

ISABELLA BANK CORP  
Form 10-Q  
August 05, 2016  
UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended June 30, 2016

or  
Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from to  
Commission File Number: 0-18415

Isabella Bank Corporation  
(Exact name of registrant as specified in its charter)

Michigan 38-2830092  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

401 N. Main St, Mt. Pleasant, MI 48858  
(Address of principal executive offices) (Zip code)  
(989) 772-9471  
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  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 (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  Yes  No

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

The number of common shares outstanding of the registrant's Common Stock (no par value) was 7,833,893 as of August 1, 2016.

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QUARTERLY REPORT ON FORM 10-Q  
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## Forward Looking Statements

This report contains certain forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. We intend such forward looking statements to be covered by the safe harbor provisions for forward looking statements contained in the Private Securities Litigation Reform Act of 1995, and are included in this statement for purposes of these safe harbor provisions. Forward looking statements, which are based on certain assumptions and describe future plans, strategies and expectations, are generally identifiable by use of the words “believe,” “expect,” “intend,” “anticipate,” “estimate,” “project” and similar expressions. Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse effect on the operations and future prospects include, but are not limited to, changes in: interest rates, general economic conditions, monetary and fiscal policy, the quality or composition of the loan or investment portfolios, demand for loan products, fluctuation in the value of collateral securing our loan portfolio, deposit flows, competition, demand for financial services in our market area, and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating forward looking statements and undue reliance should not be placed on such statements. Further information concerning our business, including additional factors that could materially affect our financial results, is included in our filings with the SEC.

## Glossary of Acronyms and Abbreviations

The acronyms and abbreviations identified below may be used throughout this Quarterly Report on Form 10-Q, or in our other SEC filings. You may find it helpful to refer back to this page while reading this report.

AFS: Available-for-sale	GAAP: U.S. generally accepted accounting principles
ALLL: Allowance for loan and lease losses	GLB Act: Gramm-Leach-Bliley Act of 1999
AOCI: Accumulated other comprehensive income	IFRS: International Financial Reporting Standards
ASC: FASB Accounting Standards Codification	IRR: Interest rate risk
ASU: FASB Accounting Standards Update	ISDA: International Swaps and Derivatives Association
ATM: Automated Teller Machine	JOBS Act: Jumpstart our Business Startups Act
BHC Act: Bank Holding Company Act of 1956	LIBOR: London Interbank Offered Rate
CFPB: Consumer Financial Protection Bureau	N/A: Not applicable
CIK: Central Index Key	N/M: Not meaningful
CRA: Community Reinvestment Act	NASDAQ: NASDAQ Stock Market Index
DIF: Deposit Insurance Fund	NASDAQ Banks: NASDAQ Bank Stock Index
DIFS: Department of Insurance and Financial Services	NAV: Net asset value
Directors Plan: Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors	NOW: Negotiable order of withdrawal
Dividend Reinvestment Plan: Isabella Bank Corporation Stockholder Dividend Reinvestment Plan and Employee Stock Purchase Plan	NSF: Non-sufficient funds
Dodd-Frank Act: Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010	OCI: Other comprehensive income (loss)
ESOP: Employee Stock Ownership Plan	OMSR: Originated mortgage servicing rights
Exchange Act: Securities Exchange Act of 1934	OREO: Other real estate owned
FASB: Financial Accounting Standards Board	OTTI: Other-than-temporary impairment
FDI Act: Federal Deposit Insurance Act	PBO: Projected benefit obligation

FDIC: Federal Deposit Insurance Corporation

FFIEC: Federal Financial Institutions Examinations Council

FRB: Federal Reserve Bank

FHLB: Federal Home Loan Bank

Freddie Mac: Federal Home Loan Mortgage Corporation

FTE: Fully taxable equivalent

PCAOB: Public Company Accounting Oversight Board

Rabbi Trust: A trust established to fund the Directors Plan

SEC: U.S. Securities & Exchange Commission

SOX: Sarbanes-Oxley Act of 2002

TDR: Troubled debt restructuring

XBRL: eXtensible Business Reporting Language

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## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements.

## INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(Dollars in thousands)

	June 30 2016	December 31 2015
<b>ASSETS</b>		
Cash and cash equivalents		
Cash and demand deposits due from banks	\$ 19,673	\$ 18,810
Interest bearing balances due from banks	7,361	2,759
Total cash and cash equivalents	27,034	21,569
AFS securities (amortized cost of \$585,579 in 2016 and \$654,348 in 2015)	602,463	660,136
Mortgage loans AFS	1,281	1,187
Loans		
Commercial	500,374	448,381
Agricultural	126,517	115,911
Residential real estate	255,116	251,501
Consumer	37,587	34,699
Gross loans	919,594	850,492
Less allowance for loan and lease losses	7,600	7,400
Net loans	911,994	843,092
Premises and equipment	28,244	28,331
Corporate owned life insurance policies	25,802	26,423
Accrued interest receivable	5,791	6,269
Equity securities without readily determinable fair values	22,427	22,286
Goodwill and other intangible assets	48,741	48,828
Other assets	6,582	9,991
<b>TOTAL ASSETS</b>	<b>\$ 1,680,359</b>	<b>\$ 1,668,112</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Deposits</b>		
Noninterest bearing	\$ 192,194	\$ 191,376
NOW accounts	197,590	212,666
Certificates of deposit under \$100 and other savings	509,364	521,793
Certificates of deposit over \$100	257,722	238,728
Total deposits	1,156,870	1,164,563
Borrowed funds	318,596	309,732
Accrued interest payable and other liabilities	9,760	9,846
Total liabilities	1,485,226	1,484,141
<b>Shareholders' equity</b>		
Common stock — no par value 15,000,000 shares authorized; issued and outstanding 7,836,442 shares (including 18,151 shares held in the Rabbi Trust) in 2016 and 7,799,867 shares (including 19,401 shares held in the Rabbi Trust) in 2015	140,188	139,198
Shares to be issued for deferred compensation obligations	4,738	4,592
Retained earnings	42,640	39,960
Accumulated other comprehensive income	7,567	221
Total shareholders' equity	195,133	183,971
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 1,680,359</b>	<b>\$ 1,668,112</b>

See notes to interim condensed consolidated financial statements (unaudited).

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## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(Dollars in thousands except per share amounts)

	Three Months Ended June 30		Six Months Ended June 30	
	2016	2015	2016	2015
Interest income				
Loans, including fees	\$9,317	\$8,875	\$18,355	\$17,900
AFS securities				
Taxable	2,303	2,238	4,703	4,345
Nontaxable	1,441	1,507	2,926	2,989
Federal funds sold and other	157	139	315	278
Total interest income	13,218	12,759	26,299	25,512
Interest expense				
Deposits	1,418	1,459	2,817	2,925
Borrowings	1,260	1,059	2,475	2,081
Total interest expense	2,678	2,518	5,292	5,006
Net interest income	10,540	10,241	21,007	20,506
Provision for loan losses	12	(535)	168	(1,261)
Net interest income after provision for loan losses	10,528	10,776	20,839	21,767
Noninterest income				
Service charges and fees	1,163	1,393	2,376	2,556
Net gain on sale of mortgage loans	127	166	209	315
Earnings on corporate owned life insurance policies	195	195	383	382
Net gains on sale of AFS securities	245	—	245	—
Other	1,022	875	1,762	1,504
Total noninterest income	2,752	2,629	4,975	4,757
Noninterest expenses				
Compensation and benefits	4,684	4,340	9,472	9,106
Furniture and equipment	1,553	1,426	3,021	2,740
Occupancy	732	672	1,490	1,393
Other	2,249	1,892	4,315	3,766
Total noninterest expenses	9,218	8,330	18,298	17,005
Income before federal income tax expense	4,062	5,075	7,516	9,519
Federal income tax expense	655	977	1,092	1,748
NET INCOME	\$3,407	\$4,098	\$6,424	\$7,771
Earnings per common share				
Basic	\$0.44	\$0.53	\$0.82	\$1.00
Diluted	\$0.43	\$0.52	\$0.80	\$0.98
Cash dividends per common share	\$0.24	\$0.23	\$0.48	\$0.46

See notes to interim condensed consolidated financial statements (unaudited).

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## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

(Dollars in thousands)

	Three Months		Six Months	
	Ended		Ended	
	June 30		June 30	
	2016	2015	2016	2015
Net income	\$3,407	\$4,098	\$6,424	\$7,771
Unrealized gains (losses) on AFS securities arising during the period	4,067	(6,520 )	11,341	(2,164 )
Unrealized gains (losses) on derivative instruments arising during the period	(152 )	—	(152 )	—
Reclassification adjustment for net realized (gains) losses included in net income	(245 )	—	(245 )	—
Comprehensive income (loss) before income tax (expense) benefit	3,670	(6,520 )	10,944	(2,164 )
Tax effect (1)	(1,121 )	2,165	(3,598 )	799
Other comprehensive income, net of tax	2,549	(4,355 )	7,346	(1,365 )
Comprehensive income	\$5,956	\$(257 )	\$13,770	\$6,406

(1) See "Note 12 – Accumulated Other Comprehensive Income" for tax effect reconciliation.

See notes to interim condensed consolidated financial statements (unaudited).



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(UNAUDITED)

(Dollars in thousands except per share amounts)

	Common Stock		Common Shares to be Issued for Deferred Compensation Obligations	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Totals
	Common Shares Outstanding	Amount				
Balance, January 1, 2015	7,776,274	\$138,755	\$ 4,242	\$32,103	\$ (506 )	\$174,594
Comprehensive income (loss)	—	—	—	7,771	(1,365 )	6,406
Issuance of common stock	94,807	2,192	—	—	—	2,192
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	123	(123 )	—	—	—
Share-based payment awards under equity compensation plan	—	—	259	—	—	259
Common stock purchased for deferred compensation obligations	—	(165 )	—	—	—	(165 )
Common stock repurchased pursuant to publicly announced repurchase plan	(73,893 )	(1,704 )	—	—	—	(1,704 )
Cash dividends paid (\$0.46 per common share)	—	—	—	(3,557 )	—	(3,557 )
Balance, June 30, 2015	7,797,188	\$139,201	\$ 4,378	\$36,317	\$ (1,871 )	\$178,025
Balance, January 1, 2016	7,799,867	\$139,198	\$ 4,592	\$39,960	\$ 221	\$183,971
Comprehensive income (loss)	—	—	—	6,424	7,346	13,770
Issuance of common stock	88,486	2,489	—	—	—	2,489
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	127	(127 )	—	—	—
Share-based payment awards under equity compensation plan	—	—	273	—	—	273
Common stock purchased for deferred compensation obligations	—	(164 )	—	—	—	(164 )
Common stock repurchased pursuant to publicly announced repurchase plan	(51,911 )	(1,462 )	—	—	—	(1,462 )
Cash dividends paid (\$0.48 per common share)	—	—	—	(3,744 )	—	(3,744 )
Balance, June 30, 2016	7,836,442	\$140,188	\$ 4,738	\$42,640	\$ 7,567	\$195,133

See notes to interim condensed consolidated financial statements (unaudited).

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## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Dollars in thousands)

	Six Months Ended June 30	
	2016	2015
<b>OPERATING ACTIVITIES</b>		
Net income	\$6,424	\$7,771
Reconciliation of net income to net cash provided by operating activities:		
Provision for loan losses	168	(1,261 )
Impairment of foreclosed assets	—	22
Depreciation	1,438	1,272
Amortization of OMSR	165	186
Amortization of acquisition intangibles	87	76
Net amortization of AFS securities	1,427	986
Net (gains) losses on sale of AFS securities	(245 )	—
Net gain on sale of mortgage loans	(209 )	(315 )
Increase in cash value of corporate owned life insurance policies	(383 )	(382 )
Share-based payment awards under equity compensation plan	273	259
Origination of loans held-for-sale	(10,810)	(25,231)
Proceeds from loan sales	10,925	25,418
Net changes in operating assets and liabilities which provided (used) cash:		
Accrued interest receivable	478	382
Other assets	(667 )	(1,765 )
Accrued interest payable and other liabilities	(238 )	126
Net cash provided by (used in) operating activities	8,833	7,544
<b>INVESTING ACTIVITIES</b>		
Activity in AFS securities		
Sales	35,664	—
Maturities, calls, and principal payments	58,145	42,200
Purchases	(26,222)	(73,134)
Net loan principal (originations) collections	(69,186)	4,071
Proceeds from sales of foreclosed assets	288	799
Purchases of premises and equipment	(1,351 )	(1,546 )
Purchases of corporate owned life insurance policies	—	(500 )
Proceeds from redemption of corporate owned life insurance policies	1,004	—
Net cash provided by (used in) investing activities	(1,658 )	(28,110)

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## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)

(Dollars in thousands)

	Six Months Ended	
	June 30	
	2016	2015
<b>FINANCING ACTIVITIES</b>		
Net increase (decrease) in deposits	\$(7,693 )	\$15,985
Net increase (decrease) in borrowed funds	8,864	17,890
Cash dividends paid on common stock	(3,744 )	(3,557 )
Proceeds from issuance of common stock	2,489	2,192
Common stock repurchased	(1,462 )	(1,704 )
Common stock purchased for deferred compensation obligations	(164 )	(165 )
Net cash provided by (used in) financing activities	(1,710 )	30,641
Increase (decrease) in cash and cash equivalents	5,465	10,075
Cash and cash equivalents at beginning of period	21,569	19,906
Cash and cash equivalents at end of period	\$27,034	\$29,981
<b>SUPPLEMENTAL CASH FLOWS INFORMATION:</b>		
Interest paid	\$5,286	\$5,042
Income taxes paid	600	2,143
<b>SUPPLEMENTAL NONCASH INFORMATION:</b>		
Transfers of loans to foreclosed assets	\$116	\$809

See notes to interim condensed consolidated financial statements (unaudited).

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## NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands except per share amounts)

## Note 1 – Basis of Presentation

As used in these notes as well as in Management's Discussion and Analysis of Financial Condition and Results of Operations, references to "Isabella," the "Corporation," "we," "our," "us," and similar terms refer to the consolidated entity consisting of Isabella Bank Corporation and its subsidiaries. Isabella Bank Corporation refers solely to the parent holding company, and Isabella Bank or the "Bank" refer to Isabella Bank Corporation's subsidiary, Isabella Bank. The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with GAAP for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In our opinion, all adjustments considered necessary for a fair presentation have been included. Operating results for the three and six month periods ended June 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. For further information, refer to our Annual Report on Form 10-K for the year ended December 31, 2015.

Our accounting policies are materially the same as those discussed in Note 1 to the Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2015.

Reclassifications: Certain amounts reported in the 2015 consolidated financial statements have been reclassified to conform with the 2016 presentation.

Restatements: In this Quarterly Report on Form 10-Q, certain prior period financial information has been restated due to an accounting correction. Impacted sections of the Consolidated Financial Statements include:

1. Consolidated Statements of Income for the three and six month periods ended June 30, 2015 and Consolidated Statements of Cash Flows for the six month period ended June 30, 2015; and
2. Notes to Consolidated Financial Statements for the three and six month periods ended June 30, 2015.

On the Consolidated Statements of Income, the effects of the restatement reduced loan interest and fee income by \$1,034 and \$1,693, respectively, and compensation and benefits were reduced by \$1,034 and \$1,693, respectively, for the three and six month periods ended June 30, 2015. The restatement did not impact net income for the three and six month periods ended June 30, 2015.

All amounts in this Quarterly Report on Form 10-Q affected by the restatement adjustments are reflected as the restated amounts. For information related to the restatement, refer to our Annual Report on Form 10-K for the year ended December 31, 2015.

## Note 2 – Computation of Earnings Per Common Share

Basic earnings per common share represents income available to common shareholders divided by the weighted average number of common shares outstanding during the period. Diluted earnings per common share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued relate solely to outstanding shares in the Directors Plan.

	Three Months Ended June 30		Six Months Ended June 30	
	2016	2015	2016	2015
Average number of common shares outstanding for basic calculation	7,819,080	7,779,365	7,807,187	7,776,413
Average potential effect of common shares in the Directors Plan (1)	183,842	176,690	184,152	176,845
Average number of common shares outstanding used to calculate diluted earnings per common share	8,002,922	7,956,055	7,991,339	7,953,258
Net income	\$3,407	\$ 4,098	\$6,424	\$ 7,771
Earnings per common share				
Basic	\$0.44	\$ 0.53	\$0.82	\$ 1.00
Diluted	\$0.43	\$ 0.52	\$0.80	\$ 0.98

(1) Exclusive of shares held in the Rabbi Trust



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Note 3 – Accounting Standards Updates

Pending Accounting Standards Updates

ASU No. 2016-01: “Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Liabilities”

In January 2016, ASU No. 2016-01 set forth the following: 1) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income; 2) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment and when an impairment exists, an entity is required to measure the investment at fair value; 3) for public entities, eliminates the requirement to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; 4) for public entities, requires the use of exit price notion when measuring the fair value of financial instruments for disclosure purposes; 5) requires an entity to present separately in other comprehensive income, the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; 6) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; and 7) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2017 and is not expected to have a significant impact on our operations or financial statement disclosures due to existing equity investments.

ASU No. 2016-02: “Leases (Topic 842)”

In February 2016, ASU No. 2016-02 was issued to create Topic 842 - Leases which will require recognition of lease assets and lease liabilities on the balance sheet for leases previously classified as operating leases. Accounting guidance is set forth for both lessee and lessor accounting. Under lessee accounting, a lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term.

For finance leases, a lessee is required to do the following: 1) recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position; 2) recognize interest on the lease liability separately from amortization of the right-of-use asset in the statement of comprehensive income; and 3) classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities in the statement of cash flows. For operating leases, a lessee is required to do the following: 1) recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position; 2) recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a generally straight-line basis; and 3) classify all cash payments within operating activities in the statement of cash flows.

The accounting applied by a lessor is largely unchanged from that applied under previous GAAP. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2018 and is not expected to have a significant impact on our operations or financial statement disclosures.

ASU No. 2016-07: “Investments - Equity Method and Joint Ventures (Topic 323): Simplifying the Transition of the Equity Method of Accounting”

In March 2016, ASU No. 2016-07 eliminates the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. Additionally, the update requires that the equity method investor add the cost of acquiring the additional interest in the investee to the current basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. Therefore, upon qualifying for the equity method of accounting, no retroactive adjustment of the investment is required. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2016 and is not expected to have a significant impact on our operations

or financial statement disclosures.

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ASU No. 2016-09: “Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting”

In March 2016, ASU No. 2016-09 updated several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2016 and is not expected to have a significant impact on our operations or financial statement disclosures.

ASU No. 2016-13: “Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments”

In June 2016, ASU No. 2016-13 updated the measurement for credit losses for AFS debt securities and assets measured at amortized cost which include loans, trade receivables, and any other financial assets with the contractual right to receive cash. Current GAAP require an “incurred loss” methodology for recognizing credit losses that delays recognition until it is probable a loss has been incurred. Under the incurred loss approach entities are limited to a probable initial recognition threshold when credit losses are measured under GAAP, an entity generally only considers past events and current conditions in measuring the incurred loss.

In the new guidance, the incurred loss impairment methodology in current GAAP is replaced with a methodology that reflects expected credit losses. This methodology requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The measurement of expected credit losses is based on relevant information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. An entity must use judgment in determining the relevant information and estimation methods that are appropriate in its circumstances which applies to assets measured either collectively or individually.

The update allows an entity to revert to historical loss information that is reflective of the contractual term (considering the effect of prepayments) for periods that are beyond the time frame for which the entity is able to develop reasonable and supportable forecasts. In addition, the disclosures of credit quality indicators in relation to the amortized cost of financing receivables, a current disclosure requirement, are further disaggregated by year of origination (or vintage). The vintage information will be useful for financial statement users to better assess changes in underwriting standards and credit quality trends in asset portfolios over time and the effect of those changes on credit losses.

Overall, the update will allow entities the ability to measure expected credit losses without the restriction of incurred or probable losses that exist under current GAAP. For users of the financial statements, the update provides decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2019 and is expected to have a significant impact our operations and financial statement disclosures as well as that of the banking industry as a whole.

#### Note 4 – AFS Securities

The amortized cost and fair value of AFS securities, with gross unrealized gains and losses, are as follows at:

	June 30, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	\$10,362	\$ 9	\$ —	\$10,371
States and political subdivisions	215,874	10,187	14	226,047
Auction rate money market preferred	3,200	—	81	3,119
Preferred stocks	3,800	—	394	3,406
Mortgage-backed securities	235,480	4,715	—	240,195
Collateralized mortgage obligations	116,863	2,512	50	119,325
Total	\$585,579	\$ 17,423	\$ 539	\$602,463



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	December 31, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	\$24,407	\$ 13	\$ 75	\$24,345
States and political subdivisions	224,752	7,511	46	232,217
Auction rate money market preferred	3,200	—	334	2,866
Preferred stocks	3,800	—	501	3,299
Mortgage-backed securities	264,109	1,156	1,881	263,384
Collateralized mortgage obligations	134,080	1,136	1,191	134,025
Total	\$654,348	\$ 9,816	\$ 4,028	\$660,136

The amortized cost and fair value of AFS securities by contractual maturity at June 30, 2016 are as follows:

	Maturing					
	Due in One Year or Less	After One Year But Within Five Years	After Five Years But Within Ten Years	After Ten Years	Securities with Variable Monthly Payments or Noncontractual Maturities	Total
Government sponsored enterprises	\$—	\$ 10,032	\$330	\$—	\$ —	\$10,362
States and political subdivisions	30,337	71,821	83,398	30,318	—	215,874
Auction rate money market preferred	—	—	—	—	3,200	3,200
Preferred stocks	—	—	—	—	3,800	3,800
Mortgage-backed securities	—	—	—	—	235,480	235,480
Collateralized mortgage obligations	—	—	—	—	116,863	116,863
Total amortized cost	\$30,337	\$ 81,853	\$83,728	\$ 30,318	\$ 359,343	\$585,579
Fair value	\$30,414	\$ 84,966	\$88,857	\$ 32,181	\$ 366,045	\$602,463

Expected maturities for government sponsored enterprises and states and political subdivisions may differ from contractual maturities because issuers may have the right to call or prepay obligations.

As the auction rate money market preferred and preferred stocks have continual call dates, they are not reported by a specific maturity group. Because of their variable monthly payments, mortgage-backed securities and collateralized mortgage obligations are not reported by a specific maturity group.

A summary of the sales activity of AFS securities was as follows for the:

	Three Months Ended June 30 2016	Six Months Ended June 30 2016
Proceeds from sales of AFS securities	\$35,664	\$35,664
Gross realized gains (losses)	\$245	\$245
Applicable income tax expense (benefit)	\$83	\$83

We had no sales of AFS securities in the three and six month periods ended June 30, 2015.

The cost basis used to determine the realized gains or losses of AFS securities sold was the amortized cost of the individual investment security as of the trade date.

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The following information pertains to AFS securities with gross unrealized losses at June 30, 2016 and December 31, 2015, aggregated by investment category and length of time that individual securities have been in a continuous loss position. There were no AFS securities with gross unrealized losses for less than twelve month as of June 30, 2016.

	June 30, 2016			December 31, 2015				
	Twelve Months or More			Less Than Twelve Months		Twelve Months or More		
	Gross Unrealized Losses	Fair Value	Total Unrealized Losses	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Total Unrealized Losses
Government sponsored enterprises	\$ —	\$ —	\$ —	\$ 75	\$ 4,925	\$ 75		\$ 75
States and political subdivisions	14	439	14	32	2,623	46		46
Auction rate money market preferred	81	3,119	81	334	2,866	334		334
Preferred stocks	394	3,406	394	501	3,299	501		501
Mortgage-backed securities	—	—	—	999	37,179	1,881		1,881
Collateralized mortgage obligations	50	12,750	50	776	26,717	1,191		1,191
Total	\$ 539	\$ 19,714	\$ 539	\$ 2,717	\$ 77,609	\$ 4,028		\$ 4,028
Number of securities in an unrealized loss position:		9	9		36	26		62

As of June 30, 2016 and December 31, 2015, we conducted an analysis to determine whether any AFS securities currently in an unrealized loss position should be other-than-temporarily impaired. Such analyses considered, among other factors, the following criteria:

- Has the value of the investment declined more than what is deemed to be reasonable based on a risk and maturity adjusted discount rate?
- Is the investment credit rating below investment grade?
- Is it probable the issuer will be unable to pay the amount when due?
- Is it more likely than not that we will have to sell the security before recovery of its cost basis?
- Has the duration of the investment been extended?

Based on our analyses, the fact that we have asserted that we do not have the intent to sell AFS securities in an unrealized loss position, and considering it is unlikely that we will have to sell any AFS securities in an unrealized loss position before recovery of their cost basis, we do not believe that the values of any AFS securities were other-than-temporarily impaired as of June 30, 2016 or December 31, 2015.

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## Note 5 – Loans and ALLL

We grant commercial, agricultural, residential real estate, and consumer loans to customers situated primarily in Clare, Gratiot, Isabella, Mecosta, Midland, Montcalm, and Saginaw counties in Michigan. The ability of the borrowers to honor their repayment obligations is often dependent upon the real estate, agricultural, manufacturing, retail, gaming, tourism, higher education, and general economic conditions of this region. Substantially all of our consumer and residential real estate loans are secured by various items of property, while commercial loans are secured primarily by real estate, business assets, and personal guarantees; a portion of loans are unsecured.

Loans that we have the intent and ability to hold in our portfolio are reported at their outstanding principal balance adjusted for any charge-offs, the ALLL, and any deferred fees or costs. Interest income is accrued over the term of the loan based on the principal amount outstanding. Loan origination fees and certain direct loan origination costs are capitalized and recognized as a component of interest income over the term of the loan using the level yield method. The accrual of interest on commercial, agricultural, and residential real estate loans is discontinued at the time the loan is 90 days or more past due unless the credit is well-secured and in the process of collection. Upon transferring the loans to nonaccrual status, we perform an evaluation to determine the net realizable value of the underlying collateral. This evaluation is used to help determine if any charge-offs are necessary. Consumer loans are typically charged-off no later than 180 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual status or charged-off at an earlier date if collection of principal or interest is considered doubtful. For loans that are placed on nonaccrual status or charged-off, all interest accrued in the current calendar year, but not collected, is reversed against interest income while interest accrued in prior calendar years, but not collected, is charged against the ALLL. Loans may be returned to accrual status after six months of continuous performance. Commercial and agricultural loans include loans for commercial real estate, commercial operating loans, farmland and agricultural production, and states and political subdivisions. Repayment of these loans is dependent upon the successful operation and management of a business. We minimize our risk by limiting the amount of direct credit exposure to any one borrower to \$15,000. Borrowers with direct credit needs of more than \$15,000 are serviced through the use of loan participations with other commercial banks. Commercial and agricultural real estate loans commonly require loan-to-value limits of 80% or less. Depending upon the type of loan, past credit history, and current operating results, we may require the borrower to pledge accounts receivable, inventory, and property and equipment. Personal guarantees are generally required from the owners of closely held corporations, partnerships, and sole proprietorships. In addition, we require annual financial statements, prepare cash flow analyses, and review credit reports.

We offer adjustable rate mortgages, construction loans, and fixed rate residential real estate loans which have amortization periods up to a maximum of 30 years. We consider the anticipated direction of interest rates, balance sheet duration, the sensitivity of our balance sheet to changes in interest rates, and overall loan demand to determine whether or not to sell fixed rate loans to Freddie Mac.

Our lending policies generally limit the maximum loan-to-value ratio on residential real estate loans to 97% of the lower of the appraised value of the property or the purchase price, with the condition that private mortgage insurance is required on loans with loan-to-value ratios in excess of 80%.

Underwriting criteria for residential real estate loans include:

- Evaluation of the borrower's ability to make monthly payments.

- Evaluation of the value of the property securing the loan.

- Ensuring the payment of principal, interest, taxes, and hazard insurance does not exceed 28% of a borrower's gross income.

- Ensuring all debt servicing does not exceed 36% of income.

- Verification of acceptable credit reports.

- Verification of employment, income, and financial information.

Appraisals are performed by independent appraisers and reviewed for appropriateness. All mortgage loan requests are reviewed by our mortgage loan committee or through a secondary market underwriting system; loans in excess of \$500 require the approval of our Internal Loan Committee, the Executive Loan Committee, the Board of Directors' Loan Committee, or the Board of Directors.



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Consumer loans include secured and unsecured personal loans. Loans are amortized for a period of up to 12 years based on the age and value of the underlying collateral. The underwriting emphasis is on a borrower's perceived intent and ability to pay rather than collateral value. No consumer loans are sold to the secondary market.

The ALLL is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the ALLL when we believe the uncollectability of the loan balance is confirmed. Subsequent recoveries, if any, are credited to the ALLL.

The appropriateness of the ALLL is evaluated on a quarterly basis and is based upon a periodic review of the collectability 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 primary factors behind the determination of the level of the ALLL are specific allocations for impaired loans, historical loss percentages, as well as unallocated components. Specific allocations for impaired loans are primarily determined based on the difference between the loan's outstanding balance to 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, less cost to sell. Historical loss allocations are calculated at the loan class and segment levels based on a migration analysis of the loan portfolio over the preceding five years. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A summary of changes in the ALLL and the recorded investment in loans by segments follows:

	Allowance for Loan Losses					
	Three Months Ended June 30, 2016					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
April 1, 2016	\$2,421	\$ 336	\$ 3,130	\$ 540	\$ 1,073	\$7,500
Charge-offs	(32 )	—	(128 )	(48 )	—	(208 )
Recoveries	189	—	45	62	—	296
Provision for loan losses	(459 )	198	83	(13 )	203	12
June 30, 2016	\$2,119	\$ 534	\$ 3,130	\$ 541	\$ 1,276	\$7,600
	Allowance for Loan Losses					
	Six Months Ended June 30, 2016					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2016	\$2,171	\$ 329	\$ 3,330	\$ 522	\$ 1,048	\$7,400
Charge-offs	(48 )	—	(369 )	(132 )	—	(549 )
Recoveries	278	92	95	116	—	581
Provision for loan losses	(282 )	113	74	35	228	168
June 30, 2016	\$2,119	\$ 534	\$ 3,130	\$ 541	\$ 1,276	\$7,600

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Allowance for Loan Losses and Recorded Investment in Loans  
June 30, 2016

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	\$811	\$ 15	\$ 1,776	\$ —	\$ —	\$2,602
Collectively evaluated for impairment	1,308	519	1,354	541	1,276	4,998
Total	\$2,119	\$ 534	\$ 3,130	\$ 541	\$ 1,276	\$7,600
Loans						
Individually evaluated for impairment	\$6,714	\$ 4,229	\$ 9,431	\$ 32		\$20,406
Collectively evaluated for impairment	493,660	122,288	245,685	37,555		899,188
Total	\$500,374	\$ 126,517	\$ 255,116	\$ 37,587		\$919,594

Allowance for Loan Losses  
Three Months Ended June 30, 2015

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
April 1, 2015	\$3,808	\$ 206	\$ 3,728	\$ 711	\$ 1,147	\$9,600
Charge-offs	(11 )	—	(205 )	(80 )	—	(296 )
Recoveries	106	—	86	39	—	231
Provision for loan losses	(421 )	157	(97 )	(79 )	(95 )	(535 )
June 30, 2015	\$3,482	\$ 363	\$ 3,512	\$ 591	\$ 1,052	\$9,000

Allowance for Loan Losses  
Six Months Ended June 30, 2015

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2015	\$3,821	\$ 216	\$ 4,235	\$ 645	\$ 1,183	\$10,100
Charge-offs	(28 )	—	(255 )	(173 )	—	(456 )
Recoveries	319	72	119	107	—	617
Provision for loan losses	(630 )	75	(587 )	12	(131 )	(1,261 )
June 30, 2015	\$3,482	\$ 363	\$ 3,512	\$ 591	\$ 1,052	\$9,000

Allowance for Loan Losses and Recorded Investment in Loans  
December 31, 2015

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	\$829	\$ 2	\$ 1,989	\$ —	\$ —	\$2,820
Collectively evaluated for impairment	1,342	327	1,341	522	1,048	4,580
Total	\$2,171	\$ 329	\$ 3,330	\$ 522	\$ 1,048	\$7,400
Loans						
Individually evaluated for impairment	\$7,969	\$ 4,068	\$ 10,266	\$ 35		\$22,338
Collectively evaluated for impairment	440,412	111,843	241,235	34,664		828,154
Total	\$448,381	\$ 115,911	\$ 251,501	\$ 34,699		\$850,492



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The following table displays the credit quality indicators for commercial and agricultural credit exposures based on internally assigned credit risk ratings as of:

Rating	June 30, 2016					
	Commercial			Agricultural		
	Real Estate	Other	Total	Real Estate	Other	Total
1 - Excellent	\$—	\$982	\$982	\$—	\$—	\$—
2 - High quality	11,359	10,318	21,677	3,963	1,428	5,391
3 - High satisfactory	100,031	31,861	131,892	24,288	11,052	35,340
4 - Low satisfactory	257,872	75,720	333,592	46,446	24,514	70,960
5 - Special mention	4,464	477	4,941	5,631	6,338	11,969
6 - Substandard	6,936	227	7,163	2,108	603	2,711
7 - Vulnerable	127	—	127	146	—	146
8 - Doubtful	—	—	—	—	—	—
Total	\$380,789	\$119,585	\$500,374	\$82,582	\$43,935	\$126,517
Rating	December 31, 2015					
	Commercial			Agricultural		
	Real Estate	Other	Total	Real Estate	Other	Total
1 - Excellent	\$—	\$499	\$499	\$—	\$—	\$—
2 - High quality	7,397	11,263	18,660	4,647	2,150	6,797
3 - High satisfactory	99,136	29,286	128,422	28,886	13,039	41,925
4 - Low satisfactory	222,431	62,987	285,418	37,279	22,166	59,445
5 - Special mention	4,501	473	4,974	3,961	1,875	5,836
6 - Substandard	9,941	256	10,197	1,623	139	1,762
7 - Vulnerable	211	—	211	146	—	146
8 - Doubtful	—	—	—	—	—	—
Total	\$343,617	\$104,764	\$448,381	\$76,542	\$39,369	\$115,911

Internally assigned credit risk ratings are reviewed, at a minimum, when loans are renewed or when management has knowledge of improvements or deterioration of the credit quality of individual credits. Descriptions of the internally assigned credit risk ratings for commercial and agricultural loans are as follows:

**1. EXCELLENT – Substantially Risk Free**

Credit has strong financial condition and solid earnings history, characterized by:

- High liquidity, strong cash flow, low leverage.
- Unquestioned ability to meet all obligations when due.

• Experienced management, with management succession in place.

• Secured by cash.

**2. HIGH QUALITY – Limited Risk**

Credit with sound financial condition and a positive trend in earnings supplemented by:

• Favorable liquidity and leverage ratios.

• Ability to meet all obligations when due.

• Management with successful track record.

• Steady and satisfactory earnings history.

• If loan is secured, collateral is of high quality and readily marketable.

• Access to alternative financing.

• Well defined primary and secondary source of repayment.

• If supported by guaranty, the financial strength and liquidity of the guarantor(s) are clearly evident.



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3. HIGH SATISFACTORY – Reasonable Risk

Credit with satisfactory financial condition and further characterized by:

- Working capital adequate to support operations.
- Cash flow sufficient to pay debts as scheduled.
- Management experience and depth appear favorable.
- Loan performing according to terms.
- If loan is secured, collateral is acceptable and loan is fully protected.

4. LOW SATISFACTORY – Acceptable Risk

Credit with bankable risks, although some signs of weaknesses are shown:

- Would include most start-up businesses.
  - Occasional instances of trade slowness or repayment delinquency – may have been 10-30 days slow within the past year.
  - Management's abilities are apparent, yet unproven.
  - Weakness in primary source of repayment with adequate secondary source of repayment.
    - Loan structure generally in accordance with policy.
  - If secured, loan collateral coverage is marginal.
  - Adequate cash flow to service debt, but coverage is low.
- To be classified as less than satisfactory, only one of the following criteria must be met.

5. SPECIAL MENTION – Criticized

Credit constitutes an undue and unwarranted credit risk but not to the point of justifying a classification of substandard. The credit risk may be relatively minor yet constitute an unwarranted risk in light of the circumstances surrounding a specific loan:

- Downward trend in sales, profit levels, and margins.
- Impaired working capital position.
- Cash flow is strained in order to meet debt repayment.
- Loan delinquency (30-60 days) and overdrafts may occur.
  - Shrinking equity cushion.
- Diminishing primary source of repayment and questionable secondary source.
- Management abilities are questionable.
- Weak industry conditions.
- Litigation pending against the borrower.
- Collateral or guaranty offers limited protection.
- Negative debt service coverage, however the credit is well collateralized and payments are current.

6. SUBSTANDARD – Classified

Credit where the borrower's current net worth, paying capacity, and value of the collateral pledged is inadequate. There is a distinct possibility that we will implement collection procedures if the loan deficiencies are not corrected. In addition, the following characteristics may apply:

- Sustained losses have severely eroded the equity and cash flow.
- Deteriorating liquidity.
- Serious management problems or internal fraud.
- Original repayment terms liberalized.
- Likelihood of bankruptcy.
- Inability to access other funding sources.
- Reliance on secondary source of repayment.
- Litigation filed against borrower.
- Collateral provides little or no value.
- Requires excessive attention of the loan officer.

Borrower is uncooperative with loan officer.

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## 7. VULNERABLE – Classified

Credit is considered “Substandard” and warrants placing on nonaccrual status. Risk of loss is being evaluated and exit strategy options are under review. Other characteristics that may apply:

- Insufficient cash flow to service debt.
- Minimal or no payments being received.
- Limited options available to avoid the collection process.
- Transition status, expect action will take place to collect loan without immediate progress being made.

## 8. DOUBTFUL – Workout

Credit has all the weaknesses inherent in a “Substandard” loan with the added characteristic that collection and/or liquidation is pending. The possibility of a loss is extremely high, but its classification as a loss is deferred until liquidation procedures are completed, or reasonably estimable. Other characteristics that may apply:

- Normal operations are severely diminished or have ceased.
- Seriously impaired cash flow.
- Original repayment terms materially altered.
- Secondary source of repayment is inadequate.
- Survivability as a “going concern” is impossible.
- Collection process has begun.
- Bankruptcy petition has been filed.
- Judgments have been filed.
- Portion of the loan balance has been charged-off.

Our primary credit quality indicator for residential real estate and consumer loans is the individual loan’s past due aging. The following tables summarize the past due and current loans as of:

	June 30, 2016				Total Past Due and Nonaccrual	Current	Total
	Accruing Interest and Past Due:						
	30-59 Days	60-89 Days	90 Days or More	Nonaccrual			
Commercial							
Commercial real estate	\$602	\$291	\$ —	\$ 127	\$ 1,020	\$379,769	\$380,789
Commercial other	75	15	194	—	284	119,301	119,585
Total commercial	677	306	194	127	1,304	499,070	500,374
Agricultural							
Agricultural real estate	441	—	—	146	587	81,995	82,582
Agricultural other	342	—	14	—	356	43,579	43,935
Total agricultural	783	—	14	146	943	125,574	126,517
Residential real estate							
Senior liens	1,200	527	—	701	2,428	205,928	208,356
Junior liens	40	—	—	—	40	8,607	8,647
Home equity lines of credit	287	—	—	—	287	37,826	38,113
Total residential real estate	1,527	527	—	701	2,755	252,361	255,116
Consumer							
Secured	22	—	—	—	22	33,958	33,980
Unsecured	1	—	—	—	1	3,606	3,607
Total consumer	23	—	—	—	23	37,564	37,587
Total	\$3,010	\$833	\$ 208	\$ 974	\$ 5,025	\$914,569	\$919,594

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	December 31, 2015				Total Past Due and Nonaccrual	Current	Total
	Accruing Interest and Past Due:						
	30-59 Days	60-89 Days	90 Days or More	Nonaccrual			
Commercial							
Commercial real estate	\$505	\$281	\$ —	—\$ 211	\$ 997	\$342,620	\$343,617
Commercial other	18	—	—	—	18	104,746	104,764
Total commercial	523	281	—	211	1,015	447,366	448,381
Agricultural							
Agricultural real estate	196	890	—	146	1,232	75,310	76,542
Agricultural other	—	—	—	—	—	39,369	39,369
Total agricultural	196	890	—	146	1,232	114,679	115,911
Residential real estate							
Senior liens	1,551	261	—	429	2,241	199,622	201,863
Junior liens	40	8	—	6	54	9,325	9,379
Home equity lines of credit	225	—	—	—	225	40,034	40,259
Total residential real estate	1,816	269	—	435	2,520	248,981	251,501
Consumer							
Secured	27	—	—	—	27	30,839	30,866
Unsecured	4	—	—	—	4	3,829	3,833
Total consumer	31	—	—	—	31	34,668	34,699
Total	\$2,566	\$1,440	\$ —	—\$ 792	\$ 4,798	\$845,694	\$850,492

## Impaired Loans

Loans may be classified as impaired if they meet one or more of the following criteria:

1. There has been a charge-off of its principal balance (in whole or in part);
2. The loan has been classified as a TDR; or
3. The loan is in nonaccrual status.

Impairment is measured on a loan-by-loan basis for commercial and agricultural loans by comparing the loan's outstanding balance to 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, less cost to sell, if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Impairment is measured on a loan-by-loan basis for residential real estate and consumer loans by comparing the loan's unpaid principal balance to the present value of expected future cash flows discounted at the loan's effective interest rate.

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We do not recognize interest income on impaired loans in nonaccrual status. For impaired loans not classified as nonaccrual, interest income is recognized daily, as earned, according to the terms of the loan agreement and the principal amount outstanding. The following is a summary of information pertaining to impaired loans as of:

	June 30, 2016			December 31, 2015		
	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance
Impaired loans with a valuation allowance						
Commercial real estate	\$5,729	\$5,848	\$ 801	\$5,659	\$5,777	\$ 818
Commercial other	93	93	10	8	8	11
Agricultural real estate	181	181	15	—	—	—
Agricultural other	—	—	—	335	335	2
Residential real estate senior liens	9,183	9,959	1,750	9,996	10,765	1,959
Residential real estate junior liens	133	143	26	143	163	30
Home equity lines of credit	—	—	—	—	—	—
Consumer secured	—	—	—	—	—	—
Total impaired loans with a valuation allowance	15,319	16,224	2,602	16,141	17,048	2,820
Impaired loans without a valuation allowance						
Commercial real estate	820	973		2,122	2,256	
Commercial other	72	83		180	191	
Agricultural real estate	3,362	3,362		3,549	3,549	
Agricultural other	686	686		184	184	
Home equity lines of credit	115	415		127	434	
Consumer secured	32	32		35	35	
Total impaired loans without a valuation allowance	5,087	5,551		6,197	6,649	
Impaired loans						
Commercial	6,714	6,997	811	7,969	8,232	829
Agricultural	4,229	4,229	15	4,068	4,068	2
Residential real estate	9,431	10,517	1,776	10,266	11,362	1,989
Consumer	32	32	—	35	35	—
Total impaired loans	\$20,406	\$21,775	\$ 2,602	\$22,338	\$23,697	\$ 2,820

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The following is a summary of information pertaining to impaired loans for the:

	Three Months Ended June 30			
	2016		2015	
	Average Interest Outstanding	Interest Recognized	Average Interest Outstanding	Interest Recognized
	Balance		Balance	
Impaired loans with a valuation allowance				
Commercial real estate	\$5,793	\$ 85	\$7,052	\$ 92
Commercial other	95	2	569	9
Agricultural real estate	91	2	44	—
Agricultural other	—	—	—	—
Residential real estate senior liens	9,508	93	10,805	99
Residential real estate junior liens	134	1	196	12
Home equity lines of credit	—	—	—	—
Consumer secured	—	—	46	1
Total impaired loans with a valuation allowance	15,621	183	18,712	213
Impaired loans without a valuation allowance				
Commercial real estate	814	28	2,230	74
Commercial other	77	2	68	2
Agricultural real estate	3,454	43	1,545	20
Agricultural other	603	10	351	7
Home equity lines of credit	118	4	190	4
Consumer secured	33	1	—	—
Total impaired loans without a valuation allowance	5,099	88	4,384	107
Impaired loans				
Commercial	6,779	117	9,919	177
Agricultural	4,148	55	1,940	27
Residential real estate	9,760	98	11,191	115
Consumer	33	1	46	1
Total impaired loans	\$20,720	\$ 271	\$23,096	\$ 320



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	Six Months Ended June 30			
	2016		2015	
	Average Interest Outstanding	Balance Recognized	Average Interest Outstanding	Balance Recognized
Impaired loans with a valuation allowance				
Commercial real estate	\$5,773	\$ 169	\$7,163	\$ 183
Commercial other	74	3	581	19
Agricultural real estate	46	2	44	1
Agricultural other	84	—	—	—
Residential real estate senior liens	9,711	193	11,208	217
Residential real estate junior liens	137	2	227	14
Home equity lines of credit	—	—	63	—
Consumer secured	—	—	49	2
Total impaired loans with a valuation allowance	15,825	369	19,335	436
Impaired loans without a valuation allowance				
Commercial real estate	1,139	47	2,818	135
Commercial other	104	4	99	5
Agricultural real estate	3,501	88	1,513	41
Agricultural other	477	16	204	8
Home equity lines of credit	121	8	155	10
Consumer secured	34	2	3	—
Total impaired loans without a valuation allowance	5,376	165	4,792	199
Impaired loans				
Commercial	7,090	223	10,661	342
Agricultural	4,108	106	1,761	50
Residential real estate	9,969	203	11,653	241
Consumer	34	2	52	2
Total impaired loans	\$21,201	\$ 534	\$24,127	\$ 635

As of June 30, 2016 and December 31, 2015, we had no commitments to advance additional funds in connection with impaired loans, which include TDRs.

**Troubled Debt Restructurings**

Loan modifications are considered to be TDRs when the modification includes terms outside of normal lending practices to a borrower who is experiencing financial difficulties.

Typical concessions granted include, but are not limited to:

1. Agreeing to interest rates below prevailing market rates for debt with similar risk characteristics.
2. Extending the amortization period beyond typical lending guidelines for loans with similar risk characteristics.
3. Forgiving principal.
4. Forgiving accrued interest.

To determine if a borrower is experiencing financial difficulties, factors we consider include:

1. The borrower is currently in default on any of their debt.
2. The borrower would likely default on any of their debt if the concession was not granted.
3. The borrower's cash flow was insufficient to service all of their debt if the concession was not granted.
4. The borrower has declared, or is in the process of declaring, bankruptcy.
5. The borrower is unlikely to continue as a going concern (if the entity is a business).

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The following is a summary of information pertaining to TDRs granted for the:

	Three Months Ended June 30			2015		
	2016	2015	2014	2015	2014	2013
	Number of Recorded Loans	Modification of Investment	Post-Modification Recorded Investment	Number of Recorded Loans	Modification of Investment	Post-Modification Recorded Investment
Commercial other	—	\$ —	\$ —	1	\$ 71	\$ 71
Agricultural other	3	201	201	7	770	770
Residential real estate						
Senior liens	—	—	—	2	210	210
Junior liens	—	—	—	1	30	30
Home equity lines of credit	—	—	—	—	—	—
Total residential real estate	—	—	—	3	240	240
Consumer unsecured	—	—	—	—	—	—
Total	3	\$ 201	\$ 201	11	\$ 1,081	\$ 1,081

	Six Months Ended June 30			2015		
	2016	2015	2014	2015	2014	2013
	Number of Recorded Loans	Modification of Investment	Post-Modification Recorded Investment	Number of Recorded Loans	Modification of Investment	Post-Modification Recorded Investment
Commercial other	—	\$ —	\$ —	5	\$ 585	\$ 585
Agricultural other	3	201	201	7	770	770
Residential real estate						
Senior liens	2	26	26	4	448	448
Junior liens	—	—	—	1	30	30
Home equity lines of credit	—	—	—	1	94	94
Total residential real estate	2	26	26	6	572	572
Consumer unsecured	1	2	2	—	—	—
Total	6	\$ 229	\$ 229	18	\$ 1,927	\$ 1,927

The following tables summarize concessions we granted to borrowers in financial difficulty for the:

	Three Months Ended June 30			2015		
	2016	2015	2014	2015	2014	2013
	Number of Recorded Loans	Modification of Investment	Below Market Interest Rate	Number of Recorded Loans	Modification of Investment	Below Market Interest Rate
			Extension of Amortization Period			Extension of Amortization Period
			Interest Rate and Extension of Amortization Period			Interest Rate and Extension of Amortization Period
Commercial other	—	\$ —	—	1	\$ 71	—
Agricultural other	—	—	3	6	724	1
Residential real estate						
Senior liens	—	—	—	—	—	2
Junior liens	—	—	—	—	—	1
Home equity lines of credit	—	—	—	—	—	—
Total residential real estate	—	—	—	—	—	3
Consumer unsecured	—	—	—	—	—	—
Total	—	\$ —	3	7	\$ 795	4



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	Six Months Ended June 30 2016		2015	
	Below Market Interest Rate	Below Market Interest Rate and Extension of Amortization Period	Below Market Interest Rate	Below Market Interest Rate and Extension of Amortization Period
	Number of Recorded Loans	Number of Recorded Loans	Number of Recorded Loans	Number of Recorded Loans
Commercial other	—	—	3	2
Agricultural other	—	3	6	1
Residential real estate				
Senior liens	2	—	1	3
Junior liens	—	—	—	1
Home equity lines of credit	—	—	—	1
Total residential real estate	2	—	1	5
Consumer unsecured	—	1	—	—
Total	2	4	10	8

We did not restructure any loans by forgiving principal or accrued interest in the three and six month periods ended June 30, 2016 or 2015.

Based on our historical loss experience, losses associated with TDRs are not significantly different than other impaired loans within the same loan segment. As such, TDRs, including TDRs that have been modified in the past 12 months that subsequently defaulted, are analyzed in the same manner as other impaired loans within their respective loan segment.

We had no loans that defaulted in the three and six month periods ended June 30, 2016 which were modified within 12 months prior to the default date. Following is a summary of loans that defaulted in the three and six month periods ended June 30, 2015, which were modified within 12 months prior to the default date:

	Three Months Ended June 30, 2015			Six Months Ended June 30, 2015		
	Pre- Default Number of Recorded Loans	Charge-Off Recorded Upon Default Investment	Post- Default Recorded Investment	Pre- Default Number of Recorded Loans	Charge-Off Recorded Upon Default Investment	Post- Default Recorded Investment
Residential real estate junior liens	1	\$ 39	\$ 39	—	\$ 39	\$ 39

The following is a summary of TDR loan balances as of:

June 30, 2016    December 31, 2015

TDRs \$19,430    \$ 21,325

#### Note 6 – Equity Securities Without Readily Determinable Fair Values

Included in equity securities without readily determinable fair values are restricted securities, which are carried at cost, and investments in unconsolidated entities accounted for under the equity method of accounting.

Equity securities without readily determinable fair values consist of the following as of:

	June 30 2016	December 31 2015
FHLB Stock	\$11,700	\$ 11,700
Corporate Settlement Solutions, LLC	7,393	7,249
FRB Stock	1,999	1,999
Valley Financial Corporation	1,000	1,000
Other	335	338
Total	\$22,427	\$ 22,286



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## Note 7 – Foreclosed Assets

Foreclosed assets are included in other assets in the consolidated balance sheets and consist of other real estate owned and repossessed assets. The following is a summary of foreclosed assets:

	June 30 2016	December 31 2015
Consumer mortgage loans collateralized by residential real estate foreclosed as a result of obtaining physical possession	\$ 35	\$ —
All other foreclosed assets	214	421
Total	\$ 249	\$ 421

Below is a summary of changes in foreclosed assets during the:

	Three Months Ended June 30	
	2016	2015
Balance, April 1	\$276	\$717
Properties transferred	27	675
Impairments	—	(22 )
Proceeds from sale	(54 )	(497 )
Balance, June 30	\$249	\$873
	Six Months Ended June 30	
	2016	2015
Balance, January 1	\$421	\$885
Properties transferred	116	809
Impairments	—	(22 )
Proceeds from sale	(288 )	(799 )
Balance, June 30	\$249	\$873

There were \$290 consumer mortgage loans collateralized by residential real estate in the process of foreclosure as of June 30, 2016.

## Note 8 – Borrowed Funds

Borrowed funds consist of the following obligations as of:

	June 30, 2016		December 31, 2015	
	Amount	Rate	Amount	Rate
FHLB advances	\$265,000	1.87%	\$235,000	1.93%
Securities sold under agreements to repurchase without stated maturity dates	53,596	0.13%	70,532	0.12%
Federal funds purchased	—	— %	4,200	0.75%
Total	\$318,596	1.58%	\$309,732	1.50%

FHLB advances are collateralized by a blanket lien on all qualified 1-4 family residential real estate loans, specific AFS securities, and FHLB stock.

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The following table lists the maturities and weighted average interest rates of FHLB advances as of:

	June 30, 2016		December 31, 2015	
	Amount	Rate	Amount	Rate
Fixed rate due 2016	\$35,000	1.20%	\$30,000	1.25%
Variable rate due 2016	—	— %	15,000	0.62%
Fixed rate due 2017	50,000	1.56%	50,000	1.56%
Fixed rate due 2018	50,000	2.16%	50,000	2.16%
Fixed rate due 2019	60,000	1.99%	40,000	2.35%
Fixed rate due 2020	10,000	1.98%	10,000	1.98%
Fixed rate due 2021	40,000	2.01%	30,000	2.26%
Variable rate due 2021 <sup>1</sup>	10,000	0.93%	—	— %
Fixed rate due 2023	10,000	3.90%	10,000	3.90%
Total	\$265,000	1.87%	\$235,000	1.93%

(1) Hedged advance (see "Derivative Instruments" section below)

Securities sold under agreements to repurchase are classified as secured borrowings and are reflected at the amount of cash received in connection with the transaction. The securities underlying the agreements have a carrying value and a fair value of \$58,137 and \$70,555 at June 30, 2016 and December 31, 2015, respectively. Such securities remain under our control. We may be required to provide additional collateral based on the fair value of underlying securities. Securities sold under repurchase agreements without stated maturity dates, federal funds purchased, and FRB Discount Window advances generally mature within one to four days from the transaction date. The following table provides a summary of securities sold under repurchase agreements without stated maturity dates, federal funds purchased, and FRB Discount Window advances for the:

	Three Months Ended June 30					
	2016		2015			
	Maximum Month End Balance	Weighted Average Balance	Weighted Average Interest Rate During the Period	Maximum Month End Balance	Weighted Average Balance	Weighted Average Interest Rate During the Period
Securities sold under agreements to repurchase without stated maturity dates	\$57,032	\$56,010	0.13 %	\$67,599	\$63,294	0.13 %
Federal funds purchased	11,800	12,294	0.69 %	12,600	5,770	0.52 %
	Six Months Ended June 30					
	2016		2015			
	Maximum Month End Balance	Weighted Average Balance	Weighted Average Interest Rate During the Period	Maximum Month End Balance	Weighted Average Balance	Weighted Average Interest Rate During the Period
Securities sold under agreements to repurchase without stated maturity dates	\$61,783	\$58,531	0.13 %	\$84,859	\$71,129	0.13 %
Federal funds purchased	11,800	8,495	0.69 %	12,600	5,738	0.50 %

We had pledged AFS securities and 1-4 family residential real estate loans in the following amounts at:

	June 30 2016	December 31 2015
Pledged to secure borrowed funds	\$335,570	\$ 339,078
Pledged to secure repurchase agreements	58,137	70,555
Pledged for public deposits and for other purposes necessary or required by law	38,465	39,038

Total

\$432,172 \$ 448,671

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AFS securities pledged to repurchase agreements without stated maturity dates consisted of the following at:

	June 30 2016	December 31 2015
States and political subdivisions	\$2,393	\$ 3,639
Mortgage-backed securities	20,781	23,075
Collateralized mortgage obligations	34,963	43,841
Total	\$58,137	\$ 70,555

AFS securities pledged to repurchase agreements are monitored to ensure the appropriate level is collateralized. In the event of maturities, calls, significant principal repayments, or significant decline in market values, we have adequate levels of available AFS securities to pledge to satisfy required collateral.

As of June 30, 2016, we had the ability to borrow up to an additional \$106,677, based on assets pledged as collateral. We had no investment securities that are restricted to be pledged for specific purposes.

#### Derivative Instruments

During the quarter ended June 30, 2016, we began to enter into interest rate swaps to manage exposure to interest rate risk and variability in cash flows. The interest rate swaps, associated with our variable rate borrowings, are designated upon inception as cash flow hedges of forecasted interest payments. We enter into LIBOR-based interest rate swaps that involve the receipt of variable amounts in exchange for fixed rate payments, in effect converting variable rate debt to fixed rate debt.

Cash flow hedges are assessed for effectiveness using regression analysis. The effective portion of changes in fair value are recorded in OCI and subsequently reclassified into interest expense in the same period in which the related interest on the variable rate borrowings affects earnings. In the event that a portion of the changes in fair value were determined to be ineffective, the ineffective amount would be recorded in earnings.

The following table provides information on derivatives related to variable rate borrowings as of June 30, 2016.

	Pay Rate	Receive Rate	Remaining Life (Years)	Notional Amount	Balance Sheet Location	Fair Value
Derivatives designated as hedging instruments						
Cash Flow Hedges:						
Interest rate swaps	1.56%	3-Month LIBOR	4.9	\$10,000	Other liabilities	\$(152)

Derivatives contain an element of credit risk which arises from the possibility that we will incur a loss as a result of a counterparty failing to meet its contractual obligations. Credit risk is minimized through counterparty collateral, transaction limits and monitoring procedures. We also manage dealer credit risk by entering into interest rate derivatives only with primary and highly rated counterparties, the use of ISDA master agreements and counterparties limits. We do not anticipate any losses from failure of interest rate derivative counterparties to honor their obligations.

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## Note 9 – Other Noninterest Expenses

A summary of expenses included in other noninterest expenses is as follows for the:

	Three Months		Six Months	
	Ended		Ended	
	June 30		June 30	
	2016	2015	2016	2015
Director fees	\$214	\$206	\$423	\$404
FDIC insurance premiums	217	203	422	415
Consulting fees	196	133	369	217
Audit and related fees	186	175	345	359
Education and travel	138	136	261	228
Marketing costs	103	114	258	226
Donations and community relations	129	114	240	257
Loan underwriting fees	127	62	235	150
Postage and freight	91	92	197	190
Printing and supplies	105	96	183	198
Legal fees	92	93	158	152
All other	651	468	1,224	970
Total other	\$2,249	\$1,892	\$4,315	\$3,766

## Note 10 – Federal Income Taxes

The reconciliation of the provision for federal income taxes and the amount computed at the federal statutory tax rate of 34% of income before federal income tax expense is as follows for the:

	Three Months		Six Months	
	Ended		Ended	
	June 30		June 30	
	2016	2015	2016	2015
Income taxes at 34% statutory rate	\$1,381	\$1,725	\$2,555	\$3,236
Effect of nontaxable income				
Interest income on tax exempt municipal securities	(486 )	(510 )	(988 )	(1,010 )
Earnings on corporate owned life insurance policies	(66 )	(66 )	(130 )	(130 )
Effect of tax credits	(193 )	(181 )	(387 )	(367 )
Other	(18 )	(26 )	(36 )	(52 )
Total effect of nontaxable income	(763 )	(783 )	(1,541 )	(1,559 )
Effect of nondeductible expenses	37	35	78	71
Federal income tax expense	\$655	\$977	\$1,092	\$1,748

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## Note 11 – Fair Value

Following is a description of the valuation methodologies, key inputs, and an indication of the level of the fair value hierarchy in which the assets or liabilities are classified.

Cash and cash equivalents: The carrying amounts of cash and demand deposits due from banks and interest bearing balances due from banks approximate fair values. As such, we classify cash and cash equivalents as Level 1.

AFS securities: AFS securities are recorded at fair value on a recurring basis. Level 1 fair value measurement is based upon quoted prices for identical instruments. Level 2 fair value measurement is based upon quoted prices for similar instruments. If quoted prices are not available, fair values are measured using independent pricing models or other model based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss and liquidity assumptions. The values for Level 1 and Level 2 investment securities are generally obtained from an independent third party. On a quarterly basis, we compare the values provided to alternative pricing sources.

Mortgage loans AFS: Mortgage loans AFS are carried at the lower of cost or fair value. The fair value of Mortgage loans AFS are based on the price secondary markets are currently offering for portfolios with similar characteristics. As such, we classify Mortgage loans AFS subject to nonrecurring fair value adjustments as Level 2.

Loans: For variable rate loans with no significant change in credit risk, fair values are based on carrying values. Fair values for fixed rate loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The resulting amounts are adjusted to estimate the effect of changes in the credit quality of borrowers since the loans were originated. As such, we classify loans as Level 3 assets.

We do not record loans at fair value on a recurring basis. However, from time-to-time, loans are classified as impaired and a specific allowance for loan loss may be established. Loans for which it is probable that payment of interest and principal will be significantly different than the contractual terms of the original loan agreement are considered impaired. Once a loan is identified as impaired, we measure the estimated impairment. The fair value of impaired loans is estimated using one of several methods, including 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, less cost to sell, if the loan is collateral dependent. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans.

We review the net realizable values of the underlying collateral for collateral dependent impaired loans on at least a quarterly basis for all loan types. To determine the collateral value, we utilize independent appraisals, broker price opinions, or internal evaluations. We review these valuations to determine whether an additional discount should be applied given the age of market information that may have been considered as well as other factors such as costs to sell an asset if it is determined that the collateral will be liquidated in connection with the ultimate settlement of the loan. We use these valuations to determine if any specific reserves or charge-offs are necessary. We may obtain new valuations in certain circumstances, including when there has been significant deterioration in the condition of the collateral, if the foreclosure process has begun, or if the existing valuation is deemed to be outdated.

The following tables list the quantitative fair value information about impaired loans as of:

Valuation Technique	June 30, 2016	
	Fair Value	Unobservable Input
		Range
		Discount applied to collateral appraisal:
		Real Estate
		20% - 30%
		Equipment
		35% - 50%
Discounted appraisal value \$7,687		Furniture, fixtures & equipment
		45%
		Cash crop inventory
		40%
		Other inventory
		50%
		Accounts receivable
		50%
		Liquor license
		75%



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December 31, 2015		
Valuation Technique	Fair Value Unobservable Input	Range
	Discount applied to collateral appraisal:	
	Real Estate	20% - 30%
	Equipment	20% - 35%
Discounted appraisal value \$9,301	Furniture, fixtures & equipment	35% - 45%
	Cash crop inventory	40%
	Other inventory	50%
	Accounts receivable	50%
	Liquor license	75%

Discount factors with ranges are based on the age of the independent appraisal, broker price opinion, or internal evaluation.

Accrued interest receivable: The carrying amounts of accrued interest receivable approximate fair value. As such, we classify accrued interest receivable as Level 1.

Equity securities without readily determinable fair values: Included in equity securities without readily determinable fair values are FHLB stock and FRB stock as well as our ownership interests in Corporate Settlement Solutions, LLC and Valley Financial Corporation. The investment in Corporate Settlement Solutions, LLC, a title insurance company, was made in the first quarter 2008 and we account for our investment under the equity method of accounting. Valley Financial Corporation is the parent company of 1st State Bank in Saginaw, Michigan, which is a community bank that opened in 2005. We made investments in Valley Financial Corporation in 2004 and in 2007 and we account for our investment under the cost method of accounting.

The lack of an active market, or other independent sources to validate fair value estimates coupled with the impact of future capital calls and transfer restrictions, is an inherent limitation in the valuation process. As the fair values of these investments are not readily determinable, they are not disclosed under a specific fair value hierarchy; however, they are reviewed quarterly for impairment. If we were to record an impairment adjustment related to these securities, it would be classified as a nonrecurring Level 3 fair value adjustment. During 2016 and 2015, there were no impairments recorded on equity securities without readily determinable fair values.

Foreclosed assets: Upon transfer from the loan portfolio, foreclosed assets (which are included in other assets) are adjusted to and subsequently carried at the lower of carrying value or fair value less costs to sell. Net realizable value is based upon independent market prices, appraised values of the collateral, or management's estimation of the value of the collateral. Due to the inherent level of estimation in the valuation process, we classify foreclosed assets as nonrecurring Level 3.

The table below lists the quantitative fair value information related to foreclosed assets as of:

June 30, 2016		
Valuation Technique	Fair Value Unobservable Input	Range
	Discount applied to collateral appraisal:	
Discounted appraisal value \$249	Real Estate	20% - 30%
December 31, 2015		
Valuation Technique	Fair Value Unobservable Input	Range
	Discount applied to collateral appraisal:	
Discounted appraisal value \$421	Real Estate	20% - 30%

Discount factors with ranges are based on the age of the independent appraisal, broker price opinion, or internal evaluations.

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Goodwill and other intangible assets: Acquisition intangibles and goodwill are evaluated for potential impairment on at least an annual basis. Acquisition intangibles and goodwill are typically qualitatively evaluated to determine if it is more likely than not that the carrying balance is impaired. If it is determined that the carrying balance of acquisition intangibles or goodwill is more likely than not to be impaired, we perform a cash flow valuation to determine the extent of the potential impairment. If the testing resulted in impairment, we would classify goodwill and other acquisition intangibles subjected to nonrecurring fair value adjustments as Level 3. During 2016 and 2015, there were no impairments recorded on goodwill and other acquisition intangibles.

OMSR: OMSR (which are included in other assets) are subject to impairment testing. To test for impairment, we utilize a discounted cash flow analysis using interest rates and prepayment speed assumptions currently quoted for comparable instruments and discount rates. If the valuation model reflects a value less than the carrying value, OMSR are adjusted to fair value through a valuation allowance as determined by the model. As such, we classify OMSR subject to nonrecurring fair value adjustments as Level 2.

Deposits: The fair value of demand, savings, and money market deposits are equal to their carrying amounts and are classified as Level 1. Fair values for variable rate certificates of deposit approximate their carrying value. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits. As such, fixed rate certificates of deposit are classified as Level 2.

Borrowed funds: The carrying amounts of federal funds purchased, borrowings under overnight repurchase agreements, and other short-term borrowings maturing within ninety days approximate their fair values. The fair values of other borrowed funds are estimated using discounted cash flow analyses based on current incremental borrowing arrangements. As such, borrowed funds are classified as Level 2.

Accrued interest payable: The carrying amounts of accrued interest payable approximate fair value. As such, we classify accrued interest payable as Level 1.

Derivative instruments: Derivative instruments, existing solely of interest rate swaps, are recorded at fair value on a recurring basis. Derivatives qualifying as cash flow hedges, when highly effective, are reported at fair value in other assets or other liabilities on our Consolidated Balance Sheets with changes in value recorded in OCI. Should the hedge no longer be considered effective, the ineffective portion of the change in fair value is recorded directly in earnings in the period in which the change occurs. The fair value of a derivative is determined by quoted market prices and model based valuation techniques. As such, we classify derivative instruments as Level 2.

Commitments to extend credit, standby letters of credit, and undisbursed loans: Our commitments to extend credit, standby letters of credit, and undisbursed funds have no carrying amount and are estimated to have no realizable fair value. Historically, a majority of the unused commitments to extend credit have not been drawn upon and, generally, we do not receive fees in connection with these commitments other than standby letter of credit fees, which are not significant.

The preceding methods described may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Although we believe our valuation methods 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 fair value measurement.

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Estimated Fair Values of Financial Instruments Not Recorded at Fair Value in their Entirety on a Recurring Basis  
Disclosure of the estimated fair values of financial instruments, which differ from carrying values, often requires the use of estimates. In cases where quoted market values in an active market are not available, we use present value techniques and other valuation methods to estimate the fair values of our financial instruments. These valuation methods require considerable judgment and the resulting estimates of fair value can be significantly affected by the assumptions made and methods used.

The carrying amount and estimated fair value of financial instruments not recorded at fair value in their entirety on a recurring basis were as follows as of:

	June 30, 2016				
	Carrying	Estimated	(Level	(Level	(Level
	Value	Fair	1)	2)	3)
		Value			
<b>ASSETS</b>					
Cash and cash equivalents	\$27,034	\$ 27,034	\$27,034	\$ —	—
Mortgage loans AFS	1,281	1,302	—	1,302	—
Gross loans	919,594	909,607	—	—	909,607
Less allowance for loan and lease losses	7,600	7,600	—	—	7,600
Net loans	911,994	902,007	—	—	902,007
Accrued interest receivable	5,791	5,791	5,791	—	—
Equity securities without readily determinable fair values (1)	22,427	N/A	—	—	—
OMSR	2,176	2,176	—	2,176	—
<b>LIABILITIES</b>					
Deposits without stated maturities	720,928	720,928	720,928	—	—
Deposits with stated maturities	435,942	435,730	—	435,730	—
Borrowed funds	318,596	322,475	—	322,475	—
Accrued interest payable	551	551	551	—	—
	December 31, 2015				
	Carrying	Estimated	(Level	(Level	(Level
	Value	Fair	1)	2)	3)
		Value			
<b>ASSETS</b>					
Cash and cash equivalents	\$21,569	\$ 21,569	\$21,569	\$ —	—
Mortgage loans AFS	1,187	1,210	—	1,210	—
Gross loans	850,492	839,398	—	—	839,398
Less allowance for loan and lease losses	7,400	7,400	—	—	7,400
Net loans	843,092	831,998	—	—	831,998
Accrued interest receivable	6,269	6,269	6,269	—	—
Equity securities without readily determinable fair values (1)	22,286	N/A	—	—	—
OMSR	2,505	2,518	—	2,518	—
<b>LIABILITIES</b>					
Deposits without stated maturities	741,683	741,683	741,683	—	—
Deposits with stated maturities	422,880	421,429	—	421,429	—
Borrowed funds	309,732	312,495	—	312,495	—
Accrued interest payable	545	545	545	—	—

Due to the characteristics of equity securities without readily determinable fair values, they are not disclosed under (1) a specific fair value hierarchy. If we were to record an impairment adjustment related to these securities, such amount would be classified as a nonrecurring Level 3 fair value adjustment.





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## Financial Instruments Recorded at Fair Value

The table below presents the recorded amount of assets and liabilities measured at fair value on:

	June 30, 2016				December 31, 2015			
	Total	(Level 1)	(Level 2)	(Level 3)	Total	(Level 1)	(Level 2)	(Level 3)
Recurring items								
AFS securities								
Government-sponsored enterprises	\$ 10,371	\$—	\$ 10,371	\$—	\$ 24,345	\$—	\$ 24,345	\$—
States and political subdivisions	226,047	—	226,047	—	232,217	—	232,217	—
Auction rate money market preferred	3,119	—	3,119	—	2,866	—	2,866	—
Preferred stocks	3,406	3,406	—	—	3,299	3,299	—	—
Mortgage-backed securities	240,195	—	240,195	—	263,384	—	263,384	—
Collateralized mortgage obligations	119,325	—	119,325	—	134,025	—	134,025	—
Total AFS securities	602,463	3,406	599,057	—	660,136	3,299	656,837	—
Derivative instruments	(152 )	—	(152 )	—	—	—	—	—
Nonrecurring items								
Impaired loans (net of the ALLL)	7,687	—	—	7,687	9,301	—	—	9,301
Foreclosed assets	249	—	—	249	421	—	—	421
Total	\$ 610,247	\$ 3,406	\$ 598,905	\$ 7,936	\$ 669,858	\$ 3,299	\$ 656,837	\$ 9,722
Percent of assets and liabilities measured at fair value		0.56 %	98.14 %	1.30 %		0.49 %	98.06 %	1.45 %

We had no assets or liabilities recorded at fair value with changes in fair value recognized through earnings, on a recurring basis, as of June 30, 2016. Additionally, we had no assets or liabilities recorded at fair value with changes in fair value recognized through earnings, on a nonrecurring basis, as of June 30, 2016.

## Note 12 – Accumulated Other Comprehensive Income

The following table summarizes the changes in AOCI by component for the:

	Three Months Ended June 30 2016				2015			
	Unrealized Holding Gains (Losses) on AFS Securities	Unrealized Gains (Losses) on Derivative Instruments	Defined Benefit Pension Plan	Total	Unrealized Holding Gains (Losses) on AFS Securities	Unrealized Gains (Losses) on Derivative Instruments	Defined Benefit Pension Plan	Total
Balance, April 1	\$ 8,333	\$ —	\$ (3,315 )	\$ 5,018	\$ 6,292	\$ —	\$ (3,808 )	\$ 2,484
OCI before reclassifications	4,067	(152 )	—	3,915	(6,520 )	—	—	(6,520 )
Amounts reclassified from AOCI	(245 )	—	—	(245 )	—	—	—	—
Subtotal	3,822	(152 )	—	3,670	(6,520 )	—	—	(6,520 )
Tax effect	(1,173 )	52	—	(1,121 )	2,165	—	—	2,165
OCI, net of tax	2,649	(100 )	—	2,549	(4,355 )	—	—	(4,355 )
Balance, June 30	\$ 10,982	\$ (100 )	\$ (3,315 )	\$ 7,567	\$ 1,937	\$ —	\$ (3,808 )	\$ (1,871)



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	Six Months Ended June 30				2015			
	2016		Unrealized		2015		Unrealized	
	Unrealized	Unrealized	Defined	Total	Unrealized	Unrealized	Defined	Total
	Holding	Gains	Benefit		Holding	Gains	Benefit	
	(Losses)	(Losses)	Pension Plan		(Losses)	(Losses)	Pension Plan	
	on	on			on	on		
	AFS	Derivative			AFS	Derivative		
	Securities	Instruments			Securities	Instruments		
Balance, January 1	\$3,536	\$ —	\$ (3,315 )	\$221	\$3,302	\$ —	\$ (3,808 )	\$ (506 )
OCI before reclassifications	11,341	(152 )	—	11,189	(2,164 )	—	—	(2,164 )
Amounts reclassified from AOCI	(245 )	—	—	(245 )	—	—	—	—
Subtotal	11,096	(152 )	—	10,944	(2,164 )	—	—	(2,164 )
Tax effect	(3,650 )	52	—	(3,598 )	799	—	—	799
OCI, net of tax	7,446	(100 )	—	7,346	(1,365 )	—	—	(1,365 )
Balance, June 30	\$10,982	\$ (100 )	\$ (3,315 )	\$7,567	\$1,937	\$ —	\$ (3,808 )	\$ (1,871)

Included in OCI for the three and six month periods ended June 30, 2016 and 2015 are changes in unrealized holding gains and losses related to auction rate money market preferred and preferred stocks. For federal income tax purposes, these securities are considered equity investments. As such, no deferred federal income taxes related to unrealized holding gains or losses are expected or recorded.

A summary of the components of unrealized holding gains on AFS securities included in OCI follows for the:

	Three Months Ended June 30			2015		
	2016	2015		2015	2015	
	Auction	Rate		Auction	Rate	
	Money	All Other	Total	Money	All Other	Total
	Market	AFS		Market	AFS	
	Preferred	Securities		Preferred	Securities	
	and			and		
	Preferred			Preferred		
	Stocks			Stocks		
Unrealized gains (losses) arising during the period	\$372	\$ 3,695	\$4,067	\$360	\$ (6,880 )	\$ (6,520)
Reclassification adjustment for net realized (gains) losses included in net income	—	(245 )	(245 )	—	—	—
Net unrealized gains (losses)	372	3,450	3,822	360	(6,880 )	(6,520 )
Tax effect	—	(1,173 )	(1,173 )	—	2,165	2,165
Unrealized gains (losses), net of tax	\$372	\$ 2,277	\$2,649	\$360	\$ (4,715 )	\$ (4,355)
	Six Months Ended June 30			2015		
	2016	2015		2015	2015	
	Auction	Rate		Auction	Rate	
	Money	All Other	Total	Money	All Other	Total
	Market	AFS		Market	AFS	
	Preferred	Securities		Preferred	Securities	
	and			and		
	Preferred			Preferred		
	Stocks			Stocks		
Unrealized gains (losses) arising during the period	\$360	\$10,981	\$11,341	\$190	\$ (2,354 )	\$ (2,164)
	—	(245 )	(245 )	—	—	—

Reclassification adjustment for net realized (gains) losses  
included in net income

Net unrealized gains (losses)	360	10,736	11,096	190	(2,354 )	(2,164 )
Tax effect	—	(3,650 )	(3,650 )	—	799	799
Unrealized gains (losses), net of tax	\$360	\$7,086	\$7,446	\$190	\$(1,555 )	\$(1,365)

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Interim Condensed Balance Sheets

	June 30 2016	December 31 2015
<b>ASSETS</b>		
Cash on deposit at the Bank	\$2,554	\$ 4,125
AFS securities	253	257
Investments in subsidiaries	144,906	133,883
Premises and equipment	2,003	2,014
Other assets	53,429	53,396
<b>TOTAL ASSETS</b>	<b>\$203,145</b>	<b>\$ 193,675</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Other liabilities	\$8,012	\$ 9,704
Shareholders' equity	195,133	183,971
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$203,145</b>	<b>\$ 193,675</b>

## Interim Condensed Statements of Income

	Three Months Ended June 30		Six Months Ended June 30	
	2016	2015	2016	2015
<b>Income</b>				
Dividends from subsidiaries	\$2,000	\$1,700	\$3,600	\$3,300
Interest income	4	35	8	71
Management fee and other	1,758	1,602	3,282	3,054
<b>Total income</b>	<b>3,762</b>	<b>3,337</b>	<b>6,890</b>	<b>6,425</b>
<b>Expenses</b>				
Compensation and benefits	1,184	1,240	2,384	2,430
Occupancy and equipment	413	401	843	811
Audit and related fees	100	114	196	215
Other	588	539	1,134	1,032
<b>Total expenses</b>	<b>2,285</b>	<b>2,294</b>	<b>4,557</b>	<b>4,488</b>
Income before income tax benefit and equity in undistributed earnings of subsidiaries	1,477	1,043	2,333	1,937
Federal income tax benefit	171	224	417	465
Income before equity in undistributed earnings of subsidiaries	1,648	1,267	2,750	2,402
Undistributed earnings of subsidiaries	1,759	2,831	3,674	5,369
<b>Net income</b>	<b>\$3,407</b>	<b>\$4,098</b>	<b>\$6,424</b>	<b>\$7,771</b>

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## Interim Condensed Statements of Cash Flows

	Six Months Ended June 30	
	2016	2015
Operating activities		
Net income	\$6,424	\$7,771
Adjustments to reconcile net income to cash provided by operations		
Undistributed earnings of subsidiaries	(3,674 )	(5,369 )
Undistributed earnings of equity securities without readily determinable fair values	(141 )	(65 )
Share-based payment awards under equity compensation plan	273	259
Depreciation	81	74
Changes in operating assets and liabilities which provided (used) cash		
Other assets	108	364
Accrued interest and other liabilities	(1,692 )	(33 )
Net cash provided by (used in) operating activities	1,379	3,001
Investing activities		
Maturities, calls, principal payments, and sales of AFS securities	—	3,000
Purchases of premises and equipment	(69 )	(105 )
Net cash provided by (used in) investing activities	(69 )	2,895
Financing activities		
Net increase (decrease) in borrowed funds	—	(211 )
Cash dividends paid on common stock	(3,744 )	(3,557 )
Proceeds from the issuance of common stock	2,489	2,192
Common stock repurchased	(1,462 )	(1,704 )
Common stock purchased for deferred compensation obligations	(164 )	(165 )
Net cash provided by (used in) financing activities	(2,881 )	(3,445 )
Increase (decrease) in cash and cash equivalents	(1,571 )	2,451
Cash and cash equivalents at beginning of period	4,125	1,035
Cash and cash equivalents at end of period	\$2,554	\$3,486

## Note 14 – Operating Segments

Our reportable segments are based on legal entities that account for at least 10% of net operating results. The operations of the Bank as of June 30, 2016 and 2015 and each of the three and six month periods then ended, represent approximately 90% or more of our consolidated total assets and operating results. As such, no additional segment reporting is presented.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

ISABELLA BANK CORPORATION FINANCIAL REVIEW

(Dollars in thousands except per share amounts)

This section reviews our financial condition and results of our operations for the unaudited three and six month periods ended June 30, 2016 and 2015. This analysis should be read in conjunction with our 2015 Annual Report on Form 10-K and with the unaudited interim condensed consolidated financial statements and notes, beginning on page 4 of this report.

Executive Summary

During the three and six months ended June 30, 2016, we reported net income of \$3,407 and \$6,424 and earnings per common share of \$0.44 and \$0.82, respectively. Net income and earnings per common share for the same periods of 2015 were \$4,098 and \$7,771 and \$0.53 and \$1.00, respectively. For the six month period ended June 30, 2016, the provision for loan losses was \$168. Net loan recoveries during the first six months of 2016 were \$32 as compared to net loan recoveries of \$161 in the first six months of 2015. During the first six months of 2015, we experienced a significant improvement in loan credit quality indicators through low levels of loans classified as less than satisfactory in addition to those considered to be nonperforming. This improvement along with net recoveries and a reduction in gross loans, resulted in a reversal of provision for loan losses of \$1,261 for the six month period ended June 30, 2015. During the six month period ended June 30, 2016, total assets grew by 0.73% to \$1,680,359, and assets under management increased to \$2,372,079 which includes loans sold and serviced, and assets managed by our Investment and Trust Services Department of \$691,720. Total loans increased by \$69,102 from December 31, 2015 which was largely driven by growth in the commercial portfolio. Growth in our residential mortgage and consumer loan portfolios has been challenging; however, we have seen growth during the first six months of 2016. Our residential mortgage and consumer loan portfolios were \$255,116 and \$37,587 as of June 30, 2016 compared to \$251,501 and \$34,699 as of December 31, 2015, respectively. We implemented new products, enhanced our marketing efforts and streamlined delivery channels for direct and indirect loans in an effort to generate growth by attracting new customers while expanding our relationships with current customers.

Our net yield on interest earning assets remains historically low at 2.97% for the six month period ended June 30, 2016. The growth in net interest income will increase only through continued growth in a strategic mix of loans, investments, and other income earning assets. We do not anticipate that the Federal Reserve Bank will increase short term interest rates significantly in 2016; therefore, we do not anticipate any significant improvements in our net yield on interest earning assets in the short term. We are committed to increasing earnings and shareholder value through growth in our loan portfolio and increasing our geographical presence while managing operating costs.

Reclassifications: Certain amounts reported in the 2015 consolidated financial statements have been reclassified to conform with the 2016 presentation.

Restatements: In this Quarterly Report on Form 10-Q, certain prior period financial information has been restated due to an accounting correction. All amounts in this Quarterly Report on Form 10-Q affected by the restatement adjustments are reflected as the restated amounts. For information related to the restatement, refer to our Annual Report on Form 10-K for the year ended December 31, 2015.

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## Results of Operations

The following table outlines our results of operations and provides certain performance measures as of, and for the three month periods ended:

	June 30 2016	March 31 2016	December 31 2015	September 30 2015	June 30 2015	
<b>INCOME STATEMENT DATA</b>						
Interest income	\$ 13,218	\$ 13,081	\$ 13,023	\$ 12,967	\$ 12,759	
Interest expense	2,678	2,614	2,577	2,580	2,518	
Net interest income	10,540	10,467	10,446	10,387	10,241	
Provision for loan losses	12	156	(772 )	(738 )	(535 )	)
Noninterest income	2,752	2,223	2,501	3,101	2,629	
Noninterest expenses	9,218	9,080	9,885	9,161	8,330	
Federal income tax expense	655	437	538	1,002	977	
Net Income	\$ 3,407	\$ 3,017	\$ 3,296	\$ 4,063	\$ 4,098	
<b>PER SHARE</b>						
Basic earnings	\$ 0.44	\$ 0.39	\$ 0.42	\$ 0.52	\$ 0.53	
Diluted earnings	\$ 0.43	\$ 0.38	\$ 0.41	\$ 0.51	\$ 0.52	
Dividends	\$ 0.24	\$ 0.24	\$ 0.24	\$ 0.24	\$ 0.23	
Tangible book value*	\$ 17.72	\$ 17.47	\$ 17.30	\$ 17.06	\$ 17.17	
Quoted market value						
High	\$ 28.25	\$ 29.90	\$ 29.90	\$ 23.85	\$ 23.80	
Low	\$ 27.63	\$ 27.25	\$ 23.50	\$ 22.75	\$ 22.70	
Close*	\$ 27.90	\$ 28.25	\$ 29.90	\$ 23.69	\$ 23.75	
Common shares outstanding*	7,836,442	7,809,079	7,799,867	7,765,333	7,797,188	
<b>PERFORMANCE RATIOS</b>						
Return on average total assets	0.81	% 0.72	% 0.81	% 1.01	% 1.04	%
Return on average shareholders' equity	7.05	% 6.37	% 7.17	% 9.03	% 9.11	%
Return on average tangible shareholders' equity	9.89	% 8.88	% 9.83	% 12.18	% 12.35	%
Net interest margin yield (FTE)	2.97	% 2.98	% 3.04	% 3.09	% 3.11	%
<b>BALANCE SHEET DATA*</b>						
Gross loans	\$ 919,594	\$ 870,291	\$ 850,492	\$ 836,671	\$ 831,831	
AFS securities	\$ 602,463	\$ 649,859	\$ 660,136	\$ 628,612	\$ 595,318	
Total assets	\$ 1,680,359	\$ 1,681,818	\$ 1,668,112	\$ 1,619,250	\$ 1,586,975	
Deposits	\$ 1,156,870	\$ 1,173,507	\$ 1,164,563	\$ 1,128,003	\$ 1,090,469	
Borrowed funds	\$ 318,596	\$ 307,896	\$ 309,732	\$ 297,610	\$ 307,599	
Shareholders' equity	\$ 195,133	\$ 190,247	\$ 183,971	\$ 182,998	\$ 178,025	
Gross loans to deposits	79.49	% 74.16	% 73.03	% 74.17	% 76.28	%
<b>ASSETS UNDER MANAGEMENT*</b>						
Loans sold with servicing retained	\$ 275,958	\$ 282,618	\$ 287,029	\$ 289,268	\$ 289,089	
Assets managed by our Investment and Trust Services Department	\$ 415,762	\$ 408,224	\$ 405,109	\$ 392,124	\$ 400,827	
Total assets under management	\$ 2,372,079	\$ 2,372,660	\$ 2,360,250	\$ 2,300,642	\$ 2,276,891	
<b>ASSET QUALITY*</b>						
Nonperforming loans to gross loans	0.13	% 0.12	% 0.09	% 0.10	% 0.19	%
Nonperforming assets to total assets	0.09	% 0.08	% 0.07	% 0.09	% 0.15	%
ALLL to gross loans	0.83	% 0.86	% 0.87	% 0.98	% 1.08	%
<b>CAPITAL RATIOS*</b>						



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Shareholders' equity to assets	11.61	% 11.31	% 11.03	% 11.30	% 11.22	%
Tier 1 leverage	8.50	% 8.44	% 8.52	% 8.54	% 8.77	%
Common equity tier 1 capital	13.08	% 13.24	% 13.44	% 13.57	% 13.94	%
Tier 1 risk-based capital	13.08	% 13.24	% 13.44	% 13.57	% 13.94	%
Total risk-based capital	13.80	% 13.97	% 14.17	% 14.41	% 14.88	%

\* At end of period

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The following table outlines our results of operations and provides certain performance measures as of, and for the six month periods ended:

	June 30 2016	June 30 2015	June 30 2014	June 30 2013	June 30 2012	
<b>INCOME STATEMENT DATA</b>						
Interest income	\$26,299	\$25,512	\$25,318	\$25,054	\$26,902	
Interest expense	5,292	5,006	4,968	5,602	7,133	
Net interest income	21,007	20,506	20,350	19,452	19,769	
Provision for loan losses	168	(1,261)	(442)	515	900	
Noninterest income	4,975	4,757	4,683	5,183	6,085	
Noninterest expenses	18,298	17,005	17,349	16,601	17,271	
Federal income tax expense	1,092	1,748	1,252	1,219	1,445	
Net Income	\$6,424	\$7,771	\$6,874	\$6,300	\$6,238	
<b>PER SHARE</b>						
Basic earnings	\$0.82	\$1.00	\$0.89	\$0.82	\$0.82	
Diluted earnings	\$0.80	\$0.98	\$0.87	\$0.80	\$0.80	
Dividends	\$0.48	\$0.46	\$0.44	\$0.42	\$0.40	
Tangible book value*	\$17.72	\$17.17	\$16.08	\$15.19	\$14.37	
Quoted market value						
High	\$29.90	\$23.80	\$23.94	\$26.00	\$24.98	
Low	\$27.25	\$22.00	\$22.52	\$21.60	\$22.30	
Close*	\$27.90	\$23.75	\$22.95	\$24.75	\$24.85	
Common shares outstanding*	7,836,442	7,797,188	7,735,156	7,703,589	7,602,545	
<b>PERFORMANCE RATIOS</b>						
Return on average total assets	0.77	% 1.00	% 0.91	% 0.88	% 0.92	%
Return on average shareholders' equity	6.71	% 8.69	% 8.24	% 7.63	% 8.03	%
Return on average tangible shareholders' equity	9.37	% 11.71	% 11.17	% 10.98	% 11.66	%
Net interest margin yield (FTE)	2.97	% 3.15	% 3.21	% 3.22	% 3.47	%
<b>BALANCE SHEET DATA*</b>						
Gross loans	\$919,594	\$831,831	\$819,253	\$805,733	\$756,433	
AFS securities	\$602,463	\$595,318	\$550,518	\$499,424	\$504,010	
Total assets	\$1,680,359	\$1,586,975	\$1,522,135	\$1,451,415	\$1,381,496	
Deposits	\$1,156,870	\$1,090,469	\$1,060,928	\$1,021,424	\$978,828	
Borrowed funds	\$318,596	\$307,599	\$279,457	\$262,460	\$234,132	
Shareholders' equity	\$195,133	\$178,025	\$171,099	\$159,288	\$159,855	
Gross loans to deposits	79.49	% 76.28	% 77.22	% 78.88	% 77.28	%
<b>ASSETS UNDER MANAGEMENT*</b>						
Loans sold with servicing retained	\$275,958	\$289,089	\$290,590	\$295,047	\$306,337	
Assets managed by our Investment and Trust Services Department	\$415,762	\$400,827	\$374,092	\$336,132	\$311,760	
Total assets under management	\$2,372,079	\$2,276,891	\$2,186,817	\$2,082,594	\$1,999,593	
<b>ASSET QUALITY*</b>						
Nonperforming loans to gross loans	0.13	% 0.19	% 0.57	% 0.52	% 0.86	%
Nonperforming assets to total assets	0.09	% 0.15	% 0.38	% 0.36	% 0.64	%
ALLL to gross loans	0.83	% 1.08	% 1.31	% 1.45	% 1.63	%
<b>CAPITAL RATIOS*</b>						
Shareholders' equity to assets	11.61	% 11.22	% 11.24	% 10.97	% 11.57	%
Tier 1 leverage	8.50	% 8.77	% 8.50	% 8.38	% 8.24	%

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Common equity tier 1 capital	13.08	% 13.94	% N/A	N/A	N/A	
Tier 1 risk-based capital	13.08	% 13.94	% 13.86	% 13.60	% 13.20	%
Total risk-based capital	13.80	% 14.88	% 15.11	% 14.85	% 14.45	%

\* At end of period

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## Average Balances, Interest Rate, and Net Interest Income

The following schedules present the daily average amount outstanding for each major category of interest earning assets, nonearning assets, interest bearing liabilities, and noninterest bearing liabilities. These schedules also present an analysis of interest income and interest expense for the periods indicated. All interest income is reported on a FTE basis using a 34% federal income tax rate. Loans in nonaccrual status, for the purpose of the following computations, are included in the average loan balances. FRB and FHLB restricted equity holdings are included in accrued income and other assets.

	Three Months Ended									
	June 30, 2016			March 31, 2016			June 30, 2015			
	Average Balance	Tax Equivalent Interest	Average Yield / Rate	Average Balance	Tax Equivalent Interest	Average Yield / Rate	Average Balance	Tax Equivalent Interest	Average Yield / Rate	
<b>INTEREST EARNING ASSETS</b>										
Loans	\$893,282	\$9,317	4.17 %	\$857,784	\$9,038	4.21 %	\$822,631	\$8,875	4.32 %	
Taxable investment securities	419,252	2,303	2.20 %	432,747	2,400	2.22 %	393,313	2,238	2.28 %	
Nontaxable investment securities	208,425	2,356	4.52 %	211,695	2,424	4.58 %	201,841	2,496	4.95 %	
Other	23,564	157	2.67 %	26,929	158	2.35 %	25,195	139	2.21 %	
Total earning assets	1,544,523	14,133	3.66 %	1,529,155	14,020	3.67 %	1,442,980	13,748	3.81 %	
<b>NONEARNING ASSETS</b>										
Allowance for loan losses	(7,557)			(7,439)			(9,575)			
Cash and demand deposits due from banks	17,942			17,769			17,406			
Premises and equipment	28,363			28,253			26,231			
Accrued income and other assets	101,341			100,770			97,813			
Total assets	\$1,684,612			\$1,668,508			\$1,574,855			
<b>INTEREST BEARING LIABILITIES</b>										
Interest bearing demand deposits	\$204,044	40	0.08 %	\$208,309	42	0.08 %	\$190,957	37	0.08 %	
Savings deposits	340,251	144	0.17 %	342,540	144	0.17 %	277,049	96	0.14 %	
Time deposits	427,753	1,234	1.15 %	420,913	1,213	1.15 %	436,244	1,326	1.22 %	
Borrowed funds	320,337	1,260	1.57 %	310,637	1,215	1.56 %	299,987	1,059	1.41 %	
Total interest bearing liabilities	1,292,385	2,678	0.83 %	1,282,399	2,614	0.82 %	1,204,237	2,518	0.84 %	
<b>NONINTEREST BEARING LIABILITIES</b>										
Demand deposits	189,520			187,067			179,733			
Other	9,360			9,592			10,873			
Shareholders' equity	193,347			189,450			180,012			
Total liabilities and shareholders' equity	\$1,684,612			\$1,668,508			\$1,574,855			
Net interest income (FTE)		\$11,455			\$11,406			\$11,230		
Net yield on interest earning assets (FTE)			2.97 %			2.98 %			3.11 %	



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	Six Months Ended					
	June 30, 2016			June 30, 2015		
	Average Balance	Tax Equivalent Interest	Average Yield / Rate	Average Balance	Tax Equivalent Interest	Average Yield / Rate
<b>INTEREST EARNING ASSETS</b>						
Loans	\$875,533	\$ 18,355	4.19 %	\$823,829	\$ 17,900	4.35 %
Taxable investment securities	425,999	4,703	2.21 %	381,950	4,345	2.28 %
Nontaxable investment securities	210,060	4,779	4.55 %	199,719	4,981	4.99 %
Other	25,246	315	2.50 %	24,808	278	2.24 %
Total earning assets	1,536,838	28,152	3.66 %	1,430,306	27,504	3.85 %
<b>NONEARNING ASSETS</b>						
Allowance for loan losses	(7,498 )			(9,942 )		
Cash and demand deposits due from banks	17,857			17,516		
Premises and equipment	28,308			26,269		
Accrued income and other assets	101,039			97,803		
Total assets	\$1,676,544			\$1,561,952		
<b>INTEREST BEARING LIABILITIES</b>						
Interest bearing demand deposits	\$206,177	82	0.08 %	\$192,797	76	0.08 %
Savings deposits	341,396	288	0.17 %	273,921	188	0.14 %
Time deposits	424,333	2,447	1.15 %	436,727	2,661	1.22 %
Borrowed funds	315,488	2,475	1.57 %	291,761	2,081	1.43 %
Total interest bearing liabilities	1,287,394	5,292	0.82 %	1,195,206	5,006	0.84 %
<b>NONINTEREST BEARING LIABILITIES</b>						
Demand deposits	188,242			176,885		
Other	9,501			10,980		
Shareholders' equity	191,407			178,881		
Total liabilities and shareholders' equity	\$1,676,544			\$1,561,952		
Net interest income (FTE)		\$ 22,860			\$ 22,498	
Net yield on interest earning assets (FTE)			2.97 %			3.15 %
<b>Net Interest Income</b>						

Net interest income is the amount by which interest income on earning assets exceeds the interest expenses on interest bearing liabilities. Net interest income is influenced by changes in the balance and mix of assets and liabilities and market interest rates. We exert some control over these factors; however, FRB monetary policy and competition have a significant impact. For analytical purposes, net interest income is adjusted to an FTE basis by adding the income tax savings from interest on tax exempt loans, and nontaxable investment securities, thus making year to year comparisons more meaningful.

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## Volume and Rate Variance Analysis

The following table sets forth the effect of volume and rate changes on interest income and expense for the periods indicated. For the purpose of this table, changes in interest due to volume and rate were determined as follows:

Volume—change in volume multiplied by the previous period's rate.

Rate—change in the FTE rate multiplied by the previous period's volume.

The change in interest due to both volume and rate has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.

	Three Months Ended June 30, 2016 Compared to March 31, 2016 Increase (Decrease) Due to			Three Months Ended June 30, 2016 Compared to June 30, 2015 Increase (Decrease) Due to			Six Months Ended June 30, 2016 Compared to June 30, 2015 Increase (Decrease) Due to		
	Volume	Rate	Net	Volume	Rate	Net	Volume	Rate	Net
Changes in interest income									
Loans	\$371	\$(92)	\$279	\$744	\$(302)	\$442	\$1,098	\$(643)	\$455
Taxable investment securities	(74 )	(23 )	(97 )	144	(79 )	65	489	(131 )	358
Nontaxable investment securities	(37 )	(31 )	(68 )	79	(219 )	(140 )	250	(452 )	(202 )
Other	(21 )	20	(1 )	(9 )	27	18	5	32	37
Total changes in interest income	239	(126)	113	958	(573 )	385	1,842	(1,194)	648
Changes in interest expense									