,766	\$42,587	\$(400)	\$770	\$(8,263)	\$108	\$59,600
Balances at January 1, 2016	\$38	\$39,515	\$42,991	\$(382)	\$497	\$(8,263)	\$112	\$74,508
Net income	0	0	5,123	0	0	0	10	5,133
Other comprehensive income	0	0	0	0	1,155	0	0	1,155
Cash dividends	0	0	(2,102)	0	0	0	(14)	(2,116)
Stock compensation expense	0	0	0	60	0	0	0	60
Purchase of treasury shares	0	0	0	0	0	(34)	0	(34)
Balances at September 30, 2016	\$38	\$39,515	\$46,012	\$(322)	\$1,652	\$(8,297)	\$108	\$78,706

See accompanying notes to consolidated financial statements.

PART I - FINANCIAL INFORMATION

FIRST CAPITAL, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended	
	<u>September 30,</u>	
	<u>2016</u>	<u>2015</u>
	(In thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$5,133	\$4,102
Adjustments to reconcile net income to net cash and cash equivalents provided by operating activities:		
Amortization of premiums and accretion of discounts on securities, net	839	516
Depreciation and amortization expense	876	533
Deferred income taxes	400	492
Stock compensation expense	60	53
Increase in cash value of life insurance	(142)	(101)
Gain on life insurance	0	(110)
Gain on sale of securities	(176)	0
Provision for loan losses	425	50
Proceeds from sales of loans	38,608	22,193
Loans originated for sale	(37,191)	(20,292)
Gain on sale of loans	(889)	(617)
Decrease (increase) in accrued interest receivable	(117)	57
Decrease in accrued interest payable	(30)	(37)
Net change in other assets/liabilities	551	(122)
Net Cash Provided By Operating Activities	8,347	6,717
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment in interest-bearing time deposits	(1,975)	(3,610)
Proceeds from maturities and sales of interest-bearing time deposits	3,090	245
Purchase of securities available for sale	(159,338)	(20,375)
Proceeds from maturities of securities available for sale	82,271	15,863
Proceeds from sales of securities available for sale	4,583	0
Principal collected on mortgage-backed obligations	13,183	8,973
Net increase in loans receivable	(7,857)	(5,124)
Proceeds from redemption of Federal Home Loan Bank stock	0	691
Proceeds from sale of foreclosed real estate	867	157
Purchase of premises and equipment	(1,384)	(561)
Net Cash Used In Investing Activities	(66,560)	(3,741)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase (decrease) in deposits	21,570	(10,050)
Purchase of treasury stock	(34)	(10)

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Dividends paid	(2,116)	(1,748)
Net Cash Provided By (Used In) Financing Activities	19,420	(11,808)
Net Increase Decrease in Cash and Cash Equivalents	(38,793)	(8,832)
Cash and cash equivalents at beginning of period	109,174	33,243
Cash and Cash Equivalents at End of Period	\$70,381	\$24,411

See accompanying notes to consolidated financial statements.

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FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Presentation of Interim Information

First Capital, Inc. (“Company”) is the savings and loan holding company for First Harrison Bank (“Bank”). The information presented in this report relates primarily to the Bank's operations. 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 portfolio. First Harrison REIT, Inc. (“REIT”) was incorporated as a wholly-owned subsidiary of First Harrison Holdings, Inc. to hold a portion of the Bank’s real estate mortgage loan portfolio. On January 21, 2009, the REIT issued 105 shares of 12.5% redeemable cumulative preferred stock with an aggregate liquidation value of \$105,000 in a private placement offering in order to satisfy certain ownership requirements to qualify as a real estate investment trust. At September 30, 2016, this noncontrolling interest represented 0.1% ownership of the REIT. FHB Risk Mitigation Services, Inc. (“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 ten other third party insurance captives for which insurance may not be currently available or economically feasible in the insurance marketplace. Heritage Hill, LLC is a wholly-owned subsidiary of the Bank that holds and manages certain foreclosed real estate properties.

In the opinion of management, the unaudited consolidated financial statements include all adjustments considered necessary to present fairly the financial position as of September 30, 2016, and the results of operations for the three months and nine months ended September 30, 2016 and 2015 and the cash flows for the nine months ended September 30, 2016 and 2015. All of these adjustments are of a normal, recurring nature. Such adjustments are the only adjustments included in the unaudited consolidated financial statements. Interim results are not necessarily indicative of results for a full year or any other period.

The accompanying unaudited consolidated financial statements and notes have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial statements and are presented as permitted by the instructions to Form 10-Q. Accordingly, they do not contain certain information included in the Company’s annual audited consolidated financial statements and related footnotes for the year ended December 31, 2015 included in the Company’s Annual Report on Form 10-K.

The unaudited consolidated financial statements include the accounts of the Company and its subsidiaries. All material intercompany balances and transactions have been eliminated in consolidation.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. Acquisition of Peoples Bancorp, Inc. of Bullitt County

On December 4, 2015, the Company completed its acquisition of Peoples Bancorp, Inc. of Bullitt County (“Peoples”) and its wholly owned subsidiary 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 financial institution. The acquisition expanded the Company’s presence into Bullitt County, Kentucky and 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.

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. 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. Currently, there is 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 was 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 was recorded as goodwill. The goodwill arising from the acquisition consisted 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.

Acquisition-related costs of approximately \$86,000 and \$353,000 are included in noninterest expense in the accompanying consolidated statements of income for the three and nine months, respectively, ended September 30, 2015. There were no acquisition-related costs for the three or nine months ended September 30, 2016.

Additional information regarding the Peoples acquisition can be found in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

*(Unaudited)***3. Investment Securities**

Debt and equity securities have been classified in the consolidated balance sheets according to management's intent. Investment securities at September 30, 2016 and December 31, 2015 are summarized as follows:

(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<u>September 30, 2016</u>				
Securities available for sale:				
Agency mortgage-backed securities	\$98,359	\$ 728	\$ 35	\$99,052
Agency CMO	17,195	89	59	17,225
Other debt securities:				
Agency notes and bonds	72,399	117	55	72,461
Municipal obligations	56,576	1,943	110	58,409
Subtotal - debt securities	244,529	2,877	259	247,147
Mutual funds	103	0	0	103
Total securities available for sale	\$244,632	\$ 2,877	\$ 259	\$247,250
Securities held to maturity:				
Agency mortgage-backed securities	\$3	\$ 0	\$ 0	\$3
Total securities held to maturity	\$3	\$ 0	\$ 0	\$3
<u>December 31, 2015</u>				
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

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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

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FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(3 – continued)

Agency notes and bonds, agency mortgage-backed securities and agency collateralized mortgage obligations (CMO) include 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), which are government-sponsored enterprises.

The amortized cost and fair value of debt securities as of September 30, 2016, by contractual maturity, are shown below. Expected maturities of mortgage-backed securities may differ from contractual maturities because the mortgages underlying the obligations may be prepaid without penalty.

	<u>Securities Available</u>		<u>Securities</u>	
	<u>for Sale</u>		<u>Held to</u>	
	Amortized	Fair	Amortized	Fair
	Cost	Value	Cost	Value
(In thousands)				
Due in one year or less	\$2,543	\$2,550	\$ 0	\$ 0
Due after one year through five years	76,637	76,854	0	0
Due after five years through ten years	17,579	17,855		
Due after ten years	32,216	33,611	0	0
	128,975	130,870	0	0
Mortgage-backed securities and CMO	115,554	116,277	3	3
	\$244,529	\$247,147	\$ 3	\$ 3

Information pertaining to investment securities available for sale with gross unrealized losses at September 30, 2016, aggregated by investment category and the length of time that individual investment securities have been in a continuous position, follows:

Number of	Fair	Gross
Investment	Value	Unrealized

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	Positions	Losses	
(Dollars in thousands)			
Continuous loss position less than twelve months:			
Agency notes and bonds	8	\$29,198	\$ 55
Agency CMO	5	5,080	43
Agency mortgage-backed securities	10	21,381	34
Municipal obligations	19	10,602	110
Total less than twelve months	42	66,261	242
Continuous loss position more than twelve months:			
Agency CMO	5	2,744	16
Agency mortgage-backed securities	1	571	1
Total more than twelve months	6	3,315	17
Total securities available for sale	48	\$69,576	\$ 259

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FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(3 – continued)

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 recover in fair value.

At September 30, 2016, the U.S. government agency debt securities, including agency notes and bonds, mortgage-backed securities and CMO, and municipal obligations in a loss position had depreciated approximately 0.4% from the amortized cost basis. All of the U.S. government agency securities and municipal obligations are issued by U.S. government agencies, government-sponsored enterprises and municipal governments, or 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 debt securities until maturity, or the foreseeable future if classified as available for sale, no declines are deemed to be other-than-temporary.

While management does not anticipate any credit-related impairment losses at September 30, 2016, additional deterioration in market and economic conditions may have an adverse impact on credit quality in the future.

During the nine months ended September 30, 2016, the Company realized gross gains on sales of available for sale municipal securities of \$176,000. During the three months ended September 30, 2016 and the three and nine months ended September 30, 2015, the Company did not have any security sales.

In June 2014, the Company acquired an additional 31,750 shares of common stock in another financial institution, in addition to the 100,000 shares acquired in December 2013, representing approximately 9% of the outstanding common stock of the entity, for a total investment of \$711,000. The investment was accounted for using the cost method of accounting and was included in other assets in the consolidated balance sheet. The Company's investment was sold for \$856,000 in July 2016, resulting in a gain of \$145,000 which was recognized in the quarter ending September 30, 2016 and is included in other noninterest income in the accompanying statement of income.

4. Loans and Allowance for Loan Losses

The Company's loan and allowance for loan loss policies are as follows:

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 the Louisville, Kentucky metropolitan statistical area (MSA). The ability of the Company's customers to honor their loan agreements is largely dependent upon the real estate and general economic conditions in this area.

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FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

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.

The recognition of income on a loan is discontinued and previously accrued interest is reversed, when interest or principal payments become ninety (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.

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 below. Specific reserves are not considered charge-offs in management's analysis of the allowance for loan losses because they are estimates and the outcome of the loan relationship is undetermined. At September 30, 2016, the Company had 10 loans on which partial charge-offs of \$468,000 had been recorded.

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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.

The allowance for loan losses reflects management's judgment of probable loan losses inherent in the loan portfolio at the balance sheet date. Additions to the allowance for loan losses are made by the 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.

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FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

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 also 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.

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 most recent twelve calendar quarters 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 below for additional discussion of the overall loss factor and loss factor multiples for classified loans as of September 30, 2016 and December 31, 2015.

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.

Management utilizes the following portfolio segments in its analysis of the allowance for loan losses: residential real estate, land, construction, commercial real estate, commercial business, home equity and second mortgage, and other consumer loans. Additional discussion of the portfolio segments and the risks associated with each segment can be found in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

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FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

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.

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 September 30, 2016, the recorded investments in loans secured by residential real estate properties for which formal foreclosure proceedings are in process was \$799,000.

Loans at September 30, 2016 and December 31, 2015 consisted of the following:

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

(In thousands)	<u>September</u> <u>30,</u> <u>2016</u>	<u>December</u> <u>31,</u> <u>2015</u>
Real estate mortgage loans:		
Residential	\$133,929	\$147,933
Land	13,195	12,962
Residential construction	26,972	16,391
Commercial real estate	93,798	84,493
Commercial real estate construction	8,848	1,090
Commercial business loans	22,888	23,095
Consumer loans:		
Home equity and second mortgage loans	42,093	38,476
Automobile loans	33,025	28,828
Loans secured by savings accounts	1,819	2,096
Unsecured loans	3,782	4,350
Other consumer loans	9,070	7,210
Gross loans	389,419	366,924
Less undisbursed portion of loans in process	(20,495)	(4,926)
Principal loan balance	368,924	361,998
Deferred loan origination fees, net	763	583
Allowance for loan losses	(3,320)	(3,415)
Loans, net	\$366,367	\$359,166

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

The following table provides the components of the Company's recorded investment in loans at September 30, 2016:

	Residential Real Estate (In thousands)	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
Recorded Investment in Loans:								
Principal loan balance	\$ 133,929	\$ 13,195	\$ 15,325	\$ 93,798	\$ 22,888	\$ 42,093	\$ 47,696	\$ 368,924
Accrued interest receivable	440	56	37	263	59	135	189	1,179
Net deferred loan origination fees and costs	73	13	0	(44)	1	720	0	763
Recorded investment in loans	\$ 134,442	\$ 13,264	\$ 15,362	\$ 94,017	\$ 22,948	\$ 42,948	\$ 47,885	\$ 370,866
Recorded Investment in Loans as Evaluated for Impairment:								
Individually evaluated for impairment	\$ 2,034	\$ 0	\$ 0	\$ 2,983	\$ 61	\$ 62	\$ 30	\$ 5,170
Collectively evaluated for impairment	132,031	13,264	15,362	90,785	22,887	42,886	47,855	365,070
Acquired with deteriorated credit quality	377	0	0	249	0	0	0	626
Ending balance	\$ 134,442	\$ 13,264	\$ 15,362	\$ 94,017	\$ 22,948	\$ 42,948	\$ 47,885	\$ 370,866

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

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

	Residential Real Estate (In thousands)	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
Recorded Investment in Loans:								
Principal loan balance	\$ 147,933	\$ 12,962	\$ 12,555	\$ 84,493	\$ 23,095	\$ 38,476	\$ 42,484	\$ 361,998
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	\$ 363,942
Recorded Investment in Loans as Evaluated for Impairment:								
Individually evaluated for impairment	\$ 1,996	\$ 24	\$ 0	\$ 3,623	\$ 167	\$ 136	\$ 0	\$ 5,946
Collectively evaluated for impairment	145,695	13,014	12,616	80,639	22,986	39,041	42,655	356,646
Acquired with deteriorated credit quality	884	0	0	466	0	0	0	1,350
Ending balance	\$ 148,575	\$ 13,038	\$ 12,616	\$ 84,728	\$ 23,153	\$ 39,177	\$ 42,655	\$ 363,942

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

An analysis of the allowance for loan losses as of September 30, 2016 is as follows:

	Residential Real Estate	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
	(In thousands)							
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	\$ 15	\$ 0	\$ 0	\$ 0	\$ 0	\$ 13	\$ 6	\$ 34
Collectively evaluated for impairment	367	49	63	1,576	141	813	277	3,286
Acquired with deteriorated credit quality	0	0	0	0	0	0	0	0
Ending balance	\$ 382	\$ 49	\$ 63	\$ 1,576	\$ 141	\$ 826	\$ 283	\$ 3,320

An analysis of the allowance for loan losses as of December 31, 2015 is as follows:

	Residential Real Estate	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
	(In thousands)							
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	\$ 6	\$ 0	\$ 0	\$ 49	\$ 100	\$ 11	\$ 0	\$ 166
Collectively evaluated for impairment	521	157	47	1,492	161	615	256	3,249
Acquired with deteriorated credit quality	0	0	0	0	0	0	0	0
Ending balance	\$ 527	\$ 157	\$ 47	\$ 1,541	\$ 261	\$ 626	\$ 256	\$ 3,415

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

An analysis of the changes in the allowance for loan losses for the three months and nine months ended September 30, 2016 is as follows:

	Residential Real Estate	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
(In thousands)								
Allowance for loan losses:								
Changes in Allowance for Loan Losses for the three-months ended September 30, 2016								
Beginning balance	\$408	\$47	\$ 42	\$ 1,473	\$ 162	\$ 791	\$ 266	\$3,189
Provisions for loan losses	(29)	2	21	100	(21)	31	96	200
Charge-offs	(14)	0	0	0	0	0	(106)	(120)
Recoveries	17	0	0	3	0	4	27	51
Ending balance	\$382	\$49	\$ 63	\$ 1,576	\$ 141	\$ 826	\$ 283	\$3,320
Changes in Allowance for Loan Losses for the nine-months ended September 30, 2016								
Beginning balance	\$527	\$157	\$ 47	\$ 1,541	\$ 261	\$ 626	\$ 256	\$3,415
Provisions for loan losses	(70)	(99)	16	96	(9)	223	268	425
Charge-offs	(108)	(9)	0	(82)	(114)	(36)	(325)	(674)
Recoveries	33	0	0	21	3	13	84	154
Ending balance	\$382	\$49	\$ 63	\$ 1,576	\$ 141	\$ 826	\$ 283	\$3,320

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

An analysis of the changes in the allowance for loan losses for the three months and nine months ended September 30, 2015 is as follows:

	Residential Real Estate	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
	(In thousands)							
Allowance for loan losses:								
Changes in Allowance for Loan Losses for the three-months ended September 30, 2015								
Beginning balance	\$634	\$173	\$ 51	\$ 1,669	\$ 161	\$ 648	\$ 264	\$3,600
Provisions for loan losses	(15)	(12)	(2)	(60)	19	26	44	0
Charge-offs	(41)	0	0	0	0	(36)	(79)	(156)
Recoveries	6	0	0	4	5	6	29	50
Ending balance	\$584	\$161	\$ 49	\$ 1,613	\$ 185	\$ 644	\$ 258	\$3,494
Changes in Allowance for Loan Losses for the nine-months ended September 30, 2015								
Beginning balance	\$609	\$201	\$ 60	\$ 1,501	\$ 1,480	\$ 720	\$ 275	\$4,846
Provisions for loan losses	27	(40)	(11)	96	(97)	(20)	95	50
Charge-offs	(61)	0	0	0	(1,205)	(68)	(203)	(1,537)
Recoveries	9	0	0	16	7	12	91	135
Ending balance	\$584	\$161	\$ 49	\$ 1,613	\$ 185	\$ 644	\$ 258	\$3,494

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

At September 30, 2016 and December 31, 2015, management applied specific qualitative factor adjustments to the residential real estate, construction, commercial real estate, commercial business, 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 \$1.7 million and \$1.4 million at September 30, 2016 and December 31, 2015, respectively. These changes were made to reflect management's estimates of inherent losses in these portfolio segments at September 30, 2016 and December 31, 2015.

At September 30, 2016 and 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, economic conditions, past due loans and other internal and external factors. 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 September 30, 2016 and December 31, 2015, respectively. The effect of the overall qualitative factor was to increase the estimated allowance for loan losses by \$509,000 and \$457,000 at September 30, 2016 and December 31, 2015, respectively. Additional discussion of the overall qualitative factor can be found in the Company's Annual Report on Form 10-K for the year ended December 31, 2015. There were no changes in management's assessment of the overall qualitative factor components from December 31, 2015 to September 30, 2016.

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 \$642,000 and \$410,000 at September 30, 2016 and December 31, 2015, respectively. During the period from December 31, 2015 to September 30, 2016, management adjusted these factors to compensate for the acquisition of the Peoples loan portfolio.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

The following table summarizes the Company's impaired loans as of September 30, 2016 and for the three months and nine months ended September 30, 2016. The Company did not recognize any interest income on impaired loans using the cash receipts method of accounting for the three or nine month periods ended September 30, 2016:

	At September 30, 2016			Three Months Ended September 30, 2016		Nine Months Ended September 30, 2016	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Interest Recorded Investment	Income Recognized	Average Interest Recorded Investment	Income Recognized
(In thousands)							
Loans with no related allowance recorded:							
Residential	\$1,914	\$2,260	\$ 0	\$1,903	\$ 6	\$1,912	\$ 20
Land	0	0	0	0	0	6	0
Construction	0	0	0	0	3	0	3
Commercial real estate	2,983	3,412	0	3,396	18	3,394	55
Commercial business	61	66	0	62	0	64	0
Home equity/2nd mortgage	49	55	0	52	0	53	1
Other consumer	10	28	0	7	0	5	0
	5,017	5,821	0	5,420	27	5,434	79
Loans with an allowance recorded:							
Residential	120	123	15	157	0	132	0
Land	0	0	0	0	0	0	0
Construction	0	0	0	0	0	0	0
Commercial real estate	0	0	0	87	0	124	0
Commercial business	0	0	0	33	0	50	0
Home equity/2nd mortgage	13	14	13	13	0	30	0
Other consumer	20	20	6	29	0	22	0
	153	157	34	319	0	358	0
Total:							
Residential	2,034	2,383	15	2,060	6	2,044	20
Land	0	0	0	0	0	6	0

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Construction	0	0	0	0	3	0	3
Commercial real estate	2,983	3,412	0	3,483	18	3,518	55
Commercial business	61	66	0	95	0	114	0
Home equity/2nd mortgage	62	69	13	65	0	83	1
Other consumer	30	48	6	36	0	27	0
	\$5,170	\$5,978	\$ 34	\$5,739	\$ 27	\$5,792	\$ 79

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FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

The following table summarizes the Company's impaired loans for the three months and nine months ended September 30, 2015. The Company did not recognize any interest income on impaired loans using the cash receipts method of accounting for the three or nine month periods ended September 30, 2015:

	Three Months Ended September 30, 2015		Nine Months Ended September 30, 2015	
	Average Interest Recorded	Investment Recognized	Average Interest Recorded	Investment Recognized
Loans with no related allowance recorded:				
Residential	\$1,177	\$ 5	\$1,211	\$ 14
Land	21	0	19	0
Construction	0	0	0	0
Commercial real estate	1,755	19	1,768	57
Commercial business	0	1	7	1
Home equity/2nd mortgage	62	1	66	1
Other consumer	0	0	0	0
	3,015	26	3,071	73
Loans with an allowance recorded:				
Residential	205	0	223	0
Land	0	0	0	0
Construction	0	0	0	0
Commercial real estate	38	0	39	0
Commercial business	0	0	419	0
Home equity/2nd mortgage	80	0	80	0
Other consumer	0	0	0	0
	323	0	761	0
Total:				
Residential	1,382	5	1,434	14
Land	21	0	19	0
Construction	0	0	0	0

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Commercial real estate	1,793	19	1,807	57
Commercial business	0	1	426	1
Home equity/2nd mortgage	142	1	146	1
Other consumer	0	0	0	0
	\$3,338	\$ 26	\$3,832	\$ 73

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FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

The following table summarizes the Company's impaired loans as of December 31, 2015:

	Recorded Investment	Unpaid Principal Balance	Related Allowance
	(In thousands)		
Loans with no related allowance recorded:			
Residential	\$1,938	\$ 2,330	\$ 0
Land	24	27	0
Construction	0	0	0
Commercial real estate	3,389	3,706	0
Commercial business	67	67	0
Home equity/2nd mortgage	56	65	0
Other consumer	0	0	0
	5,474	6,195	0
Loans with an allowance recorded:			
Residential	58	62	6
Land	0	0	0
Construction	0	0	0
Commercial real estate	234	260	49
Commercial business	100	100	100
Home equity/2nd mortgage	80	81	11
Other consumer	0	0	0
	472	503	166
Total:			
Residential	1,996	2,392	6
Land	24	27	0
Construction	0	0	0
Commercial real estate	3,623	3,966	49
Commercial business	167	167	100
Home equity/2nd mortgage	136	146	11
Other consumer	0	0	0

\$5,946 \$6,698 \$ 166

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FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – 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 September 30, 2016 and December 31, 2015:

	September 30, 2016			December 31, 2015		
	Nonaccrual Loans	Loans 90+ Days Past Due Still Accruing	Total Nonperforming Loans	Nonaccrual Loans	Loans 90+ Days Past Due Still Accruing	Total Nonperforming Loans
	(In thousands)					
Residential	\$1,584	\$ 27	\$ 1,611	\$1,648	\$ 271	\$ 1,919
Land	0	0	0	24	75	99
Construction	0	177	177	0	0	0
Commercial real estate	1,658	0	1,658	2,267	0	2,267
Commercial business	61	0	61	167	0	167
Home equity/2nd mortgage	44	0	44	116	0	116
Other consumer	30	0	30	0	9	9
Total	\$3,377	\$ 204	\$ 3,581	\$4,222	\$ 355	\$ 4,577

The following table presents the aging of the recorded investment in loans at September 30, 2016:

	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Purchased Credit Impaired Loans	Total Loans
		(In thousands)					
Residential	\$2,387	\$ 417	\$ 928	\$ 3,732	\$130,333	\$ 377	\$134,442
Land	152	0	0	152	13,112	0	13,264
Construction	0	0	177	177	15,185	0	15,362
Commercial real estate	0	0	742	742	93,026	249	94,017
Commercial business	119	57	0	176	22,772	0	22,948
Home equity/2nd mortgage	100	269	13	382	42,566	0	42,948
Other consumer	235	115	30	380	47,505	0	47,885

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Total	\$2,993	\$ 858	\$ 1,890	\$ 5,741	\$364,499	\$ 626	\$370,866
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FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

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

	30-59 Days Past Due (In thousands)	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Purchased Credit Impaired Loans	Total Loans
Residential	\$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/2nd 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

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 institution'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 institution 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 institution's books as an asset is not warranted.

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

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

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

	Residential Real Estate (In thousands)	Land	Construction	Commercial Real Estate	Commercial Business	Home Equity & 2nd Mtg	Other Consumer	Total
<u>September 30,</u>								
<u>2016</u>								
Pass	\$131,029	\$13,105	\$15,362	\$84,107	\$22,023	\$42,703	\$47,782	\$356,111
Special Mention	518	88	0	3,466	864	161	73	5,170
Substandard	1,035	71	0	4,696	0	40	0	5,842
Doubtful	1,860	0	0	1,748	61	44	30	3,743
Loss	0	0	0	0	0	0	0	0
Total	\$134,442	\$13,264	\$15,362	\$94,017	\$22,948	\$42,948	\$47,885	\$370,866
December 31,								
2015								
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

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

The following table summarizes the Company's troubled debt restructurings (TDRs) by accrual status as of September 30, 2016 and December 31, 2015:

	September 30, 2016				December 31, 2015			
	Accruing	Nonaccrual	Total	Related Allowance for Loan Losses	Accruing	Nonaccrual	Total	Related Allowance for Loan Losses
	(In thousands)							
Troubled debt restructurings:								
Residential real estate	\$336	\$ 328	\$664	\$ 0	\$342	\$ 315	\$657	\$ 0
Commercial real estate	1,320	171	1,491	0	1,348	294	1,642	0
Home equity and 2nd mortgage	18	0	18	0	20	0	20	0
Total	\$1,674	\$ 499	\$2,173	\$ 0	\$1,710	\$ 609	\$2,319	\$ 0

At September 30, 2016 and December 31, 2015, 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 either the three and nine months ended September 30, 2016 or September 30, 2015.

There were no principal charge-offs recorded as a result of TDRs and there was no specific allowance for loan losses related to TDRs modified during the three and nine months ended September 30, 2016 or September 30, 2015.

There were no TDRs modified within the previous 12 months for which there was a subsequent payment default (defined as the loan becoming more than 90 days past due, being moved to nonaccrual status, or the collateral being foreclosed upon) during the three and nine months ended September 30, 2016 and 2015. 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.

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FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

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 that have evidence of credit deterioration since origination for which it is deemed probable at the date of acquisition that the acquirer will not collect all contractually required principal and interest payments are accounted for in accordance with Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 310-30. 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 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 September 30, 2016 and December 31, 2015:

(In thousands)	<u>September</u> <u>30,</u> <u>2016</u>	<u>December</u> <u>31,</u> <u>2015</u>
Residential real estate	\$ 377	\$ 884
Commercial real estate	249	466
Carrying amount	626	1,350
Allowance for loan losses	-	-
Carrying amount, net of allowance	\$ 626	\$ 1,350

The outstanding balance of PCI loans accounted for under ASC 310-30, including contractual principal, interest, fees and penalties was \$778,000 and \$1.6 million at September 30, 2016 and December 31, 2015, respectively.

There was no allowance for loan losses related to PCI loans at September 30, 2016 or at December 31, 2015. There were no net provisions for loan loss related to PCI loans for the nine months ended September 30, 2016, nor for the three and nine months ended September 30, 2015. There was a \$6,000 reduction of the allowance for loan losses on PCI loans for the three months ended September 30, 2016. There were no reductions of the allowance for loan losses on PCI loans for the three and nine months ended September 30, 2015.

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FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(4 – continued)

Accretable yield, or income expected to be collected, is as follows for the three and nine month periods ended September 30, 2016:

<i>(In thousands)</i>	Three Months Ended September 30, 2016	Nine Months Ended September 30, 2016
Balance at beginning of period	\$ 165	\$ 319
New loans purchased	-	-
Accretion to income	(17)	(61)
Disposals and other adjustments	(19)	(93)
Reclassification (to) from nonaccretable difference	42	6
Balance at end of period	\$ 171	\$ 171

5. Supplemental Disclosure for Earnings Per Share

	Three Months Ended 9/30/2016	Three Months Ended 9/30/2015	Nine Months Ended 9/30/2016	Nine Months Ended 9/30/2015
<u>Basic</u>	(Dollars in thousands, except for share and per share data)			
Earnings:				
Net income attributable to First Capital, Inc.	\$1,758	\$1,398	\$5,123	\$4,092
Shares:				
Weighted average common shares outstanding	3,342,015	2,740,631	3,340,066	2,740,608
Net income attributable to First Capital, Inc. per common share, basic	\$0.53	\$0.51	\$1.53	\$1.49
<u>Diluted</u>				
Earnings:				
Net income attributable to First Capital, Inc.	\$1,758	\$1,398	\$5,123	\$4,092

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Shares:

Weighted average common shares outstanding	3,342,015	2,740,631	3,340,066	2,740,608
Add: Dilutive effect of restricted stock	2,034	838	1,787	373
Weighted average common shares outstanding, as adjusted	3,344,049	2,741,469	3,341,853	2,740,981
Net income attributable to First Capital, Inc. per common share, diluted	\$0.53	\$0.51	\$1.53	\$1.49

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

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FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

6. Stock Option 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 September 30, 2016, no stock options had been granted under the Plan.

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 vests ratably from the grant date through July 1, 2020, with 20% of the shares vesting each year on July 1 beginning July 1, 2016. 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 three-month and nine-month periods ended September 30, 2016 amounted to \$21,000 and \$61,000, respectively.

A summary of the Company's nonvested restricted shares under the Plan as of September 30, 2016 and changes during the nine-month period then ended is presented below.

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	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2016	18,000	\$ 24.50
Granted	-	-
Vested	4,000	\$ 24.50
Forfeited	-	-
Nonvested at September 30, 2016	14,000	\$ 24.50

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FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(6 – continued)

There were 4,000 restricted shares that vested during the nine-month period ended September 30, 2016. The total fair value of restricted shares that vested during the nine-month period ended September 30, 2016 was \$132,000. At September 30, 2016, there was \$322,000 of total unrecognized compensation expense related to nonvested restricted shares. The compensation expense is expected to be recognized over the remaining vesting period of 3.75 years.

7. Supplemental Disclosures of Cash Flow Information

	Nine Months Ended <u>September 30,</u> <u>2016</u> <u>2015</u> <i>(In thousands)</i>	
Cash payments for:		
Interest	\$1,400	\$740
Taxes (net of refunds received)	713	1,035
Noncash investing activities:		
Transfers from loans to real estate acquired through foreclosure	582	605

8. 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:

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Inputs to the valuation methodology are quoted prices, unadjusted, for identical assets or liabilities in active markets

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.

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 on the following page. 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. The table below presents the balances of assets measured at fair value on a recurring and nonrecurring basis as of September 30, 2016 and December 31, 2015. The Company had no liabilities measured at fair value as of September 30, 2016 or December 31, 2015.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(8 – continued)

(In thousands)	Carrying Value			
	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
September 30, 2016				
Assets Measured on a Recurring Basis				
Securities available for sale:				
Agency mortgage-backed securities	\$0	\$99,052	\$0	\$99,052
Agency CMO	0	17,225	0	17,225
Agency notes and bonds	0	72,461	0	72,461
Municipal obligations	0	58,409	0	58,409
Mutual funds	103	0	0	103
Total securities available for sale	\$103	\$247,147	\$0	\$247,250
Assets Measured on a Nonrecurring Basis				
Impaired loans:				
Residential real estate	\$0	\$0	\$2,019	\$2,019
Commercial real estate	0	0	2,983	2,983
Commercial business	0	0	61	61
Home equity and second mortgage	0	0	49	49
Other consumer	0	0	24	24
Total impaired loans	\$0	\$0	\$5,136	\$5,136
Loans held for sale	\$0	\$2,553	\$0	\$2,553
Foreclosed real estate:				
Residential real estate	\$0	\$0	\$519	\$519
Commercial real estate	0	0	3,735	3,735
Total foreclosed real estate	\$0	\$0	\$4,254	\$4,254
December 31, 2015				
Assets Measured on a Recurring Basis				
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

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Assets Measured on a Nonrecurring Basis

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
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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

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FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(8 – continued)

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 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.

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.

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 carried 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 September 30, 2016 and December 31, 2015, 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, adjusted for estimated costs to sell the property, costs to complete or repair the property and other factors to reflect management's estimate of the fair value of the collateral given the current market conditions and the condition of the collateral. At September 30, 2016, 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 32% to 60%, with a weighted average discount of 45%. At December 31, 2015, the discount from appraised value ranged from 10% to 59%, with a weighted average discount of 16%. The Company recognized provisions for loan losses of \$106,000 and \$83,000 for the nine months ended September 30, 2016 and 2015, respectively, for impaired loans. The Company recognized provisions for loan losses of \$1,000 for the three months ended September 30, 2015 for impaired loans. The Company did not recognize any provisions for loan losses for impaired loans for the three months ended September 30, 2016.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(8 – continued)

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

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 September 30, 2016, 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 8% to 41%, with a weighted average of 39%. At December 31, 2015, the discount from appraised value ranged from 9% to 43%, with a weighted average of 30%. The Company recognized losses of \$83,000 to write down foreclosed real estate for the nine months ended September 30, 2016. There were no charges to write down foreclosed real estate recognized in income for the three months ended September 30, 2016 or for the three and nine months ended September 30, 2015.

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 nine month periods ended September 30, 2016 and 2015. There were no transfers into or out of the Company's Level 3 financial assets for the nine month periods ended September 30, 2016 and 2015. In addition, there were no transfers into or out of Levels 1 and 2 of the fair value hierarchy during the nine month periods ended September 30, 2016 and 2015.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(8 – continued)

GAAP requires disclosure of the fair value of financial assets and financial liabilities, whether or not recognized in the balance sheet. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company. The estimated fair values of the Company's financial instruments are as follows:

(In thousands)	Carrying Value	Fair Value	Fair Value Measurements Using		
			<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
September 30, 2016					
Financial assets:					
Cash and cash equivalents	\$70,381	\$70,381	\$70,381	\$0	\$0
Interest-bearing time deposits	15,540	15,565	0	15,565	0
Securities available for sale	247,250	247,250	103	247,147	0
Securities held to maturity	3	3	0	3	0
Loans held for sale	2,553	2,614	0	2,614	0
Loans, net	366,367	374,656	0	0	374,656
FHLB and other stock	1,650	1,650	0	1,650	0
Accrued interest receivable	2,361	2,361	0	2,361	0
Financial liabilities:					
Deposits	658,747	658,389	0	0	658,389
Accrued interest payable	137	137	0	137	0
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

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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

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FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(8 – continued)

The carrying amounts in the preceding table are included in the consolidated balances sheets under the applicable captions. 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 and Interest-Bearing Time Deposits

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

Investment Securities

For marketable equity securities, the fair values are based on quoted market prices. For debt securities, 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, a restricted equity security, the carrying amount is a reasonable estimate of fair value because it is not marketable. For other cost method equity 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 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 for the same remaining maturities. 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 sale 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 amounts of retail repurchase agreements approximate their 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

(Unaudited)

9. 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 May 2014, the FASB issued Accounting Standards Update (“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 customers 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 (as defined in ASU No. 2014-09), the guidance was originally effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. 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 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 (as defined in ASU No. 2016-01), 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. The adoption of this update is not expected to have a material impact on the Company's consolidated financial position or results of operations.

FIRST CAPITAL, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

(9 – continued)

In March 2016, the FASB issued ASU No. 2016-09, *Compensation – Stock Compensation (Topic 718) – Improvements to Employee Share-Based Payment Accounting*. The guidance is intended to simplify several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. For public business entities, the guidance is effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Early adoption is permitted. 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 June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments – Credit Losses (Topic 326)*. The update replaces the incurred loss methodology for recognizing credit losses under current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. Under the new guidance, an entity will measure all expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions and reasonable and supportable forecasts. The expected loss model will apply to loans and leases, unfunded lending commitments, held-to-maturity debt securities and other debt instruments measured at amortized cost. The impairment model for available-for-sale debt securities will require the recognition of credit losses through a valuation allowance when fair value is less than amortized cost, regardless of whether the impairment is considered to be other-than-temporary. For the Company, the amendments in the update are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted as of fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently assessing the impact the guidance will have upon adoption.

In August 2016, the FASB issued ASU No. 2016-15, *Statement of Cash Flows (Topic 230) – Classification of Certain Cash Receipts and Cash Payments*. The update addresses eight specific cash flow issues with the objective of reducing diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments in the update are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. If an entity adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period, and all amendments must be adopted in the same period. The adoption of this update is not expected to have a material impact on the Company's consolidated financial position or results of operations.

PART I - ITEM 2

**MANAGEMENT'S DISCUSSION AND
ANALYSIS OF FINANCIAL CONDITION AND
RESULTS OF OPERATIONS**

FIRST CAPITAL, INC.

Safe Harbor Statement for Forward-Looking Statements

This Quarterly Report on Form 10-Q may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are not historical facts nor guarantees of future performance; rather they are statements based on the Company's current expectations regarding its business strategies and their intended results and its future performance. Forward-looking statements can be identified by use of the words "expects," "believes," "anticipates," "intends," "could" and similar expressions. Forward-looking statements also include but are not limited to, statements regarding estimated cost savings, plans and objectives for future operations, and the Company's business and growth strategies.

Numerous risks and uncertainties could cause or contribute to the Company's actual results, performance and achievements being materially different from those expressed or implied by the forward-looking statements. Factors that may cause or contribute to these differences include, without limitation, general economic conditions, including changes in market interest rates and changes in monetary and fiscal policies of the federal government; the ability of the Company to execute its business plan; legislative and regulatory changes; the quality and composition of the loan and investment securities portfolio; loan demand; deposit flows; competition; and changes in accounting principles and guidelines. Additional factors that may affect our results are discussed in Part II of this Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2015 under "Item 1A. Risk Factors." These factors should be considered in evaluating the forward-looking statements and undue reliance should not be placed on such statements. These forward-looking statements are made only as of the date of this Form 10-Q and, except as required by applicable law or regulation, the Company assumes no obligation and disclaims any obligation to update any forward-looking statements.

Critical Accounting Policies

During the nine months ended September 30, 2016, there was no significant change in the Company's critical accounting policies or the application of critical accounting policies as disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

Financial Condition

Total assets increased \$26.3 million from \$715.8 million at December 31, 2015 to \$742.1 million at September 30, 2016, an increase of 3.7%.

Net loans receivable (excluding loans held for sale) increased \$7.2 million from \$359.2 million at December 31, 2015 to \$366.4 million at September 30, 2016. Commercial real estate, other consumer loans and home equity and second mortgage loans increased \$9.3 million, \$5.2 million and \$3.6 million, respectively, during the nine months ended September 30, 2016, while residential mortgage loans decreased \$14.0 million during the period.

Securities available for sale increased \$60.5 million from \$186.8 million at December 31, 2015 to \$247.3 million at September 30, 2016, as management continues to invest excess liquidity obtained in the Peoples acquisition in securities available for sale. Purchases of \$159.3 million of securities classified as available for sale were made during the nine months ended September 30, 2016 and consisted primarily of U.S. government agency notes and bonds and mortgage-backed securities and municipal bonds. Maturities and principal repayments of available for sale securities totaled \$82.3 million and \$13.2 million, respectively, during the nine months ended September 30, 2016. Municipal bonds with a value of \$4.6 million were sold during the same period.

PART I - ITEM 2

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FIRST CAPITAL, INC.

Cash and cash equivalents decreased from \$109.2 million at December 31, 2015 to \$70.4 million at September 30, 2016, primarily due to a decrease of \$38.0 million in federal funds sold as excess liquidity is invested in investment securities.

Total deposits increased 3.4% from \$637.2 million at December 31, 2015 to \$658.7 million at September 30, 2016. Interest-bearing demand and savings accounts increased \$31.7 million during the nine months ended September 30, 2016 primarily due to normal fluctuations in accounts of local municipalities, new accounts and current time deposit accountholders transferring funds to non-maturity deposits as customers opt not to lock in to longer terms in the current low-rate environment. This also contributed to a decrease in time deposits of \$9.3 million during the period.

Total stockholders' equity attributable to the Company increased from \$74.4 million at December 31, 2015 to \$78.6 million at September 30, 2016 primarily due to retained net income of \$3.0 million and a net increase of \$1.2 million in the net unrealized gain on securities available for sale for the nine months ended September 30, 2016. The increase in unrealized gains on available for sale securities during the period is primarily due to changes in long-term market interest rates.

Results of Operations

Net income for the nine-month periods ended September 30, 2016 and 2015. Net income attributable to the Company was \$5.1 million (\$1.53 per share) for the nine months ended September 30, 2016 compared to \$4.1 million (\$1.49 per share) for the same time period in 2015. The increase is primarily due to increases in net interest income after provision for loan losses and noninterest income partially offset by an increase in noninterest expense.

Net income for the three-month periods ended September 30, 2016 and 2015. Net income attributable to the Company was \$1.8 million (\$0.53 per share) for the three months ended September 30, 2016 compared to \$1.4 million (\$0.51 per share) for the three months ended September 30, 2015. Again, the increase is primarily due to increases in

net interest income after provision for loan losses and noninterest income partially offset by an increase in noninterest expense.

Net interest income for the nine-month periods ended September 30, 2016 and 2015. Net interest income increased \$4.6 million for the nine months ended September 30, 2016 compared to the same period in 2015 primarily due to an increase in interest-earning assets, partially offset by a decrease in the interest rate spread.

Total interest income increased \$5.2 million for the nine months ended September 30, 2016 compared to the same period in 2015. For the nine months ended September 30, 2016, the average balance of interest-earning assets and their tax-equivalent yield were \$682.3 million and 3.78%, respectively. During the same period in 2015, the average balance of those assets was \$437.6 million and the tax-equivalent yield was 4.29%. Both the increase in average balance of interest-earning assets and the decrease in the average tax-equivalent yield for the nine months ended September 30, 2016 are primarily attributable to the Peoples acquisition. Through the acquisition, the Company acquired loans, investment securities, interest-bearing deposits with banks and federal funds sold with fair values of approximately \$56 million, \$132 million, \$5 million and \$28 million, respectively. The high concentration of investment securities, interest-bearing deposits with banks and federal funds sold, which generally provide a lower yield than loans, led to the decrease in the overall tax-equivalent yield on interest-earning assets for 2016.

PART I - ITEM 2

MANAGEMENT'S DISCUSSION AND

ANALYSIS OF FINANCIAL CONDITION AND

RESULTS OF OPERATIONS

FIRST CAPITAL, INC.

Total interest expense increased \$668,000 for the nine months ended September 30, 2016 compared to the same period in 2015. The average rate paid on interest-bearing liabilities increased from 0.28% for the nine months ended September 30, 2015 to 0.35% for the same period in 2016. The average balance of interest-bearing liabilities increased from \$339.6 million for 2015 to \$527.6 million for 2016 primarily due to the Peoples acquisition, with the Company assuming deposit liabilities with a fair value of \$209 million. As a result of the changes in interest-earning assets and interest-bearing liabilities, the interest rate spread decreased from 4.01% for the nine months ended September 30, 2015 to 3.43% for the same period in 2016.

Net interest income for the three-month periods ended September 30, 2016 and 2015. Net interest income increased \$1.5 million for the three months ended September 30, 2016 compared to the three months ended September 30, 2015 primarily due to an increase in interest-earning assets, partially offset by a decrease in the interest rate spread.

Total interest income increased \$1.7 million for the three months ended September 30, 2016 compared to the same period in 2015. For the three months ended September 30, 2016, the average balance of interest-earning assets and their tax-equivalent yield were \$684.8 million and 3.72%, respectively. During the same period in 2015, the average balance of those assets was \$433.2 million and the tax-equivalent yield was 4.34%. The changes in balances and yields are primarily due to the Peoples acquisition as previously described.

Total interest expense increased \$194,000 for the three months ended September 30, 2016 compared to the three months ended September 30, 2015. The average balance of interest-bearing liabilities increased from \$333.1 million to \$531.9 million when comparing the two periods and the average rate paid on those liabilities increased from 0.26% for the three months ended September 30, 2015 to 0.31% for the same period in 2016. As a result, the tax-equivalent interest rate spread decreased from 4.08% for the three months ended September 30, 2015 to 3.41% for the three months ended September 30, 2016.

Provision for loan losses. The provision for loan losses increased from \$50,000 for the nine-month period ended September 30, 2015 to \$425,000 for the same period in 2016. The provision for loan losses was \$200,000 for the three

months ended September 30, 2016, but no provision for loan losses was recorded for the same period in 2015. The Bank recognized net charge-offs of \$520,000 for the nine months ended September 30, 2016 compared to \$1.4 million during the same period in 2015. The 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.

Provisions for loan losses are charges to earnings to maintain the total allowance for loan losses at a level considered adequate 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.

PART I - ITEM 2

**MANAGEMENT'S DISCUSSION AND
ANALYSIS OF FINANCIAL CONDITION AND
RESULTS OF OPERATIONS
FIRST CAPITAL, INC.**

The methodology used in determining the allowance for loan losses includes segmenting the loan portfolio by identifying risk characteristics common to groups 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 groups of loans with similar characteristics by applying loss factors that consider the qualitative factors which may affect the loss rates.

The allowance for loan losses was \$3.3 million at September 30, 2016 and \$3.4 million at December 31, 2015. Management has deemed these amounts as adequate at each date based on its best estimate of probable known and inherent loan losses at each date. At September 30, 2016, nonperforming loans amounted to \$3.6 million compared to \$4.6 million at December 31, 2015. Included in nonperforming loans at September 30, 2016 are loans 90 days or more past due and still accruing interest of \$204,000. These loans are accruing interest because the estimated value of the collateral and collection efforts are deemed sufficient to ensure full recovery. At September 30, 2016 and December 31, 2015, nonaccrual loans amounted to \$3.4 million and \$4.2 million, respectively.

Noninterest income for the nine-month periods ended September 30, 2016 and 2015. Noninterest income for the nine months ended September 30, 2016 increased \$929,000 compared to the nine months ended September 30, 2015. The increase was primarily due to increases in service charges on deposit accounts, gains on the sale of loans and gains on the sale of securities of \$441,000, \$272,000 and \$176,000, respectively, when comparing the two periods. The increase in service charges on deposit accounts was primarily due to fees earned on the acquired Peoples accounts.

Noninterest income for the three-month periods ended September 30, 2016 and 2015. Noninterest income for the quarter ended September 30, 2016 increased \$524,000 to \$1.8 million compared to \$1.2 million for the quarter ended September 30, 2015. The increase was primarily due to increases in gains on the sale of loans, services charges on deposit accounts and other income of \$240,000, \$149,000 and \$153,000, respectively. The increase in other income was primarily due to the sale of the Company's investment in another financial institution in July 2016, resulting in a gain of \$145,000.

Noninterest expense for the nine-month periods ended September 30, 2016 and 2015. Noninterest expense for the nine months ended September 30, 2016 increased \$3.7 million compared to the same period in 2015 due primarily to the increased expenses associated with operating the five offices acquired from Peoples. Compensation and benefits increased \$2.2 million when comparing the two periods due to normal salary increases and the retained Peoples personnel. Other operating expense, data processing expense and occupancy and equipment expense also increased \$924,000, \$513,000 and \$282,000, respectively, when comparing the two periods.

Noninterest expense for the three-month periods ended September 30, 2016 and 2015. Noninterest expense for the quarter ended September 30, 2016 increased \$1.3 million compared to the quarter ended September 30, 2015. Compensation and benefits, other operating expense and data processing expense increased \$796,000, \$225,000 and \$209,000, respectively, when comparing the two periods, due primarily to the Peoples acquisition.

PART I - ITEM 2

**MANAGEMENT'S DISCUSSION AND
ANALYSIS OF FINANCIAL CONDITION AND
RESULTS OF OPERATIONS
FIRST CAPITAL, INC.**

Income tax expense. Income tax expense for the nine-month period ended September 30, 2016 was \$1.9 million, for an effective tax rate of 27.0%, compared to \$1.5 million, for an effective tax rate of 26.3%, for the same period in 2015. For the three-month period ended September 30, 2016, income tax expense and the effective tax rate were \$666,000 and 27.4%, respectively, compared to \$507,000 and 26.6%, respectively, for the same period in 2015.

Liquidity and Capital Resources

The Bank's primary sources of funds are customer deposits, proceeds from loan repayments, maturing securities and FHLB advances. While loan repayments and maturities are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by market interest rates, general economic conditions and competition. At September 30, 2016, the Bank had cash and cash equivalents of \$70.4 million and securities available-for-sale with a fair value of \$247.3 million. If the Bank requires funds beyond its ability to generate them internally, it has additional borrowing capacity with the FHLB of Indianapolis and additional collateral eligible for repurchase agreements.

The Bank's primary investing activity is the origination of one-to-four family mortgage loans and, to a lesser extent, consumer, multi-family, commercial real estate and residential construction loans. The Bank also invests in U.S. Government and agency securities and mortgage-backed securities issued by U.S. Government agencies.

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. 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, on a stand-alone basis, is responsible for paying any dividends declared to its shareholders. The Board of Directors of the Company also has authorized the repurchase of shares of its common stock. The Company's primary source of income is dividends received from the Bank. The amount of dividends that

the Bank may declare and pay to the Company in any calendar year, without the receipt of prior approval from the Office of the Comptroller of the Currency (“OCC”) but with prior notice to the OCC, cannot exceed net income for that year to date plus retained net income (as defined in the applicable OCC regulations) for the preceding two calendar years. On a stand-alone basis, the Company had liquid assets of \$608,000 at September 30, 2016.

The Bank is required to maintain specific amounts of capital pursuant to regulatory requirements. As of September 30, 2016, the Bank was in compliance with all regulatory capital requirements that were effective as of such date with Tier 1 capital to average assets, common equity Tier 1 capital to risk-weighted assets, Tier 1 capital to risk-weighted assets and total capital to risk-weighted assets ratios of 9.3%, 14.6%, 14.6% and 15.3%, respectively. The regulatory requirements at that date to be considered “well-capitalized” under applicable regulations were 5.0%, 6.5%, 8.0% and 10.0%, respectively. At September 30, 2016, the Bank was considered “well-capitalized” under applicable regulatory guidelines.

PART I - ITEM 2

**MANAGEMENT'S DISCUSSION AND
ANALYSIS OF FINANCIAL CONDITION AND
RESULTS OF OPERATIONS**

FIRST CAPITAL, INC.

Off-Balance Sheet Arrangements

In the normal course of operations, the Company engages in a variety of financial transactions that, in accordance with GAAP, are not recorded on the Company's financial statements. These transactions involve, to varying degrees, elements of credit, interest rate and liquidity risk. Such transactions are primarily used to manage customers' requests for funding and take the form of loan commitments and letters of credit. A further presentation of the Company's off-balance sheet arrangements is presented in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

For the nine months ended September 30, 2016, the Company did not engage in any off-balance sheet transactions reasonably likely to have a material effect on the Company's financial condition, results of operations or cash flows.

PART I – ITEM 3

QUANTITATIVE AND QUALITATIVE DISCLOSURES

ABOUT MARKET RISK

FIRST CAPITAL, INC.

Qualitative Aspects of Market Risk. Market risk is the risk that the estimated fair value of the Company's assets and liabilities will decline as a result of changes in interest rates or financial market volatility, or that the Company's 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. 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 retail deposits, compared to brokered deposits, reduce 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 Federal Reserve Board.

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.

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PART I – ITEM 3**QUANTITATIVE AND QUALITATIVE DISCLOSURES****ABOUT MARKET RISK****FIRST CAPITAL, INC.**

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 September 30, 2016 and December 31, 2015 financial information:

Immediate Change in the Level of Interest Rates	At September 30, 2016 One Year Horizon		At December 31, 2015 One Year Horizon	
	Dollar Change (Dollars in thousands)	Percent Change	Dollar Change	Percent Change
300bp	\$188	0.82 %	\$903	3.79 %
200bp	199	0.87	756	3.18
100bp	81	0.35	442	1.86
Static	0	0	0	0
(100)bp	(632)	(2.75)	(1,296)	(5.44)

At September 30, 2016 and December 31, 2015, the Company’s simulated exposure to a change in interest rates shows that an immediate and sustained decrease in rates of 1.00% would decrease the Company’s net interest income over a one year horizon compared to a flat interest rate scenario. Alternatively, at September 30, 2016 and December 31, 2015, an immediate and sustained increase in rates of 1.00%, 2.00% or 3.00% would increase the Company’s net interest income 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.

PART I – ITEM 3**QUANTITATIVE AND QUALITATIVE DISCLOSURES****ABOUT MARKET RISK****FIRST CAPITAL, INC.**

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 September 30, 2016 and December 31, 2015 financial information:

Immediate Change in the Level of Interest Rates	At September 30, 2016			Economic Value of Equity as a Percent of Present Value of Assets		
	Economic Dollar Amount	Value of Equity Dollar Change	Percent Change	EVE Ratio	Change	
300bp	\$78,495	\$(18,764)	(19.29)%	11.29	%	(173)bp
200bp	87,937	(9,322)	(9.59)	12.35		(67)bp
100bp	93,571	(3,688)	(3.79)	12.83		(19)bp
Static	97,259	0	0	13.02		0 bp
(100)bp	103,827	6,568	6.73	13.59		57 bp

Immediate Change in the Level of Interest Rates	At December 31, 2015			Economic Value of Equity as a Percent of Present Value of Assets		
	Economic Dollar Amount	Value of Equity Dollar Change	Percent Change	EVE Ratio	Change	
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	0	0	14.23		0 bp
(100)bp	98,469	(2,940)	(2.90)	13.55		(68)bp

The previous tables indicate that at September 30, 2016 and 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 in prevailing interest rates. At September 30, 2016, the Company would expect a decrease in its EVE in the event of a sudden and sustained 100 basis point increase in prevailing interest rates and an increase in its EVE in the event of a sudden and sustained 100 basis point decrease in prevailing interest rates. Alternatively, at December 31, 2015, the Company would expect an increase in its EVE in the event of a sudden and sustained 100 basis point increase and a decrease in its EVE in the event of a sudden and sustained 100 basis point decrease in prevailing interest rates.

PART I – ITEM 3

QUANTITATIVE AND QUALITATIVE DISCLOSURES

ABOUT MARKET RISK

FIRST CAPITAL, INC.

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.

PART I - ITEM 4

CONTROLS AND PROCEDURES

FIRST CAPITAL, INC.

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 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.

There have been no changes in the Company's internal control over financial reporting during the quarter ended September 30, 2016 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II

OTHER INFORMATION

FIRST CAPITAL, INC.

Item 1. Legal Proceedings

The Company is not a party to any legal proceedings. Periodically, there have been various claims and lawsuits involving the Bank, mainly as a plaintiff, such as claims to enforce liens, condemnation proceedings on properties in which the Bank holds security interests, claims involving the making and servicing of real property loans and other issues incident to the Bank's business. The Bank is not a party to any pending legal proceedings that management believes would have a material adverse effect on its financial condition or operations.

Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2015, which could materially affect our business, financial condition or future results. There have been no material changes to the risk factors described in our Annual Report on Form 10-K, however these are not the only risks that we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid Per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or	(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or
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			Programs	Programs
July 1 through July 31, 2016	60	33.31	60	143,620
August 1 through August 31, 2016	0	N/A	0	143,620
September 1 through September 30, 2016	0	N/A	0	143,620
Total	60	33.31	60	

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.

PART II

OTHER INFORMATION

FIRST CAPITAL, INC.

Item 3. Defaults upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

- 3.1 Articles of Incorporation of First Capital, Inc. (1)
- 3.2 Fifth Amended and Restated Bylaws of First Capital, Inc. (2)
- 11.0 Statement Re: Computation of Per Share Earnings (incorporated by reference to Note 5 of the Unaudited Consolidated Financial Statements contained herein)
- 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
- 32.1 Section 1350 Certification of Chief Executive Officer
- 32.2 Section 1350 Certification of Chief Financial Officer

The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2016, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets, 101.0(ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statement of Changes in Stockholders' Equity, (v) the Consolidated Statements of Cash Flows and (vi) the Notes to the Consolidated Financial Statements.

- 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, as amended by that Amendment to Articles of
- (1) Incorporation provided as Exhibit 3.1 to the Current Report on Form 8-K filed with the Securities and Exchange Commission on May 19, 2016.
 - (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.

SIGNATURES

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

FIRST CAPITAL, INC.
(Registrant)

Dated November 14, 2016 **BY:** /s/William W. Harrod
William W. Harrod
President and CEO

Dated November 14, 2016 **BY:** /s/ Michael C. Frederick
Michael C. Frederick
Executive Vice President, CFO
and Treasurer