FIRST CAPITAL INC
Form 10-Q
August 13, 2014
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**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 June 30, 2014**

**OR**

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

**For the transition period from __________ to __________**

**Commission File 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 x No ¨

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a 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 | x |

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 2,741,325 shares of common stock were outstanding as of July 31, 2014.

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# FIRST CAPITAL, INC.

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## PART I - FINANCIAL INFORMATION

## FIRST CAPITAL, INC. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

*(Unaudited)*

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| | *(In thousands)* | |
| **ASSETS** | | |
| Cash and due from banks | $ 11,236 | $ 10,058 |
| Interest bearing deposits with banks | 1,110 | 467 |
| Federal funds sold | 3,082 | 611 |
| Total cash and cash equivalents | 15,428 | 11,136 |
| Interest-bearing time deposits | 5,900 | 4,425 |
| Securities available for sale, at fair value | 107,254 | 108,762 |
| Securities-held to maturity | 8 | 9 |
| Loans, net | 297,997 | 288,506 |
| Loans held for sale | 3,824 | 1,611 |
| Federal Home Loan Bank stock, at cost | 2,820 | 2,820 |
| Foreclosed real estate | 49 | 466 |
| Premises and equipment | 10,472 | 10,347 |
| Accrued interest receivable | 1,551 | 1,716 |
| Cash value of life insurance | 6,409 | 6,332 |
| Goodwill | 5,386 | 5,386 |
| Other assets | 2,439 | 2,868 |
| **Total Assets** | $ 459,537 | $ 444,384 |
| **LIABILITIES** | | |
| Deposits: | | |
| Noninterest-bearing | $ 62,884 | $ 56,436 |
| Interest-bearing | 323,869 | 317,394 |
| Total deposits | 386,753 | 373,830 |
| Retail repurchase agreements | 10,617 | 9,310 |
| Advances from Federal Home Loan Bank | 5,000 | 5,500 |
| Accrued interest payable | 155 | 192 |
| Accrued expenses and other liabilities | 1,765 | 2,213 |
| Total liabilities | 404,290 | 391,045 |

| | | |
|---|---|---|
| **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 3,164,416 shares; outstanding 2,743,502 shares (2,784,088 in 2013) | 32 | 32 |
| Additional paid-in capital | 24,313 | 24,313 |
| Retained earnings-substantially restricted | 38,602 | 36,947 |
| Accumulated other comprehensive income (loss) | 384 | (720) |
| Less treasury stock, at cost - 420,914 shares (380,328 shares in 2013) | (8,189) | (7,345) |
| Total First Capital, Inc. stockholders equity | 55,142 | 53,227 |
| Noncontrolling interest in subsidiary | 105 | 112 |
| Total equity | 55,247 | 53,339 |
| **Total Liabilities and Equity** | $ 459,537 | $ 444,384 |

See accompanying notes to consolidated financial statements.

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## PART I - FINANCIAL INFORMATION

## FIRST CAPITAL, INC. AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF INCOME

*(Unaudited)*

| | Three Months Ended June 30, 2014 | Three Months Ended June 30, 2013 | Six Months Ended June 30, 2014 | Six Months Ended June 30, 2013 |
|---|---|---|---|---|
| | *(In thousands, except per share data)* | | | |
| **INTEREST INCOME** | | | | |
| Loans, including fees | $ 4,036 | $ 3,925 | $ 7,874 | $ 7,849 |
| Securities: | | | | |
| Taxable | 303 | 315 | 620 | 663 |
| Tax-exempt | 274 | 267 | 564 | 534 |
| Federal Home Loan Bank dividends | 26 | 24 | 65 | 49 |
| Federal funds sold and interest bearing deposits with banks | 24 | 23 | 42 | 35 |
| Total interest income | 4,663 | 4,554 | 9,165 | 9,130 |
| **INTEREST EXPENSE** | | | | |
| Deposits | 291 | 386 | 580 | 790 |
| Retail repurchase agreements | 6 | 7 | 12 | 15 |
| Advances from Federal Home Loan Bank | 0 | 47 | 3 | 93 |
| Total interest expense | 297 | 440 | 595 | 898 |
| Net interest income | 4,366 | 4,114 | 8,570 | 8,232 |
| Provision for loan losses | 90 | 225 | 115 | 475 |
| Net interest income after provision for loan losses | 4,276 | 3,889 | 8,455 | 7,757 |
| **NONINTEREST INCOME** | | | | |
| Service charges on deposit accounts | 822 | 783 | 1,545 | 1,504 |
| Commission income | 120 | 76 | 198 | 195 |
| Gain on sale of securities | 54 | 0 | 54 | 21 |
| Gain on sale of mortgage loans | 212 | 258 | 319 | 481 |
| Mortgage brokerage fees | 9 | 6 | 14 | 17 |
| Increase in cash surrender value of life insurance | 40 | 42 | 77 | 84 |
| Other income | 30 | 23 | 59 | 48 |
| Total noninterest income | 1,287 | 1,188 | 2,266 | 2,350 |
| **NONINTEREST EXPENSE** | | | | |
| Compensation and benefits | 1,836 | 1,724 | 3,671 | 3,475 |
| Occupancy and equipment | 293 | 278 | 612 | 599 |
| Data processing | 397 | 365 | 764 | 711 |

| | | | | |
|---|---|---|---|---|
| Professional fees | 153 | 202 | 298 | 370 |
| Advertising | 69 | 71 | 133 | 109 |
| Other operating expenses | 601 | 666 | 1,170 | 1,364 |
| Total noninterest expense | 3,349 | 3,306 | 6,648 | 6,628 |
| Income before income taxes | 2,214 | 1,771 | 4,073 | 3,479 |
| Income tax expense | 692 | 557 | 1,251 | 1,068 |
| **Net Income** | 1,522 | 1,214 | 2,822 | 2,411 |
| Less: net income attributable to noncontrolling interest in subsidiary | 4 | 4 | 7 | 7 |
| **Net Income Attributable to First Capital, Inc.** | $ 1,518 | $ 1,210 | $ 2,815 | $ 2,404 |
| Earnings per common share attributable to First Capital, Inc. | | | | |
| Basic | $ 0.55 | $ 0.43 | $ 1.02 | $ 0.86 |
| Diluted | $ 0.55 | $ 0.43 | $ 1.02 | $ 0.86 |
| Dividends per share | $ 0.21 | $ 0.20 | $ 0.42 | $ 0.40 |

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 June 30, 2014 | Three Months Ended June 30, 2013 | Six Months Ended June 30, 2014 | Six Months Ended June 30, 2013 |
|---|---|---|---|---|
| | *(In thousands)* | | | |
| **Net Income** | $ 1,522 | $ 1,214 | $ 2,822 | $ 2,411 |
| **OTHER COMPREHENSIVE INCOME (LOSS)** | | | | |
| Unrealized gains (losses) on securities available for sale: | | | | |
| Unrealized holding gains (losses) arising during the period | 902 | (2,337) | 1,873 | (2,825) |
| Income tax (expense) benefit | (354) | 926 | (736) | 1,119 |
| Net of tax amount | 548 | (1,411) | 1,137 | (1,706) |
| Less: reclassification adjustment for realized gains included in net income | (54) | 0 | (54) | (21) |
| Income tax expense | 21 | 0 | 21 | 8 |
| Net of tax amount | (33) | 0 | (33) | (13) |
| **Other Comprehensive Income (Loss), net of tax** | 515 | (1,411) | 1,104 | (1,719) |
| **Comprehensive Income (Loss)** | 2,037 | (197) | 3,926 | 692 |
| Less: comprehensive income attributable to the noncontrolling interest in subsidiary | 4 | 4 | 7 | 7 |
| **Comprehensive Income (Loss) Attributable to First Capital, Inc.** | $ 2,033 | $ (201) | $ 3,919 | $ 685 |

See accompanying notes to consolidated financial statements.

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## 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 | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Noncontrolling Interest | Total |
|---|---|---|---|---|---|---|---|
| Balances at January 1, 2013 | $ 32 | $ 24,313 | $ 34,101 | $ 1,704 | $ (7,326) | $ 112 | $ 52,936 |
| Net income | 0 | 0 | 2,404 | 0 | 0 | 7 | 2,411 |
| Other comprehensive loss | 0 | 0 | 0 | (1,719) | 0 | 0 | (1,719) |
| Cash dividends | 0 | 0 | (1,113) | 0 | 0 | (14) | (1,127) |
| Balances at June 30, 2013 | $ 32 | $ 24,313 | $ 35,392 | $ (15) | $ (7,326) | $ 105 | $ 52,501 |
| Balances at January 1, 2014 | $ 32 | $ 24,313 | $ 36,947 | $ (720) | $ (7,345) | $ 112 | $ 53,339 |
| Net income | 0 | 0 | 2,815 | 0 | 0 | 7 | 2,822 |
| Other comprehensive income | 0 | 0 | 0 | 1,104 | 0 | 0 | 1,104 |
| Cash dividends | 0 | 0 | (1,160) | 0 | 0 | (14) | (1,174) |
| Purchase of treasury shares | 0 | 0 | 0 | 0 | (844) | 0 | (844) |
| Balances at June 30, 2014 | $ 32 | $ 24,313 | $ 38,602 | $ 384 | $ (8,189) | $ 105 | $ 55,247 |

See accompanying notes to consolidated financial statements.

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**PART I - FINANCIAL INFORMATION**

**FIRST CAPITAL, INC. AND SUBSIDIARY**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

*(Unaudited)*

| | Six Months Ended June 30, 2014 | Six Months Ended June 30, 2013 |
|---|---|---|
| | *(In thousands)* | |
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Net income | $ 2,822 | $ 2,411 |
| 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 | 347 | 491 |
| Depreciation and amortization expense | 348 | 355 |
| Deferred income taxes | (65) | 128 |
| Increase in cash value of life insurance | (77) | (84) |
| Gain on sale of securities | (54) | (21) |
| Provision for loan losses | 115 | 475 |
| Proceeds from sales of loans | 12,656 | 23,207 |
| Loans originated for sale | (14,550) | (20,283) |
| Gain on sale of loans | (319) | (481) |
| Decrease in accrued interest receivable | 165 | 56 |
| Decrease in accrued interest payable | (37) | (46) |
| Net change in other assets/liabilities | (592) | 285 |
| **Net Cash Provided By Operating Activities** | 759 | 6,493 |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | |
| Investment in interest-bearing time deposits | (1,475) | (280) |
| Purchase of securities available for sale | (15,469) | (19,922) |
| Proceeds from maturities of securities available for sale | 10,923 | 18,850 |
| Proceeds from sales of securities available for sale | 2,612 | 246 |
| Principal collected on mortgage-backed obligations | 4,892 | 6,959 |
| Net increase in loans receivable | (9,564) | (3,493) |
| Proceeds from sale of foreclosed real estate | 375 | 157 |
| Purchase of premises and equipment | (473) | (189) |
| **Net Cash Provided By (Used In) Investing Activities** | (8,179) | 2,328 |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | |
| Net increase in deposits | 12,923 | 5,270 |

| | | |
|---|---|---|
| Net decrease in advances from Federal Home Loan Bank | (500) | (100) |
| Net increase (decrease) in retail repurchase agreements | 1,307 | (2,655) |
| Purchase of treasury stock | (844) | 0 |
| Dividends paid | (1,174) | (1,127) |
| **Net Cash Provided By Financing Activities** | 11,712 | 1,388 |
| **Net Increase in Cash and Cash Equivalents** | 4,292 | 10,209 |
| Cash and cash equivalents at beginning of period | 11,136 | 21,811 |
| **Cash and Cash Equivalents at End of Period** | $ 15,428 | $ 32,020 |

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 June 30, 2014, this noncontrolling interest represented 0.2% ownership of the REIT.

In the opinion of management, the unaudited consolidated financial statements include all adjustments considered necessary to present fairly the financial position as of June 30, 2014, and the results of operations for the three months and six months ended June 30, 2014 and 2013 and the cash flows for the six months ended June 30, 2014. 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, 2013 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.

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

**2. Investment Securities**

Debt and equity securities have been classified in the consolidated balance sheets according to management s intent. Investment securities at June 30, 2014 and December 31, 2013 are summarized as follows:

| *(In thousands)* | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| **June 30, 2014** | | | | |
| Securities available for sale: | | | | |
| Agency mortgage-backed securities | $ 28,006 | $ 225 | $ 126 | $ 28,105 |
| Agency CMO | 17,660 | 121 | 219 | 17,562 |
| Other debt securities: | | | | |
| Agency notes and bonds | 25,382 | 48 | 251 | 25,179 |
| Municipal obligations | 33,257 | 1,053 | 262 | 34,048 |
| Subtotal - debt securities | 104,305 | 1,447 | 858 | 104,894 |
| Mutual funds | 2,373 | 2 | 15 | 2,360 |
| Total securities available for sale | $ 106,678 | $ 1,449 | $ 873 | $ 107,254 |
| Securities held to maturity: | | | | |
| Agency mortgage-backed securities | $ 8 | $ 0 | $ 0 | $ 8 |
| Total securities held to maturity | $ 8 | $ 0 | $ 0 | $ 8 |
| **December 31, 2013** | | | | |
| Securities available for sale: | | | | |
| Agency mortgage-backed securities | $ 18,408 | $ 205 | $ 244 | $ 18,369 |
| Agency CMO | 20,486 | 96 | 341 | 20,241 |
| Other debt securities: | | | | |
| Agency notes and bonds | 31,594 | 49 | 729 | 30,914 |
| Municipal obligations | 36,200 | 778 | 938 | 36,040 |
| Subtotal - debt securities | 106,688 | 1,128 | 2,252 | 105,564 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Mutual funds | | 3,238 | | 0 | | 40 | | 3,198 |
| Total securities available for sale | $ | 109,926 | $ | 1,128 | $ | 2,292 | $ | 108,762 |
| Securities held to maturity: | | | | | | | | |
| Agency mortgage-backed securities | $ | 9 | $ | 0 | $ | 0 | $ | 9 |
| Total securities held to maturity | $ | 9 | $ | 0 | $ | 0 | $ | 9 |

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(2 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 June 30, 2014, 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.

| | Securities Available for Sale | | Securities Held to Maturity | |
|---|---|---|---|---|
| *(In thousands)* | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Due in one year or less | $ 0 | $ 0 | $ 0 | $ 0 |
| Due after one year through five years | 13,411 | 13,487 | 0 | 0 |
| Due after five years through ten years | 25,943 | 26,232 | | |
| Due after ten years | 19,285 | 19,508 | 0 | 0 |
| | 58,639 | 59,227 | 0 | 0 |
| Mortgage-backed securities and CMO | 45,666 | 45,667 | 8 | 8 |
| | $ 104,305 | $ 104,894 | $ 8 | $ 8 |

Information pertaining to investment securities available for sale with gross unrealized losses at June 30, 2014, aggregated by investment category and the length of time that individual investment securities have been in a continuous position, follows:

| Number of Investment | Fair Value | Gross Unrealized |
|---|---|---|

| *(Dollars in thousands)* | **Positions** | | **Losses** |
|---|---|---|---|
| Continuous loss position less than twelve months: | | | |
| Agency notes and bonds | 2 | $ 1,401 | $ 2 |
| Agency CMO | 1 | 699 | 2 |
| Agency mortgage-backed securities | 14 | 10,438 | 41 |
| Municipal obligations | 1 | 108 | 1 |
| Total less than twelve months | 18 | 12,646 | 46 |
| Continuous loss position more than twelve months: | | | |
| Agency notes and bonds | 12 | 13,396 | 249 |
| Agency CMO | 10 | 8,604 | 217 |
| Agency mortgage-backed securities | 6 | 6,425 | 85 |
| Municipal obligations | 18 | 7,517 | 261 |
| Mutual fund | 1 | 406 | 15 |
| Total more than twelve months | 47 | 36,348 | 827 |
| Total securities available for sale | 65 | $ 48,994 | $ 873 |

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(2 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 June 30, 2014, the 64 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 1.8% 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.

During the three months and six months ended June 30, 2014, the Company realized gross gains on sales of available for sale municipal securities of $54,000. During the six months ended June 30, 2013, the Company realized gross gains on sales of available for sale municipal securities of $21,000. The Company did not sell any securities during the three months ended June 30, 2013.

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 is accounted for using the cost method of accounting and is included in other assets in the consolidated balance sheet.

**3. 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 southern Indiana. The ability of the Company s customers to honor their loan agreements is dependent upon the real estate and general economic conditions in this area.

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

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(3 continued)

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 June 30, 2014, the Company had 13 loans on which partial charge-offs of $481,000 had been recorded.

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

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)*

(3 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 June 30, 2014 and December 31, 2013, as well as a discussion of changes in management s allowance for loan losses methodology from 2013 to 2014.

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

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, 2013.

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(3 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.

Loans at June 30, 2014 and December 31, 2013 consisted of the following:

| *(In thousands)* | **June 30, 2014** | **December 31, 2013** |
|---|---|---|
| Real estate mortgage loans: | | |
| Residential | $ 105,377 | $ 107,029 |
| Land | 9,938 | 10,309 |
| Residential construction | 13,274 | 14,423 |
| Commercial real estate | 78,547 | 76,496 |
| Commercial real estate construction | 1,078 | 1,715 |
| Commercial business loans | 28,354 | 21,956 |
| Consumer loans: | | |

| | | |
|---|---|---|
| Home equity and second mortgage loans | 36,833 | 34,815 |
| Automobile loans | 24,948 | 23,983 |
| Loans secured by savings accounts | 994 | 1,138 |
| Unsecured loans | 3,706 | 3,541 |
| Other consumer loans | 4,961 | 4,824 |
| Gross loans | 308,010 | 300,229 |
| Less undisbursed portion of loans in process | (5,359) | (7,142) |
| Principal loan balance | 302,651 | 293,087 |
| Deferred loan origination fees, net | 412 | 341 |
| Allowance for loan losses | (5,066) | (4,922) |
| Loans, net | $ 297,997 | $ 288,506 |

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(3 continued)

The following table provides the components of the Company s recorded investment in loans at June 30, 2014:

| | Residential Real Estate | Land | Construction | Commercial Real Estate | Commercial Business | Home Equity & 2nd Mtg | Other Consumer | Total |
|---|---|---|---|---|---|---|---|---|
| | | | | *(In thousands)* | | | | |
| **Recorded Investment in Loans:** | | | | | | | | |
| Principal loan balance | $ 105,377 | $ 9,938 | $ 8,993 | $ 78,547 | $ 28,354 | $ 36,833 | $ 34,609 | $ 302,651 |
| Accrued interest receivable | 347 | 45 | 22 | 202 | 77 | 129 | 136 | 958 |
| Net deferred loan origination fees and costs | 59 | 2 | 0 | (30) | (9) | 390 | 0 | 412 |
| Recorded investment in loans | $ 105,783 | $ 9,985 | $ 9,015 | $ 78,719 | $ 28,422 | $ 37,352 | $ 34,745 | $ 304,021 |
| **Recorded Investment in Loans as Evaluated for Impairment:** | | | | | | | | |
| Individually evaluated for impairment | $ 1,446 | $ 113 | $ 0 | $ 2,671 | $ 1,864 | $ 96 | $ 0 | $ 6,190 |
| Collectively evaluated for impairment | 104,337 | 9,872 | 9,015 | 76,048 | 26,558 | 37,256 | 34,745 | 297,831 |
| Acquired with deteriorated credit quality | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Ending balance | $ 105,783 | $ 9,985 | $ 9,015 | $ 78,719 | $ 28,422 | $ 37,352 | $ 34,745 | $ 304,021 |

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(3 continued)

The following table provides the components of the Company s recorded investment in loans at December 31, 2013:

| | Residential Real Estate | Land | Construction | Commercial Real Estate | Commercial Business | Home Equity 2nd Mtg | & Other Consumer | Total |
|---|---|---|---|---|---|---|---|---|
| | | | | | *(In thousands)* | | | |
| **Recorded Investment in Loans:** | | | | | | | | |
| Principal loan balance | $ 107,029 | $ 10,309 | $ 8,996 | $ 76,496 | $ 21,956 | $ 34,815 | $ 33,486 | $ 293,087 |
| Accrued interest receivable | 427 | 49 | 22 | 202 | 56 | 126 | 168 | 1,050 |
| Net deferred loan origination fees and costs | 52 | 2 | 0 | (32) | (9) | 328 | 0 | 341 |
| Recorded investment in loans | $ 107,508 | $ 10,360 | $ 9,018 | $ 76,666 | $ 22,003 | $ 35,269 | $ 33,654 | $ 294,478 |
| **Recorded Investment in Loans as Evaluated for Impairment:** | | | | | | | | |
| Individually evaluated for impairment | $ 2,040 | $ 120 | $ 0 | $ 2,586 | $ 1,898 | $ 276 | $ 0 | $ 6,920 |
| Collectively evaluated for impairment | 105,468 | 10,240 | 9,018 | 74,080 | 20,105 | 34,993 | 33,654 | 287,558 |
| Acquired with deteriorated credit quality | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Ending balance | $ 107,508 | $ 10,360 | $ 9,018 | $ 76,666 | $ 22,003 | $ 35,269 | $ 33,654 | $ 294,478 |

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(3 continued)

An analysis of the allowance for loan losses as of June 30, 2014 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 | $ 61 | $ 0 | $ 0 | $ 107 | $ 1,226 | $ 0 | $ 0 | $ 1,394 |
| Collectively evaluated for impairment | 782 | 153 | 78 | 1,173 | 218 | 932 | 336 | 3,672 |
| Acquired with deteriorated credit quality | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Ending balance | $ 843 | $ 153 | $ 78 | $ 1,280 | $ 1,444 | $ 932 | $ 336 | $ 5,066 |

An analysis of the allowance for loan losses as of December 31, 2013 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 | $ 112 | $ 0 | $ 0 | $ 145 | $ 1,259 | $ 13 | $ 0 | $ 1,529 |
| Collectively evaluated for impairment | 699 | 152 | 63 | 1,139 | 187 | 864 | 289 | 3,393 |
| | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Acquired with deteriorated credit quality | | | | | | | | |
| Ending balance | $ 811 | $ 152 | $ 63 | $ 1,284 | $ 1,446 | $ 877 | $ 289 | $ 4,922 |

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(3 continued)

An analysis of the changes in the allowance for loan losses for the three months and six months ended June 30, 2014 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 June 30, 2014 | | | | | | | | |
| Beginning balance | $ 838 | $ 144 | $ 70 | $ 1,276 | $ 1,450 | $ 902 | $ 331 | $ 5,011 |
| Provisions for loan losses | 24 | 9 | 8 | 4 | (10) | 41 | 14 | 90 |
| Charge-offs | (21) | 0 | 0 | 0 | 0 | (36) | (36) | (93) |
| Recoveries | 2 | 0 | 0 | 0 | 4 | 25 | 27 | 58 |
| Ending balance | $ 843 | $ 153 | $ 78 | $ 1,280 | $ 1,444 | $ 932 | $ 336 | $ 5,066 |
| Changes in Allowance for Loan Losses for the six-months ended June 30, 2014 | | | | | | | | |
| Beginning balance | $ 811 | $ 152 | $ 63 | $ 1,284 | $ 1,446 | $ 877 | $ 289 | $ 4,922 |
| Provisions for loan losses | 113 | 1 | 15 | (4) | (7) | (70) | 67 | 115 |
| Charge-offs | (84) | 0 | 0 | 0 | 0 | (54) | (88) | (226) |
| Recoveries | 3 | 0 | 0 | 0 | 5 | 179 | 68 | 255 |
| Ending balance | $ 843 | $ 153 | $ 78 | $ 1,280 | $ 1,444 | $ 932 | $ 336 | $ 5,066 |

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(3 continued)

An analysis of the changes in the allowance for loan losses for the three months and six months ended June 30, 2013 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 June 30, 2013 | | | | | | | | |
| Beginning balance | $ 940 | $ 69 | $ 50 | $ 1,291 | $ 1,226 | $ 886 | $ 330 | $ 4,792 |
| Provisions for loan losses | 24 | 6 | 10 | 89 | 33 | 9 | 54 | 225 |
| Charge-offs | (99) | (2) | 0 | (89) | 0 | (21) | (65) | (276) |
| Recoveries | 40 | 0 | 0 | 0 | 1 | 20 | 33 | 94 |
| Ending balance | $ 905 | $ 73 | $ 60 | $ 1,291 | $ 1,260 | $ 894 | $ 352 | $ 4,835 |
| Changes in Allowance for Loan Losses for the six-months ended June 30, 2013 | | | | | | | | |
| Beginning balance | $ 922 | $ 71 | $ 0 | $ 1,310 | $ 1,223 | $ 919 | $ 291 | $ 4,736 |
| Provisions for loan losses | 236 | 4 | 60 | 56 | (13) | (24) | 156 | 475 |
| Charge-offs | (297) | (2) | 0 | (89) | 0 | (35) | (171) | (594) |
| Recoveries | 44 | 0 | 0 | 14 | 50 | 34 | 76 | 218 |
| Ending balance | $ 905 | $ 73 | $ 60 | $ 1,291 | $ 1,260 | $ 894 | $ 352 | $ 4,835 |

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(3 continued)

At June 30, 2014 and December 31, 2013, for each loan portfolio segment, management applied an overall qualitative factor of 1.18 to the Company s historical loss factors. The overall qualitative factor is derived from management s analysis of changes and trends in the following qualitative factors:

Underwriting Standards Management reviews the findings of periodic internal audit loan reviews, independent outsourced loan reviews and loan reviews performed by the banking regulators to evaluate the risk associated with changes in underwriting standards. At June 30, 2014 and December 31, 2013, management assessed the risk associated with this component as neutral, requiring no adjustment to the historical loss factors.

Economic Conditions Management analyzes trends in housing and unemployment data in the Harrison, Floyd, Washington and Clark counties of Indiana, the Company s primary market area, to evaluate the risk associated with economic conditions. Due to a decrease in new home construction and an increase in unemployment in the Company s primary market area, management assigned a risk factor of 1.20 for this component at June 30, 2014 and December 31, 2013.

Past Due Loans Management analyzes trends in past due loans for the Company to evaluate the risk associated with delinquent loans. In general, past due loan ratios have remained at elevated levels compared to historical amounts since 2007, and management assigned a risk factor of 1.20 for this component at June 30, 2014 and December 31, 2013.

Other Internal and External Factors This component includes management s consideration of other qualitative factors such as loan portfolio composition. The Company has focused on the origination of commercial business and real estate loans in an effort to convert the Company s balance sheet from that of a traditional thrift institution to a commercial bank. In addition, the Company has increased its investment in mortgage loans in which it does not hold a first lien position. Commercial loans and second mortgage loans generally entail greater credit risk than residential mortgage loans secured by a first lien. As a result of changes in the loan portfolio composition and other factors, management assigned a risk factor of 1.30 at June 30, 2014 and December 31, 2013.

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 June 30, 2014 and December 31, 2013, respectively. The effect of the overall qualitative factor was to increase the estimated allowance for loan losses by $461,000 and $471,000 at June 30, 2014 and December 31, 2013, respectively.

Management also adjusts the historical loss factors for loans classified as watch, special mention and substandard that are not individually evaluated for impairment. The adjustments consider the increased likelihood of loss on classified loans based on the Company s separate historical experience for classified loans. The effect of the adjustments for classified loans was to increase the estimated allowance for loan losses by $465,000 and $521,000 at June 30, 2014 and December 31, 2013, respectively.

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(3 continued)

The following table summarizes the Company s impaired loans as of June 30, 2014 and for the three months and six months ended June 30, 2014:

| | At June 30, 2014 | | | Three Months Ended June 30, 2014 | | | Six Months Ended June 30, 2014 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized | Interest Recognized Cash Method | Average Recorded Investment | Interest Income Recognized | Interest Recognized - Cash Method |
| | *(In thousands)* | | | | | | | | |
| **Loans with no related allowance recorded:** | | | | | | | | | |
| Residential | $ 1,184 | $ 1,462 | $ 0 | $ 1,345 | $ 8 | $ 9 | $ 1,427 | $ 18 | $ 21 |
| Land | 113 | 129 | 0 | 119 | 0 | 0 | 119 | 0 | 0 |
| Construction | 0 | 0 | 0 | 130 | 0 | 0 | 87 | 0 | 0 |
| Commercial real estate | 1,760 | 1,781 | 0 | 1,525 | 17 | 19 | 1,562 | 34 | 36 |
| Commercial business | 188 | 209 | 0 | 94 | 0 | 0 | 126 | 0 | 0 |
| Home Equity/2nd mortgage | 96 | 110 | 0 | 169 | 0 | 0 | 197 | 1 | 1 |
| Other consumer | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| | 3,341 | 3,691 | 0 | 3,382 | 25 | 28 | 3,518 | 53 | 58 |
| **Loans with an allowance recorded:** | | | | | | | | | |
| Residential | 262 | 302 | 61 | 436 | 0 | 0 | 440 | 0 | 0 |
| Land | 0 | 0 | 0 | 3 | 0 | 0 | 2 | 0 | 0 |
| Construction | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Commercial real estate | 911 | 1,031 | 107 | 1,123 | 0 | 0 | 1,065 | 0 | 0 |
| Commercial business | 1,676 | 1,909 | 1,226 | 1,726 | 0 | 0 | 1,720 | 0 | 0 |
| Home Equity/2nd mortgage | 0 | 0 | 0 | 16 | 0 | 0 | 18 | 0 | 0 |
| Other consumer | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| | 2,849 | 3,242 | 1,394 | 3,304 | 0 | 0 | 3,245 | 0 | 0 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **Total:** | | | | | | | | | |
| Residential | 1,446 | 1,764 | 61 | 1,781 | 8 | 9 | 1,867 | 18 | 21 |
| Land | 113 | 129 | 0 | 122 | 0 | 0 | 121 | 0 | 0 |
| Construction | 0 | 0 | 0 | 130 | 0 | 0 | 87 | 0 | 0 |
| Commercial real estate | 2,671 | 2,812 | 107 | 2,648 | 17 | 19 | 2,627 | 34 | 36 |
| Commercial business | 1,864 | 2,118 | 1,226 | 1,820 | 0 | 0 | 1,846 | 0 | 0 |
| Home Equity/2nd mortgage | 96 | 110 | 0 | 185 | 0 | 0 | 215 | 1 | 1 |
| Other consumer | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| | $ 6,190 | $ 6,933 | $ 1,394 | $ 6,686 | $ 25 | $ 28 | $ 6,763 | $ 53 | $ 58 |

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(3 continued)

The following table summarizes the Company s impaired loans for the three months and six months ended June 30, 2013:

| | Three Months Ended June 30, 2013 | | | Six Months Ended June 30, 2013 | | |
|---|---|---|---|---|---|---|
| | Average Recorded Investment | Interest Income Recognized | Interest Recognized - Cash Method | Average Recorded Investment | Interest Income Recognized | Interest Recognized - Cash Method |
| **Loans with no related allowance recorded:** | | | | | | |
| Residential | $ 1,273 | $ 2 | $ 0 | $ 1,324 | $ 5 | $ 1 |
| Land | 126 | 0 | 0 | 125 | 0 | 0 |
| Construction | 232 | 0 | 0 | 289 | 0 | 0 |
| Commercial real estate | 106 | 0 | 0 | 582 | 0 | 0 |
| Commercial business | 0 | 4 | 3 | 0 | 4 | 3 |
| Home Equity/2nd mortgage | 251 | 1 | 1 | 167 | 2 | 1 |
| Other consumer | 0 | 0 | 0 | 0 | 0 | 0 |
| | 1,988 | 7 | 4 | 2,487 | 11 | 5 |
| **Loans with an allowance recorded:** | | | | | | |
| Residential | 625 | 0 | 0 | 731 | 0 | 0 |
| Land | 3 | 0 | 0 | 2 | 0 | 0 |
| Construction | 0 | 0 | 0 | 0 | 0 | 0 |
| Commercial real estate | 1,161 | 0 | 0 | 1,208 | 0 | 0 |
| Commercial business | 1,776 | 0 | 0 | 1,776 | 0 | 0 |
| Home Equity/2nd mortgage | 49 | 0 | 0 | 57 | 1 | 0 |
| Other consumer | 0 | 0 | 0 | 0 | 0 | 0 |
| | 3,614 | 0 | 0 | 3,774 | 1 | 0 |

| | | | | | | |
|---|---|---|---|---|---|---|
| **Total:** | | | | | | |
| Residential | 1,898 | 2 | 0 | 2,055 | 5 | 1 |
| Land | 129 | 0 | 0 | 127 | 0 | 0 |
| Construction | 232 | 0 | 0 | 289 | 0 | 0 |
| Commercial real estate | 1,267 | 0 | 0 | 1,790 | 0 | 0 |
| Commercial business | 1,776 | 4 | 3 | 1,776 | 4 | 3 |
| Home Equity/2nd mortgage | 300 | 1 | 1 | 224 | 3 | 1 |
| Other consumer | 0 | 0 | 0 | 0 | 0 | 0 |
| | $ 5,602 | $ 7 | $ 4 | $ 6,261 | $ 12 | $ 5 |

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(3 continued)

The following table summarizes the Company s impaired loans as of December 31, 2013:

| | Recorded Investment | Unpaid Principal Balance | Related Allowance |
|---|---|---|---|
| | | *(In thousands)* | |
| **Loans with no related allowance recorded:** | | | |
| Residential | $ 1,591 | $ 1,869 | $ 0 |
| Land | 120 | 131 | 0 |
| Construction | 0 | 0 | 0 |
| Commercial real estate | 1,637 | 1,643 | 0 |
| Commercial business | 189 | 209 | 0 |
| Home equity/2nd mortgage | 254 | 268 | 0 |
| Other consumer | 0 | 0 | 0 |
| | 3,791 | 4,120 | 0 |
| **Loans with an allowance recorded:** | | | |
| Residential | 449 | 487 | 112 |
| Land | 0 | 0 | 0 |
| Construction | 0 | 0 | 0 |
| Commercial real estate | 949 | 1,048 | 145 |
| Commercial business | 1,709 | 1,909 | 1,259 |
| Home equity/2nd mortgage | 22 | 22 | 13 |
| Other consumer | 0 | 0 | 0 |
| | 3,129 | 3,466 | 1,529 |
| **Total:** | | | |
| Residential | 2,040 | 2,356 | 112 |
| Land | 120 | 131 | 0 |
| Construction | 0 | 0 | 0 |

| | | | |
|---|---|---|---|
| Commercial real estate | 2,586 | 2,691 | 145 |
| Commercial business | 1,898 | 2,118 | 1,259 |
| Home equity/2nd mortgage | 276 | 290 | 13 |
| Other consumer | 0 | 0 | 0 |
| | $ 6,920 | $ 7,586 | $ 1,529 |

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(3 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 June 30, 2014 and December 31, 2013:

| | June 30, 2014 | | | December 31, 2013 | | |
|---|---|---|---|---|---|---|
| | | Loans 90+ Days Past Due | | | Loans 90+ Days Past Due | |
| | Nonaccrual Loans | Still Accruing | Total Nonperforming Loans | Nonaccrual Loans | Still Accruing | Total Nonperforming Loans |
| | *(In thousands)* | | | | | |
| Residential | $ 945 | $ 68 | $ 1,013 | $ 1,533 | $ 180 | $ 1,713 |
| Land | 113 | 0 | 113 | 120 | 0 | 120 |
| Construction | 0 | 0 | 0 | 0 | 0 | 0 |
| Commercial real estate | 1,395 | 0 | 1,395 | 1,456 | 0 | 1,456 |
| Commercial business | 1,864 | 0 | 1,864 | 1,898 | 0 | 1,898 |
| Home equity/2nd mortgage | 73 | 0 | 73 | 252 | 39 | 291 |
| Other consumer | 0 | 2 | 2 | 0 | 8 | 8 |
| Total | $ 4,390 | $ 70 | $ 4,460 | $ 5,259 | $ 227 | $ 5,486 |

The following table presents the aging of the recorded investment in loans at June 30, 2014:

| | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or More Past Due | Total Past Due | Current | Total Loans |
|---|---|---|---|---|---|---|
| | *(In thousands)* | | | | | |
| Residential | $ 3,064 | $ 181 | $ 296 | $ 3,541 | $ 102,242 | $ 105,783 |
| Land | 159 | 0 | 0 | 159 | 9,826 | 9,985 |
| Construction | 0 | 0 | 0 | 0 | 9,015 | 9,015 |
| Commercial real estate | 0 | 46 | 0 | 46 | 78,673 | 78,719 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Commercial business | 0 | 0 | 189 | 189 | 28,233 | 28,422 |
| Home equity/2nd mortgage | 248 | 107 | 34 | 389 | 36,963 | 37,352 |
| Other consumer | 248 | 22 | 2 | 272 | 34,473 | 34,745 |
| Total | $ 3,719 | $ 356 | $ 521 | $ 4,596 | $ 299,425 | $ 304,021 |

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(3 continued)

The following table presents the aging of the recorded investment in loans at December 31, 2013:

| | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or More Past Due | Total Past Due | Current | Total Loans |
|---|---|---|---|---|---|---|
| | | | *(In thousands)* | | | |
| Residential | $ 3,160 | $ 830 | $ 701 | $ 4,691 | $ 102,817 | $ 107,508 |
| Land | 162 | 109 | 12 | 283 | 10,077 | 10,360 |
| Construction | 0 | 0 | 0 | 0 | 9,018 | 9,018 |
| Commercial real estate | 231 | 500 | 49 | 780 | 75,886 | 76,666 |
| Commercial business | 0 | 0 | 189 | 189 | 21,814 | 22,003 |
| Home equity/2nd mortgage | 411 | 24 | 132 | 567 | 34,702 | 35,269 |
| Other consumer | 296 | 34 | 8 | 338 | 33,316 | 33,654 |
| Total | $ 4,260 | $ 1,497 | $ 1,091 | $ 6,848 | $ 287,630 | $ 294,478 |

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.

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(3 continued)

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

| | Residential Real Estate | Land | Construction | Commercial Real Estate | Commercial Business | Home Equity & 2nd Mtg | Other Consumer | Total |
|---|---|---|---|---|---|---|---|---|
| | | | | *(In thousands)* | | | | |
| **June 30, 2014** | | | | | | | | |
| Pass | $ 103,761 | $ 6,816 | $ 9,015 | $ 72,009 | $ 23,643 | $ 36,812 | $ 34,691 | $ 286,747 |
| Special Mention | 183 | 0 | 0 | 4,633 | 2,915 | 98 | 37 | 7,866 |
| Substandard | 894 | 3,056 | 0 | 682 | 0 | 369 | 17 | 5,018 |
| Doubtful | 945 | 113 | 0 | 1,395 | 1,864 | 73 | 0 | 4,390 |
| Loss | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Ending balance | $ 105,783 | $ 9,985 | $ 9,015 | $ 78,719 | $ 28,422 | $ 37,352 | $ 34,745 | $ 304,021 |
| **December 31, 2013** | | | | | | | | |
| Pass | $ 103,594 | $ 7,096 | $ 9,018 | $ 71,893 | $ 19,328 | $ 34,693 | $ 33,627 | $ 279,249 |
| Special Mention | 756 | 0 | 0 | 2,627 | 458 | 198 | 27 | 4,066 |
| Substandard | 1,625 | 3,144 | 0 | 690 | 319 | 126 | 0 | 5,904 |
| Doubtful | 1,533 | 120 | 0 | 1,456 | 1,898 | 252 | 0 | 5,259 |
| Loss | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Ending balance | $ 107,508 | $ 10,360 | $ 9,018 | $ 76,666 | $ 22,003 | $ 35,269 | $ 33,654 | $ 294,478 |

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(3 continued)

The following table summarizes the Company s troubled debt restructurings (TDRs) by accrual status as of June 30, 2014 and December 31, 2013:

| | June 30, 2014 | | | | December 31, 2013 | | | |
|---|---|---|---|---|---|---|---|---|
| | Accruing | Nonaccrual | Total | Related Allowance for Loan Losses | Accruing | Nonaccrual | Total | Related Allowance for Loan Losses |
| | *(In thousands)* | | | | | | | |
| **Troubled debt restructurings:** | | | | | | | | |
| Residential real estate | $ 501 | $ 171 | $ 672 | $ 8 | $ 508 | $ 226 | $ 734 | $ 45 |
| Commercial real estate | 1,276 | 361 | 1,637 | 0 | 1,130 | 0 | 1,130 | 0 |
| Commercial business | 0 | 1,676 | 1,676 | 1,226 | 0 | 1,709 | 1,709 | 1,259 |
| Home equity and 2nd mortgage | 23 | 0 | 23 | 0 | 24 | 0 | 24 | 0 |
| Total | $ 1,800 | $ 2,208 | $ 4,008 | $ 1,234 | $ 1,662 | $ 1,935 | $ 3,597 | $ 1,304 |

At June 30, 2014 and December 31, 2013, there were no commitments to lend additional funds to debtors whose loan terms have been modified in a TDR.

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(3 continued)

The following table summarizes information in regard to TDRs that were restructured during the six months ended June 30, 2014. There were no TDRs that were restructured during the three months ended June 30, 2014:

| | Six months ended June 30, 2014 | | |
|---|---|---|---|
| | **Number of Contracts** | **Pre-Modification Outstanding Balance** | **Post-Modification Outstanding Balance** |
| | | *(Dollars in thousands)* | |
| **Troubled debt restructurings:** | | | |
| Commercial real estate | 3 | $ 542 | $ 542 |
| Total | 3 | $ 542 | $ 542 |

For the TDRs listed above, the terms of modification included a temporary decrease in the borrowers monthly payments. There were no principal charge-offs recorded as a result of TDRs during the three months and six months ended June 30, 2014, and there was no specific allowance for loan losses related to TDRs modified during the three months and six months ended June 30, 2014.

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 months and six months ended June 30, 2014 and 2013. 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)*

(3 continued)

The following table summarizes information in regard to TDRs that were restructured during the three and six months ended June 30, 2013:

| | Three months ended June 30, 2013 | | | Six months ended June 30, 2013 | | |
|---|---|---|---|---|---|---|
| | Number of Contracts | Pre-Modification Outstanding Balance | Post-Modification Outstanding Balance | Number of Contracts | Pre-Modification Outstanding Balance | Post-Modification Outstanding Balance |
| | | *(Dollars in thousands)* | | | *(Dollars in thousands)* | |
| **Troubled debt restructurings:** | | | | | | |
| Residential real estate | 1 | $ 160 | $ 160 | 1 | $ 160 | $ 160 |
| Total | 1 | $ 160 | $ 160 | 1 | $ 160 | $ 160 |

For the TDR listed above, the term of modification included a reduction of the stated interest rate. There were no principal charge-offs recorded as a result of TDRs during the three months and six months ended June 30, 2013, and there was no specific allowance for loan losses related to TDRs modified during the three months and six months ended June 30, 2013.

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

## 4. Supplemental Disclosure for Earnings Per Share

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2014 | June 30, 2013 | June 30, 2014 | June 30, 2013 |
| | *(Dollars in thousands, except for share and per share data)* | | | |
| **Basic and Diluted:** | | | | |
| Earnings: | | | | |
| Net income attributable to First Capital, Inc. | $ 1,518 | $ 1,210 | $ 2,815 | $ 2,404 |
| Shares: | | | | |
| Weighted average common shares outstanding | 2,757,335 | 2,784,997 | 2,770,637 | 2,784,997 |
| Net income attributable to First Capital, Inc. per common share, basic and diluted | $ 0.55 | $ 0.43 | $ 1.02 | $ 0.86 |

There were no potentially dilutive shares for the three and six month periods ended June 30, 2014 and 2013.

## 5. Stock Option Plan

For the six month periods ended June 30, 2014 and 2013, the Company did not recognize any compensation expense related to its stock option plans. Expense is recognized ratably over the five-year vesting period of the options. At June 30, 2014, there was no unrecognized compensation expense related to nonvested stock options to be recognized over the remaining vesting period. The Black-Scholes option pricing model was used to determine the fair value of the options granted in prior periods.

## 6. Supplemental Disclosures of Cash Flow Information

| | Six Months Ended June 30, | |
|---|---|---|
| | 2014 | 2013 |
| | *(In thousands)* | |

| | | |
|---|---|---|
| Cash payments for: | | |
| Interest | $ 632 | $ 945 |
| Taxes | 1,042 | 1,091 |
| Noncash investing activities: | | |
| Transfers from loans to real estate acquired through foreclosure | 75 | 551 |

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

## 7. Fair Value Measurements

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

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

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

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

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(7 continued)

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 June 30, 2014 and December 31, 2013. The Company had no liabilities measured at fair value as of June 30, 2014 or December 31, 2013.

| | Carrying Value | | | |
|---|---|---|---|---|
| *(In thousands)* | **Level 1** | **Level 2** | **Level 3** | **Total** |
| **June 30, 2014** | | | | |
| ***Assets Measured on a Recurring Basis*** | | | | |
| Securities available for sale: | | | | |
| Agency mortgage-backed securities | $ 0 | $ 28,105 | $ 0 | $ 28,105 |
| Agency CMO | 0 | 17,562 | 0 | 17,562 |
| Agency notes and bonds | 0 | 25,179 | 0 | 25,179 |
| Municipal obligations | 0 | 34,048 | 0 | 34,048 |
| Mutual funds | 2,360 | 0 | 0 | 2,360 |
| Total securities available for sale | $ 2,360 | $ 104,894 | $ 0 | $ 107,254 |
| ***Assets Measured on a Nonrecurring Basis*** | | | | |
| Impaired loans: | | | | |
| Residential real estate | $ 0 | $ 0 | $ 1,385 | $ 1,385 |
| Land | 0 | 0 | 113 | 113 |
| Construction | 0 | 0 | 0 | 0 |
| Commercial real estate | 0 | 0 | 2,564 | 2,564 |
| Commercial business | 0 | 0 | 638 | 638 |
| Home equity and second mortgage | 0 | 0 | 96 | 96 |
| Total impaired loans | $ 0 | $ 0 | $ 4,796 | $ 4,796 |
| Loans held for sale | $ 0 | $ 3,824 | $ 0 | $ 3,824 |

| | | | | |
|---|---|---|---|---|
| Foreclosed real estate: | | | | |
| Residential real estate | $ 0 | $ 0 | $ 49 | $ 49 |
| Total foreclosed real estate | $ 0 | $ 0 | $ 49 | $ 49 |
| **December 31, 2013** | | | | |
| ***Assets Measured on a Recurring Basis*** | | | | |
| Securities available for sale: | | | | |
| Agency mortgage-backed securities | $ 0 | $ 18,369 | $ 0 | $ 18,369 |
| Agency CMO | 0 | 20,241 | 0 | 20,241 |
| Agency notes and bonds | 0 | 30,914 | 0 | 30,914 |
| Municipal obligations | 0 | 36,040 | 0 | 36,040 |
| Mutual funds | 3,198 | 0 | 0 | 3,198 |
| Total securities available for sale | $ 3,198 | $ 105,564 | $ 0 | $ 108,762 |
| ***Assets Measured on a Nonrecurring Basis*** | | | | |
| Impaired loans: | | | | |
| Residential real estate | $ 0 | $ 0 | $ 1,928 | $ 1,928 |
| Land | 0 | 0 | 120 | 120 |
| Construction | 0 | 0 | 0 | 0 |
| Commercial real estate | 0 | 0 | 2,441 | 2,441 |
| Commercial business | 0 | 0 | 639 | 639 |
| Home equity and second mortgage | 0 | 0 | 263 | 263 |
| Total impaired loans | $ 0 | $ 0 | $ 5,391 | $ 5,391 |
| Loans held for sale | $ 0 | $ 1,611 | $ 0 | $ 1,611 |
| Foreclosed real estate: | | | | |
| Residential real estate | $ 0 | $ 0 | $ 466 | $ 466 |
| Total foreclosed real estate | $ 0 | $ 0 | $ 466 | $ 466 |

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(7 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 June 30, 2014 and December 31, 2013, 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 June 30, 2014 and December 31, 2013, the significant unobservable inputs used in the fair value measurement of impaired loans included a discount from appraised value for estimates of changes in market conditions, the condition of the collateral and estimated costs to sell the collateral ranging from 10% to 48%. The Company recognized provisions for loan losses of $21,000 and $45,000 for the six months ended June 30, 2014 and 2013, respectively, for impaired loans. The Company recognized provisions for loan losses of $8,000 for the three months ended June 30, 2014. No provisions for loan losses were recognized for the three months ended June 30, 2013 for impaired loans.

**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(7 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 June 30, 2014, 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 0% to 23%. At December 31, 2013, the discount from appraised value ranged from 10% to 38%. The Company recognized charges of $32,000 to write down foreclosed real estate to fair value for the six months ended June 30, 2013. There were no charges to write down foreclosed real estate recognized in income for the three months and six months ended June 30, 2014, or the three months ended June 13, 2013.

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 six month periods ended June 30, 2014 and 2013. There were no transfers into or out of the Company s Level 3 financial assets for the six month periods ended June 30, 2014 and 2013. In addition, there were no transfers into or out of Levels 1 and 2 of the fair value hierarchy during the six month periods ended June 30, 2014 and 2013.

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(7 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:

| | Carrying | Fair | Fair Vale Measurements Using | | |
|---|---|---|---|---|---|
| *(In thousands)* | Value | Value | Level 1 | Level 2 | Level 3 |
| **June 30, 2014** | | | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | $ 15,428 | $ 15,428 | $ 15,428 | $ 0 | $ 0 |
| Interest-bearing time deposits | 5,900 | 6,033 | 0 | 6,033 | 0 |
| Securities available for sale | 107,254 | 107,254 | 2,360 | 104,894 | 0 |
| Securities held to maturity | 8 | 8 | 0 | 8 | 0 |
| Loans held for sale | 3,824 | 3,912 | 0 | 3,912 | 0 |
| Loans, net | 297,997 | 299,088 | 0 | 0 | 299,088 |
| FHLB stock | 2,820 | 2,820 | 0 | 2,820 | 0 |
| Accrued interest receivable | 1,551 | 1,551 | 0 | 1,551 | 0 |
| Cost method investment (included in other assets) | 711 | 711 | 0 | 711 | 0 |
| Financial liabilities: | | | | | |
| Deposits | 386,753 | 386,680 | 0 | 0 | 386,680 |
| Retail repurchase agreements | 10,617 | 10,617 | 0 | 10,617 | 0 |
| Advances from FHLB | 5,000 | 5,000 | 0 | 5,000 | 0 |
| Accrued interest payable | 155 | 155 | 0 | 155 | 0 |
| **December 31, 2013:** | | | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | $ 11,136 | $ 11,136 | $ 11,136 | $ 0 | $ 0 |
| Interest-bearing time deposits | 4,425 | 4,458 | 0 | 4,458 | 0 |
| Securities available for sale | 108,762 | 108,762 | 3,198 | 105,564 | 0 |

| | | | | | |
|---|---|---|---|---|---|
| Securities held to maturity | 9 | 9 | 0 | 9 | 0 |
| Loans held for sale | 1,611 | 1,644 | 0 | 1,644 | 0 |
| Loans, net | 288,506 | 287,753 | 0 | 0 | 287,753 |
| FHLB stock | 2,820 | 2,820 | 0 | 2,820 | 0 |
| Accrued interest receivable | 1,716 | 1,716 | 0 | 1,716 | 0 |
| Cost method investment (included in other assets) | 540 | 540 | 0 | 540 | 0 |
| Financial liabilities: | | | | | |
| Deposits | 373,830 | 373,883 | 0 | 0 | 373,883 |
| Retail repurchase agreements | 9,310 | 9,310 | 0 | 9,310 | 0 |
| Advances from FHLB | 5,500 | 5,500 | 0 | 5,500 | 0 |
| Accrued interest payable | 192 | 192 | 0 | 192 | 0 |

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**FIRST CAPITAL, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

*(Unaudited)*

(7 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)*

**8. Recent Accounting Pronouncements**

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

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

In March 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. The update provides a five-step revenue recognition model for all revenue arising from contracts with 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 revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. For public entities, the guidance is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period, and must be applied either retrospectively or using the modified retrospective approach. Early adoption is not permitted. 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.

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# 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 report may contain forward-looking statements within the meaning of the federal securities laws. These statements are not historical facts; 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 are preceded by terms such as expects, believes, anticipates, intends and similar expressions.

Forward-looking statements are not guarantees of future performance. 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; 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 the Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2013 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. 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 six months ended June 30, 2014, 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, 2013.

## Financial Condition

Total assets increased from $444.4 million at December 31, 2013 to $459.5 million at June 30, 2014, an increase of 3.4%.

Net loans receivable (excluding loans held for sale) increased $9.5 million from $288.5 million at December 31, 2013 to $298.0 million at June 30, 2014. Commercial business loans and commercial real estate loans increased $6.4 million and $2.1 million, respectively, during the six months ended June 30, 2014 while residential mortgage loans and residential construction loans decreased $1.7 million and $1.1 million, respectively, during the period. This was primarily due to the Bank s continued effort to reposition its lending portfolio with more commercial loans.

Securities available for sale decreased $1.5 million from $108.8 million at December 31, 2013 to $107.3 million at June 30, 2014. Purchases of $15.5 million of securities classified as available for sale were made during the six months ended June 30, 2014 and consisted primarily of U.S. government agency notes and bonds and mortgage-backed securities. Maturities, principal repayments and sales of available for sale securities totaled $10.9 million, $4.9 million and $2.6 million, respectively, during the six months ended June 30, 2014.

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# RESULTS OF OPERATIONS

# FIRST CAPITAL, INC.

Cash and cash equivalents increased from $11.1 million at December 31, 2013 to $15.4 million at June 30, 2014, primarily due to an increase of $2.5 million in federal funds sold.

Total deposits increased 3.4% from $373.8 million at December 31, 2013 to $386.8 million at June 30, 2014. Interest-bearing demand and savings accounts increased $13.1 million during the six months ended June 30, 2014 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. Time deposits decreased $6.7 million over the same six month period. Noninterest-bearing checking accounts increased by $6.4 million during the period due to a combination of growth in existing accounts and new accounts.

FHLB borrowings decreased $500,000 from December 31, 2013 to June 30, 2014 as the Bank paid off $5.5 million in advances and borrowed $5.0 million during the six month period.

Retail repurchase agreements, which represent overnight borrowings from deposit customers, including businesses and local municipalities, increased from $9.3 million at December 31, 2013 to $10.6 million at June 30, 2014 due to normal balance fluctuation.

Total stockholders equity attributable to the Company increased from $53.2 million at December 31, 2013 to $55.1 million at June 30, 2014 primarily due to retained net income of $1.7 million and a net increase of $1.1 million in the net unrealized gain on securities available for sale for the six months ended June 30, 2014. This was partially offset by the Company repurchasing 40,586 shares of common stock for $844,000.

**Results of Operations**

**Net Income for the six-month periods ended June 30, 2014 and 2013.** Net income attributable to the Company was $2.8 million ($1.02 per share) for the six months ended June 30, 2014 compared to $2.4 million ($0.86 per share) for the same time period in 2013. The increase is primarily due to an increase in net interest income after provision for loan losses partially offset by a decrease in noninterest income.

**Net Income for the three-month periods ended June 30, 2014 and 2013.** Net income attributable to the Company was $1.5 million ($0.55 per share) for the three months ended June 30, 2014 compared to $1.2 million ($0.43 per share) for the three months ended June 30, 2013. The increase is primarily due to increases in net interest income after provision for loan losses and noninterest income.

**Net interest income for the six-month periods ended June 30, 2014 and 2013.** Net interest income increased $338,000 for the six months ended June 30, 2014 compared to the same period in 2013 primarily due to an increase in the interest rate spread and a decrease in the average balance of interest-bearing liabilities.

## PART I - ITEM 2

## MANAGEMENT S DISCUSSION AND

## ANALYSIS OF FINANCIAL CONDITION AND

## RESULTS OF OPERATIONS

## FIRST CAPITAL, INC.

Total interest income increased $35,000 for the six months ended June 30, 2014 compared to the same period in 2013. For the six months ended June 30, 2014, the tax-equivalent yield of interest-earning assets was 4.47%, compared to 4.44% during the same period in 2013. The increase in the yield on interest-earning assets is due primarily to a change in asset mix. The average balance of loans receivable increased from $286.5 million for the six months ended June 30, 2013 to $296.6 million for the six months ended June 30, 2014 while the average balance in lower yielding federal funds sold and investment securities decreased by $6.9 million and $6.0 million, respectively, when comparing the two periods.

Total interest expense decreased $303,000 for the six months ended June 30, 2014 compared to the same period in 2013. The average rate paid on interest-bearing liabilities decreased from 0.52% for the six months ended June 30, 2013 to 0.35% for the same period in 2014. The average balance of interest-bearing liabilities decreased from $348.1 million for 2013 to $338.9 million for 2014 primarily due to a decrease of $12.9 million in the average balance of time deposits partially offset by a $9.7 million increase in the average balance of savings and interest-bearing demand deposits. As a result, the tax-equivalent interest rate spread increased from 3.92% for the six-month period ended June 30, 2013 to 4.12% for the same period in 2014.

**Net interest income for the three-month periods ended June 30, 2014 and 2013.** Net interest income increased $252,000 for the three months ended June 30, 2014 compared to the three months ended June 30, 2013 primarily due to an increase in the interest rate spread and an increase in the ratio of average interest-earning assets to average interest-bearing liabilities.

Total interest income increased $109,000 for the three months ended June 30, 2014 compared to the same period in 2013. For the three months ended June 30, 2014, the average balance of interest-earning assets and their tax-equivalent yield were $429.4 million and 4.49%, respectively. During the same period in 2013, the average balance of those assets was $426.8 million and the tax-equivalent yield was 4.43%. The increase in yield was primarily due to the previously mentioned change in asset mix.

Total interest expense decreased $143,000 for the three months ended June 30, 2014 compared to the three months ended June 30, 2013. The average balance of interest-bearing liabilities decreased from $352.4 million to $342.2 million when comparing the two periods and the average rate paid on those liabilities decreased from 0.50% for the three months ended June 30, 2013 to 0.35% for the same period in 2014. As a result, the tax-equivalent interest rate spread increased from 3.93% for the three months ended June 30, 2013 to 4.14% for the three months ended June 30, 2014. The ratio of average interest-earning assets to average interest-bearing liabilities increased from 121.1% for 2013 to 125.5% for 2014.

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# PART I - ITEM 2

# MANAGEMENT S DISCUSSION AND

# ANALYSIS OF FINANCIAL CONDITION AND

# RESULTS OF OPERATIONS

# FIRST CAPITAL, INC.

**Provision for loan losses**. The provision for loan losses decreased from $475,000 for the six-month period ended June 30, 2013 to $115,000 for the same period in 2014 and from $225,000 for the three months ended June 30, 2013 to $90,000 for the three months ended June 30, 2014. Net charge offs amounted to $376,000 for the six-month period ended June 30, 2013 compared to a net recovery of $29,000 for the six months ended June 30, 2014. During the six-month period ended June 30, 2014, gross loans receivable increased $7.8 million. As stated earlier in this report, commercial business loans and commercial real estate loans increased $6.4 million and $2.1 million, respectively, and residential mortgage loans and residential construction loans decreased $1.7 million and $1.1 million, respectively, during the six months ended June 30, 2014. The decrease in the provision for loan losses is due to the decrease in net charge-offs for 2014 compared to 2013 and a decrease in provisions related to nonperforming loans as discussed further below.

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 collectibility 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.

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 $5.1 million at June 30, 2014 and $4.9 million at December 31, 2013. 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 June 30, 2014, nonperforming loans amounted to $4.5 million compared to $5.5 million at December 31, 2013. Included in nonperforming loans at June 30, 2014 are loans 90 days or more past due and still accruing interest which are secured by residential mortgages of $68,000 and consumer loans of $2,000. These loans are accruing interest because the estimated value of the collateral and collection efforts are deemed sufficient to ensure full recovery. At June 30, 2014 and December 31, 2013, nonaccrual loans amounted to $4.4 million and $5.3 million, respectively.

**Noninterest income for the six-month periods ended June 30, 2014 and 2013**. Noninterest income for the six months ended June 30, 2014 decreased $84,000 compared to the six months ended June 30, 2013. This decrease was primarily due a decrease of $162,000 in gains on the sale of loans when comparing the two periods due to the overall slowdown in mortgage activity in the Bank s primary lending market.

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PART I - ITEM 2

MANAGEMENT S DISCUSSION AND

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FIRST CAPITAL, INC.

**Noninterest income for the three-month periods ended June 30, 2014 and 2013**. Noninterest income for the quarter ended June 30, 2014 increased $99,000 to $1.3 million compared to $1.2 million for the quarter ended June 30, 2013. The increase was primarily due to increases in gains on the sale of securities, commission income and service charges on deposit accounts of $54,000, $44,000 and $39,000, respectively.

**Noninterest expense for the six-month periods ended June 30, 2014 and 2013**. Noninterest expense for the six months ended June 30, 2014 increased $20,000 compared to the same period in 2013 primarily due to an increase in compensation and benefit expense of $196,000 that was partially offset by a decrease in other operating expenses of $194,000. Other operating expenses decreased primarily due to reductions in costs associated with the maintenance and disposal of property acquired through foreclosure and losses on ATM and debit cards. Compensation and benefits expenses increased primarily due to normal increases in salaries and employee benefits.

**Noninterest expense for the three-month periods ended June 30, 2014 and 2013**. Noninterest expense for the quarter ended June 30, 2014 increased $43,000 compared to the quarter ended June 30, 2013. Compensation and benefits expense increased $112,000 when comparing the two periods primarily due to normal increases in salaries and benefits. This was partially offset by decreases in other operating expenses of $65,000 and professional service fees of $49,000. The decrease in other operating expenses was primarily due to decreased costs associated with the maintenance and disposal of property acquired through foreclosure. The decrease in professional fees is primarily due to a compensation study and an evaluation of the Bank s asset liability model, both of which occurred in 2013.

**Income tax expense.** Income tax expense for the six-month period ended June 30, 2014 was $1.3 million, compared to $1.1 million for the same period in 2013. The effective tax rate was 30.7% for each period. For the three-month period ended June 30, 2014, income tax expense and the effective tax rate were $692,000 and 31.3%, respectively, compared to $557,000 and 31.5%, respectively, for the same period in 2013.

**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 June 30, 2014, the Bank had cash and cash equivalents of $15.4 million and securities available-for-sale with a fair value of $107.3 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.

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**PART I - ITEM 2**

**MANAGEMENT S DISCUSSION AND**

**ANALYSIS OF FINANCIAL CONDITION AND**

**RESULTS OF OPERATIONS**

**FIRST CAPITAL, INC.**

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 Bank is required to maintain specific amounts of capital pursuant to regulatory requirements. As of June 30, 2014, the Bank was in compliance with all regulatory capital requirements that were effective as of such date with tangible capital to adjusted total assets, Tier I capital to risk-weighted assets and risk-based capital to risk-weighted assets ratios of 10.7%, 14.7% and 15.9%, respectively. The regulatory requirements at that date to be considered well-capitalized under applicable regulations were 5.0%, 6.0% and 10.0%, respectively. At June 30, 2014, the Bank was considered well-capitalized under applicable regulatory guidelines.

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 Company also has repurchased 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) for the preceding two calendar years. On a stand-alone basis, the Company had liquid assets of $210,000 at June 30, 2014.

**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, 2013.

For the six months ended June 30, 2014, 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.

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## 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 June 30, 2014 and December 31, 2013 financial information:

| Immediate Change in the Level of Interest Rates | At June 30, 2014 One Year Horizon Dollar Change | At June 30, 2014 One Year Horizon Percent Change | At December 31, 2013 One Year Horizon Dollar Change | At December 31, 2013 One Year Horizon Percent Change |
|---|---|---|---|---|
| | *(Dollars in thousands)* | | *(Dollars in thousands)* | |
| 300bp | $ (299) | (1.72)% | $ (152) | (0.88)% |
| 200bp | 74 | 0.43 | 197 | 1.14 |
| 100bp | 170 | 0.98 | 280 | 1.62 |
| Static | 0 | 0 | 0 | 0 |
| (100)bp | (333) | (1.92) | (232) | (1.34) |

At June 30, 2014 and December 31, 2013, the Company s simulated exposure to a change in interest rates shows that an immediate and sustained increase in rates of 1.00% or 2.00% would increase the Company s net interest income over a one year horizon compared to a flat interest rate scenario. Alternatively, an immediate and sustained decrease in rates of 1.00% or an immediate and sustained increase in rates of 3.00% would decrease the Company s net interest income at both time periods over a one year horizon compared to a flat interest rate scenario.

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

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**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 June 30, 2014 and December 31, 2013 financial information:

| | At June 30, 2014 | | | | |
|---|---|---|---|---|---|
| | Economic Value of Equity | | | Economic Value of Equity as a Percent of Present Value of Assets | |
| Immediate Change in the Level of Interest Rates | Dollar Amount | Dollar Change | Percent Change | EVE Ratio | Change |
| 300bp | $ 51,472 | $ (18,207) | (26.13)% | 12.15% | (304)bp |
| 200bp | 61,070 | (8,609) | (12.36) | 14.04 | (115)bp |
| 100bp | 68,465 | (1,214) | (1.74) | 15.34 | 15bp |
| Static | 69,679 | 0 | 0 | 15.19 | 0bp |
| (100)bp | 68,832 | (847) | (1.22) | 14.62 | (57)bp |

| | At December 31, 2013 | | | | |
|---|---|---|---|---|---|
| | Economic Value of Equity | | | Economic Value of Equity as a Percent of Present Value of Assets | |
| Immediate Change in the Level of Interest Rates | Dollar Amount | Dollar Change | Percent Change | EVE Ratio | Change |
| 300bp | $ 44,399 | $ (15,949) | (26.43)% | 11.01% | (271)bp |
| 200bp | 51,134 | (9,214) | (15.27) | 12.31 | (141)bp |
| 100bp | 56,380 | (3,968) | (6.57) | 13.19 | (53)bp |
| Static | 60,348 | 0 | 0 | 13.72 | 0bp |
| (100)bp | 64,329 | 3,981 | 6.60 | 14.22 | 50bp |

The previous tables indicate that at June 30, 2014 and December 31, 2013, the Company would expect a decrease in its EVE in the event of a sudden and sustained 100 to 300 basis point increase in prevailing interest rates. At June 30, 2014, the Company would expect a slight decrease in its EVE in the event of a sudden and sustained 100 basis point decrease in prevailing interest rates compared to an expected increase under the same scenario at December 31, 2013.

## 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 June 30, 2014 that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

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## 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 it 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, 2013, 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 Programs | (d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| April 1 through April 30, 2014 | 0 | N/A | 0 | 188,673 |
| May 1 through May 31, 2014 | 40,582 | 20.78 | 40,582 | 148,091 |
| June 1 through June 30, 2014 | 4 | 20.00 | 4 | 148,087 |
| Total | 40,586 | 20.78 | 40,586 | |

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.

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## 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 | Fourth Amended and Restated Bylaws of First Capital, Inc. (2) |
| 10.1 | *Amended and Restated Employment Agreement between First Capital, Inc., First Harrison Bank and William W. Harrod (3) |
| 10.2 | *Amended and Restated Employment Agreement between First Capital, Inc., First Harrison Bank and M. Chris Frederick (3) |
| 10.3 | *Amended and Restated Employment Agreement between First Capital, Inc., First Harrison Bank and Dennis Thomas (4) |
| 10.4 | *Employee Severance Compensation Plan (5) |
| 10.5 | *First Capital, Inc. 2009 Equity Incentive Plan (6) |
| 10.6 | Statement Re: Computation of Per Share Earnings (incorporated by reference to Note 3 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 |

101.0 The following materials from the Company s Quarterly Report on Form 10-Q for the quarter ended June 30, 2014, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets, (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.

* Management contract or compensatory plan, contract or arrangement.

(1) Incorporated by reference from the Exhibits filed with the Registration Statement on Form SB-2, and any amendments thereto, Registration No. 333-63515.

(2) Incorporated by reference to the Current Report on Form 8-K filed with the Securities and Exchange Commission on August 22, 2007.

(3) Incorporated by reference to the Annual Report on Form 10-K for the year ended December 31, 2012.

(4) Incorporated by reference to the Annual Report on Form 10-K for the year ended December 31, 2013.

(5) Incorporated by reference to the Quarterly Report on Form 10-QSB for the quarter ended December 31, 1998.

(6) Incorporated by reference to the appendix to the Company s definitive proxy materials on Schedule 14A filed with the Securities and Exchange Commission on April 9, 2009.

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## 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.<br>(Registrant) |
| **Dated** August 13, 2014 | **BY**: /s/ William W. Harrod<br>William W. Harrod<br>President and CEO |
| **Dated** August 13, 2014 | **BY:** /s/ Michael C. Frederick<br>Michael C. Frederick<br>Executive Vice President, CFO and Treasurer |