

ISABELLA BANK CORP  
Form 10-Q  
November 09, 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 September 30, 2016

or  
Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from to  
Commission File 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 7,831,272 as of November 4, 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

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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)

	September 30 2016	December 31 2015
<b>ASSETS</b>		
Cash and cash equivalents		
Cash and demand deposits due from banks	\$ 19,274	\$ 18,810
Interest bearing balances due from banks	2,061	2,759
Total cash and cash equivalents	21,335	21,569
AFS securities (amortized cost of \$549,893 in 2016 and \$654,348 in 2015)	564,229	660,136
Mortgage loans AFS	685	1,187
Loans		
Commercial	554,847	448,381
Agricultural	133,637	115,911
Residential real estate	260,122	251,501
Consumer	40,760	34,699
Gross loans	989,366	850,492
Less allowance for loan and lease losses	7,800	7,400
Net loans	981,566	843,092
Premises and equipment	28,986	28,331
Corporate owned life insurance policies	25,985	26,423
Accrued interest receivable	6,868	6,269
Equity securities without readily determinable fair values	22,573	22,286
Goodwill and other intangible assets	48,700	48,828
Other assets	5,571	9,991
<b>TOTAL ASSETS</b>	<b>\$ 1,706,498</b>	<b>\$ 1,668,112</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Deposits</b>		
Noninterest bearing	\$ 201,804	\$ 191,376
NOW accounts	205,817	212,666
Certificates of deposit under \$100 and other savings	504,599	521,793
Certificates of deposit over \$100	263,613	238,728
Total deposits	1,175,833	1,164,563
Borrowed funds	325,409	309,732
Accrued interest payable and other liabilities	10,072	9,846
Total liabilities	1,511,314	1,484,141
<b>Shareholders' equity</b>		
Common stock — no par value 15,000,000 shares authorized; issued and outstanding 7,833,481 shares (including 22,296 shares held in the Rabbi Trust) in 2016 and 7,799,867 shares (including 19,401 shares held in the Rabbi Trust) in 2015	139,980	139,198
Shares to be issued for deferred compensation obligations	4,908	4,592
Retained earnings	44,280	39,960
Accumulated other comprehensive income	6,016	221
Total shareholders' equity	195,184	183,971
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 1,706,498</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 September 30 2016 2015		Nine Months Ended September 30 2016 2015	
Interest income				
Loans, including fees	\$9,965	\$8,984	\$28,320	\$26,884
AFS securities				
Taxable	2,037	2,310	6,740	6,655
Nontaxable	1,411	1,507	4,337	4,496
Federal funds sold and other	194	166	509	444
Total interest income	13,607	12,967	39,906	38,479
Interest expense				
Deposits	1,496	1,480	4,313	4,405
Borrowings	1,251	1,100	3,726	3,181
Total interest expense	2,747	2,580	8,039	7,586
Net interest income	10,860	10,387	31,867	30,893
Provision for loan losses	17	(738 )	185	(1,999 )
Net interest income after provision for loan losses	10,843	11,125	31,682	32,892
Noninterest income				
Service charges and fees	1,276	1,468	3,652	4,024
Net gain on sale of mortgage loans	263	157	472	472
Earnings on corporate owned life insurance policies	183	188	566	570
Net gains on sale of AFS securities	—	—	245	—
Other	1,224	1,288	2,986	2,792
Total noninterest income	2,946	3,101	7,921	7,858
Noninterest expenses				
Compensation and benefits	4,940	4,750	14,412	13,856
Furniture and equipment	1,543	1,511	4,564	4,251
Occupancy	790	728	2,280	2,121
Other	2,160	2,172	6,475	5,938
Total noninterest expenses	9,433	9,161	27,731	26,166
Income before federal income tax expense	4,356	5,065	11,872	14,584
Federal income tax expense	763	1,002	1,855	2,750
NET INCOME	\$3,593	\$4,063	\$10,017	\$11,834
Earnings per common share				
Basic	\$0.46	\$0.52	\$1.28	\$1.52
Diluted	\$0.45	\$0.51	\$1.25	\$1.49
Cash dividends per common share	\$0.25	\$0.24	\$0.73	\$0.70

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

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(Dollars in thousands)

	Three Months Ended September 30		Nine Months Ended September 30	
	2016	2015	2016	2015
Net income	\$3,593	\$4,063	\$10,017	\$11,834
Unrealized gains (losses) on AFS securities arising during the period	(2,548 )	5,301	8,793	3,137
Unrealized gains (losses) on derivative instruments arising during the period	91	—	(61 )	—
Reclassification adjustment for net realized (gains) losses included in net income	—	—	(245 )	—
Comprehensive income (loss) before income tax (expense) benefit	(2,457 )	5,301	8,487	3,137
Tax effect (1)	906	(1,818 )	(2,692 )	(1,019 )
Other comprehensive income, net of tax	(1,551 )	3,483	5,795	2,118
Comprehensive income	\$2,042	\$7,546	\$15,812	\$13,952

(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)	—	—	—	11,834	2,118	13,952
Issuance of common stock	142,388	3,310	—	—	—	3,310
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	123	(123 )	—	—	—
Share-based payment awards under equity compensation plan	—	—	425	—	—	425
Common stock purchased for deferred compensation obligations	—	(279 )	—	—	—	(279 )
Common stock repurchased pursuant to publicly announced repurchase plan	(153,329 )	(3,588 )	—	—	—	(3,588 )
Cash dividends paid (\$0.70 per common share)	—	—	—	(5,416 )	—	(5,416 )
Balance, September 30, 2015	7,765,333	\$138,321	\$ 4,544	\$38,521	\$ 1,612	\$182,998
Balance, January 1, 2016	7,799,867	\$139,198	\$ 4,592	\$39,960	\$ 221	\$183,971
Comprehensive income (loss)	—	—	—	10,017	5,795	15,812
Issuance of common stock	131,697	3,683	—	—	—	3,683
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	127	(127 )	—	—	—
Share-based payment awards under equity compensation plan	—	—	443	—	—	443
Common stock purchased for deferred compensation obligations	—	(279 )	—	—	—	(279 )
Common stock repurchased pursuant to publicly announced repurchase plan	(98,083 )	(2,749 )	—	—	—	(2,749 )
Cash dividends paid (\$0.73 per common share)	—	—	—	(5,697 )	—	(5,697 )
Balance, September 30, 2016	7,833,481	\$139,980	\$ 4,908	\$44,280	\$ 6,016	\$195,184

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

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

(Dollars in thousands)

	Nine Months Ended September 30	
	2016	2015
<b>OPERATING ACTIVITIES</b>		
Net income	\$10,017	\$11,834
Reconciliation of net income to net cash provided by operating activities:		
Provision for loan losses	185	(1,999 )
Impairment of foreclosed assets	—	22
Depreciation	2,116	1,925
Amortization of OMSR	299	273
Amortization of acquisition intangibles	128	122
Net amortization of AFS securities	2,115	1,514
Net (gains) losses on sale of AFS securities	(245 )	—
Net gain on sale of mortgage loans	(472 )	(472 )
Increase in cash value of corporate owned life insurance policies	(566 )	(570 )
Share-based payment awards under equity compensation plan	443	425
Origination of loans held-for-sale	(22,994 )	(36,140 )
Proceeds from loan sales	23,968	36,682
Net changes in operating assets and liabilities which provided (used) cash:		
Accrued interest receivable	(599 )	(1,141 )
Other assets	1,005	(5,277 )
Accrued interest payable and other liabilities	165	(117 )
Net cash provided by (used in) operating activities	15,565	7,081
<b>INVESTING ACTIVITIES</b>		
Activity in AFS securities		
Sales	35,664	—
Maturities, calls, and principal payments	111,543	72,345
Purchases	(44,622 )	(131,800)
Net loan principal (originations) collections	(138,870)	(1,065 )
Proceeds from sales of foreclosed assets	348	1,305
Purchases of premises and equipment	(2,771 )	(4,397 )
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	(37,704 )	(64,112 )

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

(Dollars in thousands)

	Nine Months Ended September 30	
	2016	2015
<b>FINANCING ACTIVITIES</b>		
Net increase (decrease) in deposits	\$11,270	\$53,519
Net increase (decrease) in borrowed funds	15,677	7,901
Cash dividends paid on common stock	(5,697 )	(5,416 )
Proceeds from issuance of common stock	3,683	3,310
Common stock repurchased	(2,749 )	(3,588 )
Common stock purchased for deferred compensation obligations	(279 )	(279 )
Net cash provided by (used in) financing activities	21,905	55,447
Increase (decrease) in cash and cash equivalents	(234 )	(1,584 )
Cash and cash equivalents at beginning of period	21,569	19,906
Cash and cash equivalents at end of period	\$21,335	\$18,322
<b>SUPPLEMENTAL CASH FLOWS INFORMATION:</b>		
Interest paid	\$8,042	\$7,587
Income taxes paid	1,350	3,193
<b>SUPPLEMENTAL NONCASH INFORMATION:</b>		
Transfers of loans to foreclosed assets	\$211	\$1,043

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 nine month periods ended September 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 nine month periods ended September 30, 2015 and

1. Consolidated Statements of Cash Flows for the nine month period ended September 30, 2015; and

2. Notes to Consolidated Financial Statements for the three and nine month periods ended September 30, 2015.

On the Consolidated Statements of Income, the effects of the restatement reduced loan interest and fee income by \$871 and \$2,564, respectively, and compensation and benefits were reduced by \$871 and \$2,564, respectively, for the three and nine month periods ended September 30, 2015. The restatement did not impact net income for the three and nine month periods ended September 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 September 30 2016		Nine Months Ended September 30 2015	
Average number of common shares outstanding for basic calculation	7,824,751	7,682,230	7,813,084	7,773,655
Average potential effect of common shares in the Directors Plan (1)	186,667	178,882	184,996	177,531
Average number of common shares outstanding used to calculate diluted earnings per common share	8,011,418	7,861,112	7,998,080	7,951,186
Net income	\$3,593	\$4,063	\$10,017	\$11,834
Earnings per common share				
Basic	\$0.46	\$0.52	\$1.28	\$1.52
Diluted	\$0.45	\$0.51	\$1.25	\$1.49

(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. 2016-05: “Derivatives and Hedging (Topic 815): Effect Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships”

In March 2016, ASU No. 2016-05 was issued to clarify designation of a hedging instrument when there is a change in counterparty. A change in the counterparty to a derivative instrument that has been designated as the hedging instrument under Topic 815 does not, in and of itself, require dedesignation of that hedging relationship provided that all other hedge accounting criteria continue to be met. 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. 2016-07: “Investments - Equity Method and Joint Ventures (Topic 323): Simplifying the Transition of the Equity Method of Accounting”

In March 2016, ASU No. 2016-07 was issued and 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



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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.

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 requires 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 calculate 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 on our operations and financial statement disclosures as well as that of the banking industry as a whole.

ASU No. 2016-15: "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments"

In August 2016, ASU No. 2016-15 was issued to provide guidance on eight specific cash flow issues: 1) debt prepayment or debt extinguishment costs; 2) settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; 3) contingent consideration payments made after a business combination; 4) proceeds from the settlement of insurance claims; 5) proceeds from the settlement of corporate-owned life insurance policies; 6) including bank-owned life insurance policies; 7) distributions received from equity method investees, beneficial interests in securitization transactions; and

8) separately identifiable cash flows and application of the predominance principle. 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.

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## Note 4 – AFS Securities

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

September 30, 2016

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	\$340	\$ 4	\$ —	\$344
States and political subdivisions	211,073	8,627	11	219,689
Auction rate money market preferred	3,200	—	55	3,145
Preferred stocks	3,800	—	212	3,588
Mortgage-backed securities	222,342	4,341	34	226,649
Collateralized mortgage obligations	109,138	1,796	120	110,814
Total	\$549,893	\$ 14,768	\$ 432	\$564,229

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 September 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	\$32	\$ —	\$308	\$ —	\$ —	\$340
States and political subdivisions	26,139	71,388	83,884	29,662	—	211,073
Auction rate money market preferred	—	—	—	—	3,200	3,200
Preferred stocks	—	—	—	—	3,800	3,800
Mortgage-backed securities	—	—	—	—	222,342	222,342
Collateralized mortgage obligations	—	—	—	—	109,138	109,138
Total amortized cost	\$26,171	\$ 71,388	\$84,192	\$ 29,662	\$ 338,480	\$549,893
Fair value	\$26,277	\$ 73,959	\$88,507	\$ 31,290	\$ 344,196	\$564,229

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.



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?

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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 September 30, 2016 or December 31, 2015.

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, advances to mortgage brokers, 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 entered into a mortgage purchase program with a financial institution where we participate in advances to mortgage brokers ("advances"). The mortgage brokers originate residential mortgage loans with the intent to sell on the secondary market. We participate in the advance to the mortgage broker, which is secured by the underlying mortgage loan, until it is ultimately sold on the secondary market. As such, the average life of each participated advance is approximately 20-30 days. Funds from the sale of the loan are used to payoff our participation in the advance to the mortgage broker. We classify these advances as commercial loans and include the outstanding balance in commercial loans on our balance sheet. Under the participation agreement, we committed to a maximum outstanding aggregate amount of \$30,000. The difference between our outstanding balances and the maximum outstanding aggregate amount are classified as "Unfunded commitments under lines of credit" in the "Contractual Obligations and Loan Commitments" section of the Management's Discussion and Analysis of Financial Condition and Results of Operations of this report.

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%.

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Underwriting criteria for originated 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 originated 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.

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, with the exception of advances to mortgage brokers, over the preceding five years. With no historical losses on advances to mortgage brokers, there is no allocation in the commercial segment displayed below based on historical loss factors. 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 September 30, 2016					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
July 1, 2016	\$2,119	\$ 534	\$ 3,130	\$ 541	\$ 1,276	\$7,600
Charge-offs	—	—	(57 )	(74 )	—	(131 )
Recoveries	118	—	153	43	—	314
Provision for loan losses	(367 )	612	(452 )	94	130	17
September 30, 2016	\$1,870	\$ 1,146	\$ 2,774	\$ 604	\$ 1,406	\$7,800
	Allowance for Loan Losses					
	Nine Months Ended September 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 )	—	(426 )	(206 )	—	(680 )



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Recoveries	396	92	248	159	—	895
Provision for loan losses	(649	)725	(378	) 129	358	185
September 30, 2016	\$1,870	\$ 1,146	\$ 2,774	\$ 604	\$ 1,406	\$7,800

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

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	\$ 804	\$ 16	\$ 1,703	\$ —	\$ —	\$ 2,523
Collectively evaluated for impairment	1,066	1,130	1,071	604	1,406	5,277
Total	\$ 1,870	\$ 1,146	\$ 2,774	\$ 604	\$ 1,406	\$ 7,800
Loans						
Individually evaluated for impairment	\$ 7,719	\$ 4,520	\$ 8,792	\$ 29		\$ 21,060
Collectively evaluated for impairment	547,128	129,117	251,330	40,731		968,306
Total	\$ 554,847	\$ 133,637	\$ 260,122	\$ 40,760		\$ 989,366

Allowance for Loan Losses  
Three Months Ended September 30, 2015

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
July 1, 2015	\$ 3,482	\$ 363	\$ 3,512	\$ 591	\$ 1,052	\$ 9,000
Charge-offs	(61 )	—	(70 )	(79 )	—	(210 )
Recoveries	68	—	33	47	—	148
Provision for loan losses	(500 )	15	(163 )	(50 )	(40 )	(738 )
September 30, 2015	\$ 2,989	\$ 378	\$ 3,312	\$ 509	\$ 1,012	\$ 8,200

Allowance for Loan Losses  
Nine Months Ended September 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	(89 )	—	(325 )	(252 )	—	(666 )
Recoveries	387	72	152	154	—	765
Provision for loan losses	(1,130 )	90	(750 )	(38 )	(171 )	(1,999 )
September 30, 2015	\$ 2,989	\$ 378	\$ 3,312	\$ 509	\$ 1,012	\$ 8,200

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	September 30, 2016				September 30, 2015			
	Commercial		Agricultural		Commercial		Agricultural	
	Real Estate	Other	Advances to Mortgage Brokers	Total	Real Estate	Other	Total	Total
1 - Excellent	\$—	\$529	\$—	\$529	\$—	\$—	\$—	\$529
2 - High quality	8,819	10,193	27,832	46,844	3,828	1,562	5,390	52,234
3 - High satisfactory	107,613	37,839	—	145,452	23,612	11,557	35,169	180,621
4 - Low satisfactory	275,806	73,465	—	349,271	50,083	25,066	75,149	424,420
5 - Special mention	4,448	733	—	5,181	6,483	6,810	13,293	18,474
6 - Substandard	6,037	1,527	—	7,564	3,126	1,510	4,636	12,200
7 - Vulnerable	6	—	—	6	—	—	—	6
8 - Doubtful	—	—	—	—	—	—	—	—
<b>Total</b>	<b>\$402,729</b>	<b>\$124,286</b>	<b>\$27,832</b>	<b>\$554,847</b>	<b>\$87,132</b>	<b>\$46,505</b>	<b>\$133,637</b>	<b>\$688,484</b>

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.

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♣ 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.

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.

Ⓛitigation filed against borrower.  
Ⓞollateral provides little or no value.

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Requires excessive attention of the loan officer.

Borrower is uncooperative with loan officer.

## 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:

	September 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			
<b>Commercial</b>							
Commercial real estate	\$979	\$48	\$ 160	\$ 68	\$ 1,255	\$401,474	\$402,729
Commercial other	284	202	24	—	510	123,776	124,286
Advances to mortgage brokers	—	—	—	—	—	27,832	27,832
<b>Total commercial</b>	<b>1,263</b>	<b>250</b>	<b>184</b>	<b>68</b>	<b>1,765</b>	<b>553,082</b>	<b>554,847</b>
<b>Agricultural</b>							
Agricultural real estate	517	181	465	—	1,163	85,969	87,132
Agricultural other	214	—	6	—	220	46,285	46,505
<b>Total agricultural</b>	<b>731</b>	<b>181</b>	<b>471</b>	<b>—</b>	<b>1,383</b>	<b>132,254</b>	<b>133,637</b>
<b>Residential real estate</b>							
Senior liens	1,077	240	192	595	2,104	210,826	212,930
Junior liens	15	15	—	27	57	8,342	8,399
Home equity lines of credit	275	—	—	—	275	38,518	38,793
<b>Total residential real estate</b>	<b>1,367</b>	<b>255</b>	<b>192</b>	<b>622</b>	<b>2,436</b>	<b>257,686</b>	<b>260,122</b>
<b>Consumer</b>							
Secured	19	19	—	—	38	36,893	36,931
Unsecured	10	3	—	—	13	3,816	3,829
<b>Total consumer</b>	<b>29</b>	<b>22</b>	<b>—</b>	<b>—</b>	<b>51</b>	<b>40,709</b>	<b>40,760</b>
<b>Total</b>	<b>\$3,390</b>	<b>\$708</b>	<b>\$ 847</b>	<b>\$ 690</b>	<b>\$ 5,635</b>	<b>\$983,731</b>	<b>\$989,366</b>





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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
Advances to mortgage brokers	—	—	—	—	—	—	—
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:

	September 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	\$5,669	\$5,788	\$ 719	\$5,659	\$5,777	\$ 818
Commercial other	1,399	1,399	85	8	8	11
Agricultural real estate	181	181	15	—	—	—
Agricultural other	134	134	1	335	335	2
Residential real estate senior liens	8,608	9,193	1,688	9,996	10,765	1,959
Residential real estate junior liens	76	86	15	143	163	30
Home equity lines of credit	—	—	—	—	—	—
Consumer secured	—	—	—	—	—	—
Total impaired loans with a valuation allowance	16,067	16,781	2,523	16,141	17,048	2,820
Impaired loans without a valuation allowance						
Commercial real estate	590	603		2,122	2,256	
Commercial other	61	72		180	191	
Agricultural real estate	3,357	3,357		3,549	3,549	
Agricultural other	848	848		184	184	
Home equity lines of credit	108	408		127	434	
Consumer secured	29	29		35	35	
Total impaired loans without a valuation allowance	4,993	5,317		6,197	6,649	
Impaired loans						
Commercial	7,719	7,862	804	7,969	8,232	829
Agricultural	4,520	4,520	16	4,068	4,068	2
Residential real estate	8,792	9,687	1,703	10,266	11,362	1,989
Consumer	29	29	—	35	35	—
Total impaired loans	\$21,060	\$22,098	\$ 2,523	\$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 September 30			
	2016		2015	
	Average Interest	Average Interest	Average Interest	Average Interest
	Outstanding	Outstanding	Outstanding	Outstanding
	Balance	Recognized	Balance	Recognized
Impaired loans with a valuation allowance				
Commercial real estate	\$5,699	\$ 90	\$7,532	\$ 112
Commercial other	746	2	280	—
Agricultural real estate	181	4	—	—
Agricultural other	67	1	168	4
Residential real estate senior liens	8,896	85	10,021	106
Residential real estate junior liens	105	—	138	1
Home equity lines of credit	—	—	—	—
Consumer secured	—	—	40	1
Total impaired loans with a valuation allowance	15,694	182	18,179	224
Impaired loans without a valuation allowance				
Commercial real estate	705	10	1,432	28
Commercial other	67	2	83	2
Agricultural real estate	3,360	42	1,819	23
Agricultural other	767	11	494	5
Home equity lines of credit	112	4	136	4
Consumer secured	31	1	—	—
Total impaired loans without a valuation allowance	5,042	70	3,964	62
Impaired loans				
Commercial	7,217	104	9,327	142
Agricultural	4,375	58	2,481	32
Residential real estate	9,113	89	10,295	111
Consumer	31	1	40	1
Total impaired loans	\$20,736	\$ 252	\$22,143	\$ 286

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	Nine Months Ended September 30			
	2016		2015	
	Average Interest Outstanding	Balance Recognized	Average Interest Outstanding	Balance Recognized
Impaired loans with a valuation allowance				
Commercial real estate	\$5,748	\$ 259	\$7,287	\$ 295
Commercial other	298	5	481	19
Agricultural real estate	91	6	29	1
Agricultural other	78	1	56	4
Residential real estate senior liens	9,439	278	10,812	323
Residential real estate junior liens	126	2	197	15
Home equity lines of credit	—	—	42	—
Consumer secured	—	—	46	3
Total impaired loans with a valuation allowance	15,780	551	18,950	660
Impaired loans without a valuation allowance				
Commercial real estate	995	57	2,356	163
Commercial other	92	6	94	7
Agricultural real estate	3,454	130	1,615	64
Agricultural other	574	27	300	13
Home equity lines of credit	118	12	149	14
Consumer secured	33	3	2	—
Total impaired loans without a valuation allowance	5,266	235	4,516	261
Impaired loans				
Commercial	7,133	327	10,218	484
Agricultural	4,197	164	2,000	82
Residential real estate	9,683	292	11,200	352
Consumer	33	3	48	3
Total impaired loans	\$21,046	\$ 786	\$23,466	\$ 921

As of September 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 September 30			2015		
	2016	2016	Post-Modification	2015	2015	Post-Modification
	Number	of Recorded	Recorded	Number	of Recorded	Recorded
	of	Loans	Investment	of	Loans	Investment
	Modification	Investment	Investment	Modification	Investment	Investment
Commercial other	1	\$ 1,315	\$ 1,315	3	\$ 1,926	\$ 1,926
Agricultural other	2	319	319	3	636	636
Residential real estate						
Senior liens	—	—	—	1	151	151
Junior liens	—	—	—	—	—	—
Home equity lines of credit	—	—	—	—	—	—
Total residential real estate	—	—	—	1	151	151
Consumer unsecured	—	—	—	—	—	—
Total	3	\$ 1,634	\$ 1,634	7	\$ 2,713	\$ 2,713

	Nine Months Ended September 30			2015		
	2016	2016	Post-Modification	2015	2015	Post-Modification
	Number	of Recorded	Recorded	Number	of Recorded	Recorded
	of	Loans	Investment	of	Loans	Investment
	Modification	Investment	Investment	Modification	Investment	Investment
Commercial other	1	\$ 1,315	\$ 1,315	8	\$ 2,511	\$ 2,511
Agricultural other	5	520	520	10	1,406	1,406
Residential real estate						
Senior liens	2	26	26	5	599	599
Junior liens	—	—	—	1	30	30
Home equity lines of credit	—	—	—	1	94	94
Total residential real estate	2	26	26	7	723	723
Consumer unsecured	1	2	2	—	—	—
Total	9	\$ 1,863	\$ 1,863	25	\$ 4,640	\$ 4,640

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

	Three Months Ended September 30			2015		
	2016	2016	Below Market	2015	2015	Below Market
	Number	of Recorded	Interest Rate and	Number	of Recorded	Interest Rate and
	of	Loans	Extension of	of	Loans	Extension of
	Modification	Investment	Amortization Period	Modification	Investment	Amortization Period
Commercial other	—	\$ —	1	\$ 1,315	3	\$ 1,926
Agricultural other	1	14	1	305	3	636
Residential real estate						
Senior liens	—	—	—	1	151	—
Junior liens	—	—	—	—	—	—
Home equity lines of credit	—	—	—	—	—	—
Total residential real estate	—	—	—	1	151	—
Consumer unsecured	—	—	—	—	—	—
Total	1	\$ 14	2	\$ 1,620	7	\$ 2,713



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	Nine Months Ended September 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	Investment	Number of Recorded Loans	Investment
Commercial other	—	\$ —	6	\$ 2,180
Agricultural other	1	14	9	1,360
Residential real estate				
Senior liens	2	26	2	201
Junior liens	—	—	—	—
Home equity lines of credit	—	—	—	—
Total residential real estate	2	26	2	201
Consumer unsecured	—	—	—	—
Total	3	\$ 40	17	\$ 3,741

We did not restructure any loans by forgiving principal or accrued interest in the three and nine month periods ended September 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 nine month periods ended September 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 nine month periods ended September 30, 2015, which were modified within 12 months prior to the default date.

	Three Months Ended September 30, 2015			Nine Months Ended September 30, 2015		
	Pre- Number of Recorded Loans	Charge-Off Recorded Upon Default	Post- Default Recorded Investment	Pre- Number of Recorded Loans	Charge-Off Recorded Upon Default	Post- Default Recorded Investment
Commercial other	1	\$ 216	\$ 25	1	\$ 216	\$ 25

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

	September 30, 2016	December 31, 2015
TDRs	\$ 20,522	\$ 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:

	September 30 2016	December 31 2015
FHLB Stock	\$ 11,700	\$ 11,700
Corporate Settlement Solutions, LLC	7,539	7,249
FRB Stock	1,999	1,999
Valley Financial Corporation	1,000	1,000
Other	335	338

Total	\$ 22,573	\$ 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:

	September 30 2016	December 31 2015
Consumer mortgage loans collateralized by residential real estate foreclosed as a result of obtaining physical possession	\$ 28	\$ —
All other foreclosed assets	256	421
Total	\$ 284	\$ 421

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

	Three Months Ended September 30	
	2016	2015
Balance, July 1	\$249	\$873
Properties transferred	95	234
Impairments	—	—
Proceeds from sale	(60 )	(506 )
Balance, September 30	\$284	\$601
	Nine Months Ended September 30	
	2016	2015
Balance, January 1	\$421	\$885
Properties transferred	211	1,043
Impairments	—	(22 )
Proceeds from sale	(348 )	(1,305 )
Balance, September 30	\$284	\$601

There were no consumer mortgage loans collateralized by residential real estate in the process of foreclosure as of September 30, 2016.

## Note 8 – Borrowed Funds

Borrowed funds consist of the following obligations as of:

	September 30, 2016		December 31, 2015	
	Amount	Rate	Amount	Rate
FHLB advances	\$250,000	2.19 %	\$235,000	1.93 %
Securities sold under agreements to repurchase without stated maturity dates	54,809	0.13 %	70,532	0.12 %
Federal funds purchased	20,600	0.67 %	4,200	0.75 %
Total	\$325,409	1.74 %	\$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:

	September 30, 2016		December 31, 2015	
	Amount	Rate	Amount	Rate
Fixed rate due 2016	\$20,000	1.40 %	\$30,000	1.25 %
Variable rate due 2016	—	— %	15,000	0.62 %
Fixed rate due 2017	50,000	1.77 %	50,000	1.56 %
Fixed rate due 2018	50,000	1.87 %	50,000	2.16 %
Fixed rate due 2019	60,000	2.55 %	40,000	2.35 %
Fixed rate due 2020	10,000	1.12 %	10,000	1.98 %
Fixed rate due 2021	40,000	3.10 %	30,000	2.26 %
Variable rate due 2021 <sup>1</sup>	10,000	1.23 %	—	— %
Fixed rate due 2023	10,000	3.53 %	10,000	3.90 %
Total	\$250,000	2.19 %	\$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 \$55,148 and \$70,555 at September 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 and federal funds purchased. We had no FRB Discount Window advances during the three and nine month periods ended September 30, 2016 or 2015.

	Three Months Ended September 30							
	2016				2015			
	Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period	%	Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period	%
Securities sold under agreements to repurchase without stated maturity dates	\$56,057	\$54,446	0.13	%	\$71,170	\$68,693	0.13	%
Federal funds purchased	20,600	8,848	0.69	%	13,100	7,265	0.51	%
	Nine Months Ended September 30							
	2016				2015			
	Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period	%	Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period	%
Securities sold under agreements to repurchase without stated maturity dates	\$61,783	\$57,159	0.13	%	\$84,859	\$70,399	0.13	%
Federal funds purchased	20,600	8,614	0.69	%	13,100	6,253	0.50	%

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

	September 30 2016	December 31 2015
Pledged to secure borrowed funds	\$ 358,795	\$ 339,078
Pledged to secure repurchase agreements	55,148	70,555

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Pledged for public deposits and for other purposes necessary or required by law	26,594	39,038
Total	\$ 440,537	\$ 448,671

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

	September 30 2016	December 31 2015
States and political subdivisions	\$ 6,906	\$ 3,639
Mortgage-backed securities	10,883	23,075
Collateralized mortgage obligations	37,359	43,841
Total	\$ 55,148	\$ 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 AFS securities to pledge to satisfy required collateral.

As of September 30, 2016, we had the ability to borrow up to an additional \$15,173, based on assets pledged as collateral. We had no investment securities that are restricted to be pledged for specific purposes.

#### Derivative Instruments

During the second quarter of 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 September 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	4.6	\$ 10,000	Other liabilities	\$(61 )

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		Nine Months	
	Ended		Ended	
	September 30		September 30	
	2016	2015	2016	2015
Audit and related fees	\$319	\$223	\$664	\$582
FDIC insurance premiums	224	204	646	619
Director fees	207	204	630	608
Consulting fees	198	124	567	341
Loan underwriting fees	142	98	377	248
Donations and community relations	134	155	374	412
Marketing costs	101	124	359	350
Education and travel	90	91	351	319
Postage and freight	95	94	292	284
Printing and supplies	103	111	286	309
Legal fees	68	121	226	273
All other	479	623	1,703	1,593
Total other	\$2,160	\$2,172	\$6,475	\$5,938

## 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		Nine Months	
	Ended		Ended	
	September 30		September 30	
	2016	2015	2016	2015
Income taxes at 34% statutory rate	\$1,481	\$1,723	\$4,036	\$4,959
Effect of nontaxable income				
Interest income on tax exempt municipal securities	(477 )	(509 )	(1,465 )	(1,519 )
Earnings on corporate owned life insurance policies	(62 )	(64 )	(192 )	(194 )
Effect of tax credits	(188 )	(175 )	(575 )	(542 )
Other	(19 )	(18 )	(55 )	(70 )
Total effect of nontaxable income	(746 )	(766 )	(2,287 )	(2,325 )
Effect of nondeductible expenses	28	45	106	116
Federal income tax expense	\$763	\$1,002	\$1,855	\$2,750

## 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.



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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 losses 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:

		September 30, 2016	
Valuation Technique	Fair Value	Unobservable Input	Range
		Discount applied to collateral appraisal:	
		Real Estate	20% - 30%
		Equipment	20% - 50%
Discounted appraisal value	\$8,844	Furniture, fixtures & equipment	45%
		Cash crop inventory	40%
		Other inventory	50%
		Accounts receivable	50%
		Liquor license	75%
		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.





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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:

September 30, 2016			
Valuation Technique	Fair Value	Unobservable Input	Range
Discount applied to collateral appraisal:			
Discounted appraisal value	\$284	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.

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.

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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, consisting 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.

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:

	September 30, 2016				
	Carrying Value	Estimated Fair Value	(Level 1)	(Level 2)	(Level 3)
<b>ASSETS</b>					
Cash and cash equivalents	\$21,335	\$ 21,335	\$21,335	\$ —	—
Mortgage loans AFS	685	691	—	691	—
Gross loans	989,366	979,645	—	—	979,645
Less allowance for loan and lease losses	7,800	7,800	—	—	7,800
Net loans	981,566	971,845	—	—	971,845
Accrued interest receivable	6,868	6,868	6,868	—	—
Equity securities without readily determinable fair values (1)	22,573	N/A	—	—	—
OMSR	2,068	2,068	—	2,068	—
<b>LIABILITIES</b>					
Deposits without stated maturities	739,035	739,035	739,035	—	—
Deposits with stated maturities	436,798	435,892	—	435,892	—
Borrowed funds	325,409	330,077	—	330,077	—
Accrued interest payable	542	542	542	—	—

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	December 31, 2015				
	Carrying Value	Estimated Fair Value	(Level 1)	(Level 2)	(Level 3)
<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.

**Financial Instruments Recorded at Fair Value**

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

	September 30, 2016				December 31, 2015			
	Total	(Level 1)	(Level 2)	(Level 3)	Total	(Level 1)	(Level 2)	(Level 3)
<b>Recurring items</b>								
<b>AFS securities</b>								
Government-sponsored enterprises	\$344	\$—	\$344	\$—	\$24,345	\$—	\$24,345	\$—
States and political subdivisions	219,689	—	219,689	—	232,217	—	232,217	—
Auction rate money market preferred	3,145	—	3,145	—	2,866	—	2,866	—
Preferred stocks	3,588	3,588	—	—	3,299	3,299	—	—
Mortgage-backed securities	226,649	—	226,649	—	263,384	—	263,384	—
Collateralized mortgage obligations	110,814	—	110,814	—	134,025	—	134,025	—
Total AFS securities	564,229	3,588	560,641	—	660,136	3,299	656,837	—
Derivative instruments	(61 )	—	(61 )	—	—	—	—	—
<b>Nonrecurring items</b>								
Impaired loans (net of the ALLL)	8,844	—	—	8,844	9,301	—	—	9,301
Foreclosed assets	284	—	—	284	421	—	—	421
Total	\$573,296	\$3,588	\$560,580	\$9,128	\$669,858	\$3,299	\$656,837	\$9,722
Percent of assets and liabilities measured at fair value		0.63 %	97.78 %	1.59 %		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 September 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 September 30, 2016.

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## Note 12 – Accumulated Other Comprehensive Income

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

	Three Months Ended September 30				2015			
	2016		2015		2015		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, July 1	\$10,982	\$ (100 )	\$ (3,315 )	\$7,567	\$1,937	\$ —	\$(3,808 )	\$(1,871)
OCI before reclassifications	(2,548 )	91	—	(2,457 )	5,301	—	—	5,301
Amounts reclassified from AOCI	—	—	—	—	—	—	—	—
Subtotal	(2,548 )	91	—	(2,457 )	5,301	—	—	5,301
Tax effect	937	(31 )	—	906	(1,818 )	—	—	(1,818 )
OCI, net of tax	(1,611 )	60	—	(1,551 )	3,483	—	—	3,483
Balance, September 30	\$9,371	\$ (40 )	\$ (3,315 )	\$6,016	\$5,420	\$ —	\$(3,808 )	\$1,612
	Nine Months Ended September 30				2015			
	2016		2015		2015		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, January 1	\$3,536	\$ —	\$ (3,315 )	\$221	\$3,302	\$ —	\$(3,808 )	\$(506 )
OCI before reclassifications	8,793	(61 )	—	8,732	3,137	—	—	3,137
Amounts reclassified from AOCI	(245 )	—	—	(245 )	—	—	—	—
Subtotal	8,548	(61 )	—	8,487	3,137	—	—	3,137
Tax effect	(2,713 )	21	—	(2,692 )	(1,019 )	—	—	(1,019 )
OCI, net of tax	5,835	(40 )	—	5,795	2,118	—	—	2,118
Balance, September 30	\$9,371	\$ (40 )	\$ (3,315 )	\$6,016	\$5,420	\$ —	\$(3,808 )	\$1,612

Included in OCI for the three and nine month periods ended September 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.

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

	Three Months Ended September 30			2015		
	2016			2015		
	Auction			Auction		
	Rate			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	\$208	\$(2,756 )	\$(2,548)	\$140	\$ 5,161	\$5,301
Reclassification adjustment for net realized (gains) losses included in net income	—	—	—	—	—	—
Net unrealized gains (losses)	208	(2,756 )	(2,548 )	140	5,161	5,301
Tax effect	—	937	937	—	(1,818 )	(1,818 )
Unrealized gains (losses), net of tax	\$208	\$(1,819 )	\$(1,611)	\$140	\$ 3,343	\$3,483
	Nine Months Ended September 30			2015		
	2016			2015		
	Auction			Auction		
	Rate			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	\$568	\$ 8,225	\$8,793	\$140	\$ 2,997	\$3,137
Reclassification adjustment for net realized (gains) losses included in net income	—	(245 )	(245 )	—	—	—
Net unrealized gains (losses)	568	7,980	8,548	140	2,997	3,137
Tax effect	—	(2,713 )	(2,713 )	—	(1,019 )	(1,019 )
Unrealized gains (losses), net of tax	\$568	\$ 5,267	\$5,835	\$140	\$ 1,978	\$2,118

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Interim Condensed Balance Sheets

	September 30 2016	December 31 2015
<b>ASSETS</b>		
Cash on deposit at the Bank	\$ 1,250	\$ 4,125
AFS securities	251	257
Investments in subsidiaries	145,320	133,883
Premises and equipment	1,983	2,014
Other assets	53,509	53,396
<b>TOTAL ASSETS</b>	<b>\$ 202,313</b>	<b>\$ 193,675</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Other liabilities	\$ 7,129	\$ 9,704
Shareholders' equity	195,184	183,971
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 202,313</b>	<b>\$ 193,675</b>

## Interim Condensed Statements of Income

	Three Months Ended September 30		Nine Months Ended September 30	
	2016	2015	2016	2015
<b>Income</b>				
Dividends from subsidiaries	\$2,000	\$1,700	\$5,600	\$5,000
Interest income	3	4	11	75
Management fee and other	1,680	1,859	4,962	4,913
<b>Total income</b>	<b>3,683</b>	<b>3,563</b>	<b>10,573</b>	<b>9,988</b>
<b>Expenses</b>				
Compensation and benefits	1,196	1,228	3,580	3,658
Occupancy and equipment	438	415	1,281	1,226
Audit and related fees	193	101	389	316
Other	427	501	1,561	1,533
<b>Total expenses</b>	<b>2,254</b>	<b>2,245</b>	<b>6,811</b>	<b>6,733</b>
Income before income tax benefit and equity in undistributed earnings of subsidiaries	1,429	1,318	3,762	3,255
Federal income tax benefit	199	123	616	588
Income before equity in undistributed earnings of subsidiaries	1,628	1,441	4,378	3,843
Undistributed earnings of subsidiaries	1,965	2,622	5,639	7,991
<b>Net income</b>	<b>\$3,593</b>	<b>\$4,063</b>	<b>\$10,017</b>	<b>\$11,834</b>



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## Interim Condensed Statements of Cash Flows

	Nine Months Ended September 30	
	2016	2015
Operating activities		
Net income	\$10,017	\$11,834
Adjustments to reconcile net income to cash provided by operations		
Undistributed earnings of subsidiaries	(5,639 )	(7,991 )
Undistributed earnings of equity securities without readily determinable fair values	(287 )	(364 )
Share-based payment awards under equity compensation plan	443	425
Depreciation	117	113
Changes in operating assets and liabilities which provided (used) cash		
Other assets	177	406
Accrued interest and other liabilities	(2,575 )	94
Net cash provided by (used in) operating activities	2,253	4,517
Investing activities		
Maturities, calls, principal payments, and sales of AFS securities	—	3,000
Purchases of premises and equipment	(86 )	(146 )
Net (advances to) repayments from subsidiaries	—	300
Net cash provided by (used in) investing activities	(86 )	3,154
Financing activities		
Net increase (decrease) in borrowed funds	—	(211 )
Cash dividends paid on common stock	(5,697 )	(5,416 )
Proceeds from the issuance of common stock	3,683	3,310
Common stock repurchased	(2,749 )	(3,588 )
Common stock purchased for deferred compensation obligations	(279 )	(279 )
Net cash provided by (used in) financing activities	(5,042 )	(6,184 )
Increase (decrease) in cash and cash equivalents	(2,875 )	1,487
Cash and cash equivalents at beginning of period	4,125	1,035
Cash and cash equivalents at end of period	\$1,250	\$2,522

## 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 September 30, 2016 and 2015 and each of the three and nine 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 nine month periods ended September 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 nine months ended September 30, 2016, we reported net income of \$3,593 and \$10,017 and earnings per common share of \$0.46 and \$1.28, respectively. Net income and earnings per common share for the same periods of 2015 were \$4,063 and \$11,834 and \$0.52 and \$1.52, respectively. While interest income for the first nine months of 2016 increased \$1,427 in comparison to the same period in 2015, the decrease in net income and earnings per common share is due primarily to changes in the provision for loan losses. During the first nine months of 2016, an increase in gross loans of \$138,874, offset by improvements in various credit quality indicators and net loan recoveries, resulted in a provision for loan losses in the amount of \$185. By contrast, during the first nine months of 2015, a reduction in gross loans during the period of \$235, coupled with significant improvements in various credit quality indicators, resulted in a reversal of the provision for loan losses in the amount of \$1,999.

During the nine month period ended September 30, 2016, total assets grew by 2.30% to \$1,706,498, and assets under management increased to \$2,406,108 which includes loans sold and serviced, and assets managed by our Investment and Trust Services Department of \$699,610. Total loans increased by \$138,874 from December 31, 2015 which was largely driven by growth in the commercial portfolio. During the third quarter of 2016, we began to participate in advances to mortgage brokers which contributed \$27,832 of the growth in the commercial loan portfolio. Growth in our residential mortgage and consumer loan portfolios has been challenging; however, we have seen growth during the first nine months of 2016. Our residential mortgage and consumer loan portfolios were \$260,122 and \$40,760 as of September 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 3.00% for the nine month period ended September 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 the remainder of 2016; therefore, we do not anticipate 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, growth in our investment and trust services, 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:

	September 30 2016	June 30 2016	March 31 2016	December 31 2015	September 30 2015	
<b>INCOME STATEMENT DATA</b>						
Interest income	\$ 13,607	\$ 13,218	\$ 13,081	\$ 13,023	\$ 12,967	
Interest expense	2,747	2,678	2,614	2,577	2,580	
Net interest income	10,860	10,540	10,467	10,446	10,387	
Provision for loan losses	17	12	156	(772)	(738)	)
Noninterest income	2,946	2,752	2,223	2,501	3,101	
Noninterest expenses	9,433	9,218	9,080	9,885	9,161	
Federal income tax expense	763	655	437	538	1,002	
Net Income	\$ 3,593	\$ 3,407	\$ 3,017	\$ 3,296	\$ 4,063	
<b>PER SHARE</b>						
Basic earnings	\$ 0.46	\$ 0.44	\$ 0.39	\$ 0.42	\$ 0.52	
Diluted earnings	\$ 0.45	\$ 0.43	\$ 0.38	\$ 0.41	\$ 0.51	
Dividends	\$ 0.25	\$ 0.24	\$ 0.24	\$ 0.24	\$ 0.24	
Tangible book value*	\$ 17.93	\$ 17.72	\$ 17.47	\$ 17.30	\$ 17.06	
Quoted market value						
High	\$ 28.08	\$ 28.25	\$ 29.90	\$ 29.90	\$ 23.85	
Low	\$ 27.60	\$ 27.63	\$ 27.25	\$ 23.50	\$ 22.75	
Close*	\$ 27.70	\$ 27.90	\$ 28.25	\$ 29.90	\$ 23.69	
Common shares outstanding*	7,833,481	7,836,442	7,809,079	7,799,867	7,765,333	
<b>PERFORMANCE RATIOS</b>						
Return on average total assets	0.85	% 0.81	% 0.72	% 0.81	% 1.01	%
Return on average shareholders' equity	7.27	% 7.05	% 6.37	% 7.17	% 9.03	%
Return on average tangible shareholders' equity	10.28	% 9.89	% 8.88	% 9.83	% 12.18	%
Net interest margin yield (FTE)	3.05	% 2.97	% 2.98	% 3.04	% 3.09	%
<b>BALANCE SHEET DATA*</b>						
Gross loans	\$ 989,366	\$ 919,594	\$ 870,291	\$ 850,492	\$ 836,671	
AFS securities	\$ 564,229	\$ 602,463	\$ 649,859	\$ 660,136	\$ 628,612	
Total assets	\$ 1,706,498	\$ 1,680,359	\$ 1,681,818	\$ 1,668,112	\$ 1,619,250	
Deposits	\$ 1,175,833	\$ 1,156,870	\$ 1,173,507	\$ 1,164,563	\$ 1,128,003	
Borrowed funds	\$ 325,409	\$ 318,596	\$ 307,896	\$ 309,732	\$ 297,610	
Shareholders' equity	\$ 195,184	\$ 195,133	\$ 190,247	\$ 183,971	\$ 182,998	
Gross loans to deposits	84.14	% 79.49	% 74.16	% 73.03	% 74.17	%
<b>ASSETS UNDER MANAGEMENT*</b>						
Loans sold with servicing retained	\$ 275,037	\$ 275,958	\$ 282,618	\$ 287,029	\$ 289,268	
Assets managed by our Investment and Trust Services Department	\$ 424,573	\$ 415,762	\$ 408,224	\$ 405,109	\$ 392,124	
Total assets under management	\$ 2,406,108	\$ 2,372,079	\$ 2,372,660	\$ 2,360,250	\$ 2,300,642	
<b>ASSET QUALITY*</b>						
Nonperforming loans to gross loans	0.16	% 0.13	% 0.12	% 0.09	% 0.10	%
Nonperforming assets to total assets	0.11	% 0.09	% 0.08	% 0.07	% 0.09	%
ALLL to gross loans	0.79	% 0.83	% 0.86	% 0.87	% 0.98	%
<b>CAPITAL RATIOS*</b>						

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Shareholders' equity to assets	11.44	% 11.61	% 11.31	% 11.03	% 11.30	%
Tier 1 leverage	8.59	% 8.50	% 8.44	% 8.52	% 8.54	%
Common equity tier 1 capital	12.41	% 13.08	% 13.24	% 13.44	% 13.57	%
Tier 1 risk-based capital	12.41	% 13.08	% 13.24	% 13.44	% 13.57	%
Total risk-based capital	13.10	% 13.80	% 13.97	% 14.17	% 14.20	%

\* 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 nine month periods ended:

	September 30 2016	September 30 2015	September 30 2014	September 30 2013	September 30 2012	
<b>INCOME STATEMENT DATA</b>						
Interest income	\$39,906	\$38,479	\$38,118	\$37,695	\$40,174	
Interest expense	8,039	7,586	7,466	8,338	10,372	
Net interest income	31,867	30,893	30,652	29,357	29,802	
Provision for loan losses	185	(1,999)	(604)	866	1,100	
Noninterest income	7,921	7,858	6,899	8,045	8,844	
Noninterest expenses	27,731	26,166	26,180	25,057	25,507	
Federal income tax expense	1,855	2,750	1,696	1,893	2,344	
Net Income	\$10,017	\$11,834	\$10,279	\$9,586	\$9,695	
<b>PER SHARE</b>						
Basic earnings	\$1.28	\$1.52	\$1.33	\$1.25	\$1.28	
Diluted earnings	\$1.25	\$1.49	\$1.30	\$1.22	\$1.24	
Dividends	\$0.73	\$0.70	\$0.66	\$0.63	\$0.60	
Tangible book value*	\$17.93	\$17.06	\$16.33	\$15.43	\$14.65	
Quoted market value						
High	\$29.90	\$23.85	\$24.00	\$26.00	\$24.98	
Low	\$27.25	\$22.00	\$21.73	\$21.55	\$22.30	
Close*	\$27.70	\$23.69	\$23.60	\$24.85	\$22.50	
Common shares outstanding*	7,833,481	7,765,333	7,740,730	7,709,781	7,611,350	
<b>PERFORMANCE RATIOS</b>						
Return on average total assets	0.80	% 1.00	% 0.90	% 0.89	% 0.94	%
Return on average shareholders' equity	6.90	% 8.80	% 8.13	% 7.84	% 8.37	%
Return on average tangible shareholders' equity	9.68	% 12.06	% 10.95	% 11.02	% 11.96	%
Net interest margin yield (FTE)	3.00	% 3.12	% 3.20	% 3.22	% 3.46	%
<b>BALANCE SHEET DATA*</b>						
Gross loans	\$989,366	\$836,671	\$825,238	\$810,335	\$768,452	
AFS securities	\$564,229	\$628,612	\$575,080	\$501,057	\$467,414	
Total assets	\$1,706,498	\$1,619,250	\$1,553,974	\$1,459,341	\$1,389,138	
Deposits	\$1,175,833	\$1,128,003	\$1,081,890	\$1,023,931	\$989,491	
Borrowed funds	\$325,409	\$297,610	\$290,438	\$266,001	\$226,580	
Shareholders' equity	\$195,184	\$182,998	\$172,076	\$161,305	\$164,147	
Gross loans to deposits	84.14	% 74.17	% 76.28	% 79.14	% 77.66	%
<b>ASSETS UNDER MANAGEMENT*</b>						
Loans sold with servicing retained	\$275,037	\$289,268	\$290,697	\$294,999	\$304,523	
Assets managed by our Investment and Trust Services Department	\$424,573	\$392,124	\$374,878	\$351,505	\$321,661	
Total assets under management	\$2,406,108	\$2,300,642	\$2,219,549	\$2,105,845	\$2,015,322	
<b>ASSET QUALITY*</b>						
Nonperforming loans to gross loans	0.16	% 0.10	% 0.56	% 0.53	% 0.98	%
Nonperforming assets to total assets	0.11	% 0.09	% 0.37	% 0.37	% 0.68	%
ALLL to gross loans	0.79	% 0.98	% 1.26	% 1.44	% 1.57	%
<b>CAPITAL RATIOS*</b>						
Shareholders' equity to assets	11.44	% 11.30	% 11.07	% 11.05	% 11.82	%
Tier 1 leverage	8.59	% 8.54	% 8.47	% 8.45	% 8.27	%

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Common equity tier 1 capital	12.41	% 13.57	% N/A	N/A	N/A	
Tier 1 risk-based capital	12.41	% 13.57	% 13.86	% 13.75	% 13.35	%
Total risk-based capital	13.10	% 14.20	% 15.11	% 15.00	% 14.60	%

\* 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								
	September 30, 2016			June 30, 2016			September 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	\$948,465	\$ 9,965	4.20 %	\$893,282	\$ 9,317	4.17 %	\$831,520	\$ 8,984	4.32 %
Taxable investment securities	365,612	2,037	2.23 %	419,252	2,303	2.20 %	402,993	2,310	2.29 %
Nontaxable investment securities	203,236	2,312	4.55 %	208,425	2,356	4.52 %	207,443	2,459	4.74 %
Other	25,134	194	3.09 %	23,564	157	2.67 %	27,689	166	2.40 %
Total earning assets	1,542,447	14,508	3.76 %	1,544,523	14,133	3.66 %	1,469,645	13,919	3.79 %
<b>NONEARNING ASSETS</b>									
Allowance for loan losses	(7,731)			(7,557)			(9,007)		
Cash and demand deposits due from banks	18,672			17,942			18,442		
Premises and equipment	28,865			28,363			26,904		
Accrued income and other assets	104,125			101,341			98,767		
Total assets	\$ 1,686,378			\$ 1,684,612			\$ 1,604,751		
<b>INTEREST BEARING LIABILITIES</b>									
Interest bearing demand deposits	\$203,994	41	0.08 %	\$204,044	40	0.08 %	\$198,351	40	0.08 %
Savings deposits	330,872	178	0.22 %	340,251	144	0.17 %	306,816	123	0.16 %
Time deposits	433,591	1,277	1.18 %	427,753	1,234	1.15 %	434,103	1,317	1.21 %
Borrowed funds	314,218	1,251	1.59 %	320,337	1,260	1.57 %	292,858	1,100	1.50 %
Total interest bearing liabilities	1,282,675	2,747	0.86 %	1,292,385	2,678	0.83 %	1,232,128	2,580	0.84 %
<b>NONINTEREST BEARING LIABILITIES</b>									
Demand deposits	196,682			189,520			181,289		
Other	9,332			9,360			11,357		
Shareholders' equity	197,689			193,347			179,977		
Total liabilities and shareholders' equity	\$ 1,686,378			\$ 1,684,612			\$ 1,604,751		
Net interest income (FTE)		\$ 11,761			\$ 11,455			\$ 11,339	
Net yield on interest earning assets (FTE)			3.05 %			2.97 %			3.09 %





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	Nine Months Ended September 30, 2016			September 30, 2015		
	Average Balance	Tax Equivalent Interest	Average Yield / Rate	Average Balance	Tax Equivalent Interest	Average Yield / Rate
<b>INTEREST EARNING ASSETS</b>						
Loans	\$900,021	\$ 28,320	4.20 %	\$826,393	\$ 26,884	4.34 %
Taxable investment securities	405,722	6,740	2.21 %	388,964	6,655	2.28 %
Nontaxable investment securities	207,769	7,091	4.55 %	202,294	7,423	4.89 %
Other	25,208	509	2.69 %	25,769	444	2.30 %
Total earning assets	1,538,720	42,660	3.70 %	1,443,420	41,406	3.82 %
<b>NONEARNING ASSETS</b>						
Allowance for loan losses	(7,576 )			(9,630 )		
Cash and demand deposits due from banks	18,130			17,824		
Premises and equipment	28,495			26,481		
Accrued income and other assets	102,072			98,124		
Total assets	\$1,679,841			\$1,576,219		
<b>INTEREST BEARING LIABILITIES</b>						
Interest bearing demand deposits	\$205,444	123	0.08 %	\$194,648	116	0.08 %
Savings deposits	337,863	466	0.18 %	284,886	311	0.15 %
Time deposits	427,441	3,724	1.16 %	435,853	3,978	1.22 %
Borrowed funds	315,061	3,726	1.58 %	292,127	3,181	1.45 %
Total interest bearing liabilities	1,285,809	8,039	0.83 %	1,207,514	7,586	0.84 %
<b>NONINTEREST BEARING LIABILITIES</b>						
Demand deposits	191,082			178,353		
Other	9,435			11,106		
Shareholders' equity	193,515			179,246		
Total liabilities and shareholders' equity	\$1,679,841			\$1,576,219		
Net interest income (FTE)		\$ 34,621			\$ 33,820	
Net yield on interest earning assets (FTE)			3.00 %			3.12 %
<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 September 30, 2016 Compared to June 30, 2016			Three Months Ended September 30, 2016 Compared to September 30, 2015			Nine Months Ended September 30, 2016 Compared to September 30, 2015		
	Volume	Rate	Net	Volume	Rate	Net	Volume	Rate	Net
Changes in interest income									
Loans	\$579	\$ 69	\$648	\$1,234	\$(253)	\$981	\$2,338	\$(902)	\$1,436
Taxable investment securities	(298)	32	(266)	(210)	(63)	(273)	282	(197)	85
Nontaxable investment securities	(59)	15	(44)	(49)	(98)	(147)	197	(529)	(332)
Other	11	26	37	(16)	44	28	(10)	75	65
Total changes in interest income	233	142	375	959	(370)	589	2,807	(1,553)	1,254
Changes in interest expense									
Interest bearing demand deposits	—	1	1	1	—	1	6	1	7
Savings deposits	(4)	38	34	10	45	55	64	91	155
Time deposits	17	26	43	(2)	(38)	(40)	(76)	(178)	(254)
Borrowed funds	(24)	15	(9)	83	68	151	260	285	545
Total changes in interest expense	(11)	80	69	92	75	167	254	199	453
Net change in interest margin (FTE)	\$244	\$ 62	\$306	\$867	\$(445)	\$422	\$2,553	\$(1,752)	\$801

Our net yield on interest earning assets remains at historically low levels as a result of the persistent low interest rate environment. While we do not anticipate significant improvement in our net yield on interest earning assets, we do expect marginal improvement as a result of loan growth throughout 2016.

	Average Yield / Rate for the Three Month Periods Ended:					
	September 30, 2016	June 30, 2016	March 31, 2016	December 31, 2015	September 30, 2015	
Total earning assets	3.76%	3.66%	3.67%	3.73%	3.79%	%
Total interest bearing liabilities	0.86%	0.83%	0.82%	0.83%	0.84%	%
Net yield on interest earning assets (FTE)	3.05%	2.97%	2.98%	3.04%	3.09%	%

	Quarter to Date Net Interest Income (FTE)				
	September 30, 2016	June 30, 2016	March 31, 2016	December 31, 2015	September 30, 2015
Total interest income (FTE)	\$14,508	\$14,133	\$14,020	\$13,970	\$13,919
Total interest expense	2,747	2,678	2,614	2,577	2,580
Net interest income (FTE)	\$11,761	\$11,455	\$11,406	\$11,393	\$11,339

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## Allowance for Loan and Lease Losses

The viability of any financial institution is ultimately determined by its management of credit risk. Loans represent our single largest concentration of risk. The ALLL is our estimation of incurred losses within the existing loan portfolio. We allocate the ALLL throughout the loan portfolio based on our assessment of the underlying risks associated with each loan segment. Our assessments include allocations based on specific impairment valuation allowances, historical charge-offs, internally assigned credit risk ratings, and past due and nonaccrual balances. A portion of the ALLL is not allocated to any one loan segment, but is instead a reflection of other qualitative risks that reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

The following table summarizes our charge-offs, recoveries, provisions for loan losses, and ALLL balances as of, and for the:

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2016	2015	2016	2015
ALLL at beginning of period	\$7,600	\$9,000	\$7,400	\$10,100
Charge-offs				
Commercial and agricultural	—	61	48	89
Residential real estate	57	70	426	325
Consumer	74	79	206	252
Total charge-offs	131	210	680	666
Recoveries				
Commercial and agricultural	118	68	488	459
Residential real estate	153	33	248	152
Consumer	43	47	159	154
Total recoveries	314	148	895	765
Net loan charge-offs	(183 )	62	(215 )	(99 )
Provision for loan losses	17	(738 )	185	(1,999 )
ALLL at end of period	\$7,800	\$8,200	\$7,800	\$8,200
Net loan charge-offs to average loans outstanding	(0.02 )%	0.01 %	(0.02 )%	(0.01 )%

The following table summarizes our charge-offs, recoveries, provisions for loan losses, and ALLL balances as of, and for the three month periods ended:

	September 30	June 30	March 31	December 31	September 30
	2016	2016	2016	2015	2015
Total charge-offs	\$ 131	\$208	\$341	\$ 238	\$ 210
Total recoveries	314	296	285	210	148
Net loan charge-offs	(183 )	(88 )	56	28	62
Net loan charge-offs to average loans outstanding	(0.02 )%	(0.01 )%	0.01 %	— %	0.01 %
Provision for loan losses	\$ 17	\$12	\$156	\$(772 )	\$(738 )
Provision for loan losses to average loans outstanding	— %	— %	0.02 %	(0.09 )%	(0.09 )%
ALLL	\$ 7,800	\$7,600	\$7,500	\$ 7,400	\$ 8,200
ALLL as a % of loans at end of period	0.79 %	0.83 %	0.86 %	0.87 %	0.98 %

During 2015, net loan recoveries and continued improvement in credit quality indicators resulted in a reduction of the ALLL in both amount and as a percentage of loans. While we have experienced significant loan growth during 2016, the level of ALLL as of September 30, 2016 has not increased at the same rate. We continue to experience improvements in various credit quality indicators, specifically historical loss factors which have led to lower levels of required reserves. The addition of advances to mortgage brokers contributed to the overall decline in the level of ALLL to gross loans as there are no historical losses requiring reserves. While these advances contribute to other qualitative factors, the impact is not significant on the required level of the ALLL. Additionally, our recoveries

continue to exceed our charge-offs which has increased the ALLL and led to lower provision for loan losses expense.

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The following table illustrates our changes within the two main components of the ALLL as of:

	September 30 2016	June 30 2016	March 31 2016	December 31 2015	September 30 2015	
<b>ALLL</b>						
Individually evaluated for impairment	\$ 2,523	\$2,602	\$2,731	\$ 2,820	\$ 3,217	
Collectively evaluated for impairment	5,277	4,998	4,769	4,580	4,983	
<b>Total</b>	<b>\$ 7,800</b>	<b>\$7,600</b>	<b>\$7,500</b>	<b>\$ 7,400</b>	<b>\$ 8,200</b>	
<b>ALLL to gross loans</b>						
Individually evaluated for impairment	0.26	% 0.28	% 0.31	% 0.33	% 0.38	%
Collectively evaluated for impairment	0.53	% 0.55	% 0.55	% 0.54	% 0.60	%
<b>Total</b>	<b>0.79</b>	<b>% 0.83</b>	<b>% 0.86</b>	<b>% 0.87</b>	<b>% 0.98</b>	<b>%</b>

While more volatile, loans individually evaluated for impairment have been relatively flat in recent quarters. The lower levels of loans collectively evaluated for impairment over the past year illustrates the downward trend we are experiencing in our overall level of ALLL to gross loans. As we anticipate continued loan growth during 2016, the level of those collectively evaluated for impairment is expected to increase provided there are no significant increases to the level of loans individually evaluated for impairment.

For further discussion of the allocation of the ALLL, see “Note 5 – Loans and ALLL” of our interim condensed consolidated financial statements.

**Loans Past Due and Loans in Nonaccrual Status**

Fluctuations in past due and nonaccrual status loans can have a significant impact on the ALLL. To determine the potential impact, and corresponding estimated losses, we analyze our historical loss trends on loans past due greater than 30 days and nonaccrual status loans. We monitor all loans that are past due and in nonaccrual status for indications of additional deterioration.

	<b>Total Past Due and Nonaccrual Loans</b>					
	September 30 2016	June 30 2016	March 31 2016	December 31 2015	September 30 2015	
Commercial and agricultural	\$3,148	\$2,247	\$2,167	\$ 2,247	\$ 1,709	
Residential real estate	2,436	2,755	2,847	2,520	2,030	
Consumer	51	23	28	31	60	
<b>Total</b>	<b>\$5,635</b>	<b>\$5,025</b>	<b>\$5,042</b>	<b>\$ 4,798</b>	<b>\$ 3,799</b>	
<b>Total past due and nonaccrual loans to gross loans</b>	<b>0.57</b>	<b>% 0.55</b>	<b>% 0.58</b>	<b>% 0.56</b>	<b>% 0.45</b>	<b>%</b>

While we experienced an increase in loans past due and nonaccrual during the third quarter, our level of past due and nonaccrual status loans remain low. These levels are the result of strengthened loan performance throughout all loan segments. A summary of loans past due and in nonaccrual status, including the composition of the ending balance of nonaccrual status loans by type, is included in “Note 5 – Loans and ALLL” of our interim condensed consolidated financial statements.

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## Troubled Debt Restructurings

We have taken a proactive approach to avoid foreclosures on borrowers who are willing to work with us in modifying their loans, thus making them more affordable. While this approach has permitted certain borrowers to develop a payment structure that will allow them to continue making payments in lieu of foreclosure, it has contributed to a significant increase in the level of loans classified as TDRs. The modifications have been successful for us and our customers as very few of the modified loans have resulted in foreclosures. At the time of the TDR, the loan is reviewed to determine whether or not to classify the loan as accrual or nonaccrual status. The majority of new modifications result in terms that satisfy our criteria for continued interest accrual. TDRs that have been placed on nonaccrual status may be placed back on accrual status after six months of continued performance.

We restructure debt with borrowers who, due to temporary financial difficulties, are unable to service their debt under the original terms. We may extend the amortization period, reduce interest rates, forgive principal, forgive interest, or a combination of these modifications. Typically, the modifications are for a period of five years or less. There were no TDRs that were government sponsored as of September 30, 2016 or December 31, 2015.

Losses associated with TDRs, if any, are included in the estimation of the ALLL in the quarter in which a loan is identified as a TDR, and we review the analysis of the ALLL estimation each reporting period to ensure its continued appropriateness.

The following tables provide a roll-forward of TDRs for the:

	Three Months Ended September 30, 2016					
	Accruing Interest		Nonaccrual		Total	
	Number	Balance	Number	Balance	Number	Balance
	of Loans	of Loans	of Loans	of Loans	of Loans	of Loans
July 1, 2016	151	\$ 18,843	6	\$ 587	157	\$ 19,430
New modifications	3	1,634	—	—	3	1,634
Principal advances (payments)	—	(204 )	—	(9 )	—	(213 )
Loans paid-off	(5 )	(272 )	—	—	(5 )	(272 )
Partial charge-offs	—	—	—	—	—	—
Balances charged-off	(1 )	(57 )	—	—	(1 )	(57 )
Transfers to OREO	—	—	—	—	—	—
Transfers to accrual status	3	218	(3)	(218 )	—	—
Transfers to nonaccrual status	(2 )	(103 )	2	103	—	—
September 30, 2016	149	\$ 20,059	5	\$ 463	154	\$ 20,522
	Nine Months Ended September 30, 2016					
	Accruing Interest		Nonaccrual		Total	
	Number	Balance	Number	Balance	Number	Balance
	of Loans	of Loans	of Loans	of Loans	of Loans	of Loans
January 1, 2016	155	\$ 20,931	5	\$ 394	160	\$ 21,325
New modifications	9	1,863	—	—	9	1,863
Principal advances (payments)	—	(831 )	—	(26 )	—	(857 )
Loans paid-off	(11 )	(1,348 )	(1)	(221 )	(12 )	(1,569 )
Partial charge-offs	—	—	—	(133 )	—	(133 )
Balances charged-off	(2 )	(72 )	—	—	(2 )	(72 )
Transfers to OREO	—	—	(1)	(35 )	(1 )	(35 )
Transfers to accrual status	3	218	(3)	(218 )	—	—
Transfers to nonaccrual status	(5 )	(702 )	5	702	—	—
September 30, 2016	149	\$ 20,059	5	\$ 463	154	\$ 20,522



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	Three Months Ended September 30, 2015					
	Accruing Interest		Nonaccrual		Total	
	Number	Balance	Number	Balance	Number	Balance
	of Loans	of Loans	of Loans	of Loans	of Loans	of Loans
July 1, 2015	156	\$ 19,518	5	\$ 940	161	\$ 20,458
New modifications	5	2,543	2	170	7	2,713
Principal advances (payments)		(308 )		(552 )	—	(860 )
Loans paid-off	(4 )	(638 )	(1)	(1 )	(5 )	(639 )
Partial charge-offs		—		(25 )	—	(25 )
Balances charged-off	—	—	—	—	—	—
Transfers to OREO	—	—	(1)	(190 )	(1 )	(190 )
Transfers to accrual status	1	30	(1)	(30 )	—	—
Transfers to nonaccrual status	(1 )	(21 )	1	21	—	—
September 30, 2015	157	\$ 21,124	5	\$ 333	162	\$ 21,457

	Nine Months Ended September 30, 2015					
	Accruing Interest		Nonaccrual		Total	
	Number	Balance	Number	Balance	Number	Balance
	of Loans	of Loans	of Loans	of Loans	of Loans	of Loans
January 1, 2015	156	\$ 20,931	13	\$ 2,410	169	\$ 23,341
New modifications	21	4,149	4	491	25	4,640
Principal advances (payments)	—	(1,033 )	—	(977 )	—	(2,010 )
Loans paid-off	(19 )	(3,016 )	(7)	(597 )	(26)	(3,613 )
Partial charge-offs	—	—	—	(87 )	—	(87 )
Balances charged-off	(1 )	(39 )	—	—	(1 )	(39 )
Transfers to OREO	—	—	(5)	(775 )	(5 )	(775 )
Transfers to accrual status	3	292	(3)	(292 )	—	—
Transfers to nonaccrual status	(3 )	(160 )	3	160	—	—
September 30, 2015	157	\$ 21,124	5	\$ 333	162	\$ 21,457

The following table summarizes our TDRs as of:

	September 30, 2016			December 31, 2015			Total Change
	Accruing Interest	Nonaccrual	Total	Accruing Interest	Nonaccrual	Total	
Current	\$ 18,787	\$ 201	\$ 18,988	\$ 20,550	\$ 146	\$ 20,696	\$(1,708)
Past due 30-59 days	367	235	602	357	—	357	245
Past due 60-89 days	308	—	308	24	—	24	284
Past due 90 days or more	597	27	624	—	248	248	376
Total	\$ 20,059	\$ 463	\$ 20,522	\$ 20,931	\$ 394	\$ 21,325	\$(803 )

Additional disclosures about TDRs are included in “Note 5 – Loans and ALLL” of our interim condensed consolidated financial statements.



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## Impaired Loans

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

	September 30, 2016			December 31, 2015		
	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance
<b>TDRs</b>						
Commercial real estate	\$6,156	\$6,274	\$ 719	\$7,619	\$7,858	\$ 818
Commercial other	1,460	1,471	85	188	199	11
Agricultural real estate	3,538	3,538	15	3,549	3,549	—
Agricultural other	982	982	1	519	519	2
Residential real estate senior liens	8,175	8,553	1,603	9,155	9,457	1,851
Residential real estate junior liens	74	74	14	133	133	28
Home equity lines of credit	108	408	—	127	427	—
Consumer secured	29	29	—	35	35	—
<b>Total TDRs</b>	<b>20,522</b>	<b>21,329</b>	<b>2,437</b>	<b>21,325</b>	<b>22,177</b>	<b>2,710</b>
<b>Other impaired loans</b>						
Commercial real estate	103	117	—	162	175	—
Commercial other	—	—	—	—	—	—
Agricultural real estate	—	—	—	—	—	—
Agricultural other	—	—	—	—	—	—
Residential real estate senior liens	433	640	85	841	1,308	108
Residential real estate junior liens	2	12	1	10	30	2
Home equity lines of credit	—	—	—	—	7	—
Consumer secured	—	—	—	—	—	—
<b>Total other impaired loans</b>	<b>538</b>	<b>769</b>	<b>86</b>	<b>1,013</b>	<b>1,520</b>	<b>110</b>
<b>Total impaired loans</b>	<b>\$21,060</b>	<b>\$22,098</b>	<b>\$ 2,523</b>	<b>\$22,338</b>	<b>\$23,697</b>	<b>\$ 2,820</b>

Additional disclosure related to impaired loans is included in “Note 5 – Loans and ALLL” of our interim condensed consolidated financial statements.

## Nonperforming Assets

The following table summarizes our nonperforming assets as of:

	September 30 2016	June 30 2016	March 31 2016	December 31 2015	September 30 2015
Nonaccrual status loans	\$ 690	\$974	\$1,016	\$ 792	\$ 796
Accruing loans past due 90 days or more	847	208	55	—	—
<b>Total nonperforming loans</b>	<b>1,537</b>	<b>1,182</b>	<b>1,071</b>	<b>792</b>	<b>796</b>
Foreclosed assets	284	249	276	421	601
<b>Total nonperforming assets</b>	<b>\$ 1,821</b>	<b>\$1,431</b>	<b>\$1,347</b>	<b>\$ 1,213</b>	<b>\$ 1,397</b>
Nonperforming loans as a % of total loans	0.16 %	0.13 %	0.12 %	0.09 %	0.10 %
Nonperforming assets as a % of total assets	0.11 %	0.09 %	0.08 %	0.07 %	0.09 %

After a loan is 90 days past due, it is placed on nonaccrual status unless it 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. Loans may be placed back on accrual status after six months of continued performance. Total nonperforming loans continues to be at historic low levels.

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Included in the nonaccrual loan balances above were loans currently classified as TDRs as of:

	September 30 2016	December 31 2015
Commercial and agricultural	\$ —	\$ 232
Residential real estate	463	162
Total	\$ 463	\$ 394

Additional disclosures about nonaccrual status loans are included in “Note 5 – Loans and ALLL” of our interim condensed consolidated financial statements.

We continue to devote considerable attention to identifying impaired loans and adjusting the net carrying value of these loans to their current net realizable values through the establishment of a specific reserve or the recording of a charge-off. We believe that we have identified all impaired loans as of September 30, 2016.

We believe that the level of the ALLL is appropriate as of September 30, 2016. We will continue to closely monitor overall credit quality indicators and our policies and procedures related to the analysis of the ALLL to ensure that the ALLL remains at the appropriate level.

#### Noninterest Income and Noninterest Expenses

Significant noninterest account balances are highlighted in the following table with additional descriptions of significant fluctuations:

	Three Months Ended September 30			
	2016	2015	Change	
			\$	%
Service charges and fees				
ATM and debit card fees	\$606	\$708	\$(102)	(14.41)%
NSF and overdraft fees	480	492	(12)	(2.44)%
Freddie Mac servicing fee	172	179	(7)	(3.91)%
Service charges on deposit accounts	92	88	4	4.55%
Net OMSR income (loss)	(108)	(34)	(74)	(217.65)%
All other	34	35	(1)	(2.86)%
Total service charges and fees	1,276	1,468	(192)	(13.08)%
Net gain on sale of mortgage loans	263	157	106	67.52%
Earnings on corporate owned life insurance policies	183	188	(5)	(2.66)%
Net gains (losses) on sale of AFS securities	—	—	—	—%
Other				
Trust and brokerage advisory fees	1,000	538	462	85.87%
Corporate Settlement Solutions joint venture	145	399	(254)	(63.66)%
Other	79	351	(272)	(77.49)%
Total other	1,224	1,288	(64)	(4.97)%
Total noninterest income	\$2,946	\$3,101	\$(155)	(5.00)%

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	Nine Months Ended September 30				
	2016	2015	Change		
			\$	%	
Service charges and fees					
ATM and debit card fees	\$1,840	\$1,798	\$42	2.34	%
NSF and overdraft fees	1,360	1,392	(32 )	(2.30	)%
Freddie Mac servicing fee	529	538	(9 )	(1.67	)%
Service charges on deposit accounts	263	258	5	1.94	%
Net OMSR income (loss)	(437 )	(61 )	(376)	(616.39)	%
All other	97	99	(2 )	(2.02	)%
Total service charges and fees	3,652	4,024	(372)	(9.24	)%
Net gain on sale of mortgage loans	472	472	—	—	%
Earnings on corporate owned life insurance policies	566	570	(4 )	(0.70	)%
Net gains (losses) on sale of AFS securities	245	—	245	N/M	
Other					
Trust and brokerage advisory fees	2,135	1,640	495	30.18	%
Corporate Settlement Solutions joint venture	362	518	(156)	(30.12	)%
Other	489	634	(145)	(22.87	)%
Total other	2,986	2,792	194	6.95	%
Total noninterest income	\$7,921	\$7,858	\$63	0.80	%

Significant changes in noninterest income are detailed below:

• ATM and debit card fees fluctuate from period-to-period based on usage of ATM and debit cards. Income for the remainder of 2016 is expected to approximate 2015 levels.

• NSF and overdraft fees fluctuate from period-to-period based on customer activity as well as the number of business days in the period. We anticipate NSF and overdraft fees in 2016 to approximate 2015 levels.

Offering rates on residential mortgage loans and increased prepayment speeds have been the most significant drivers behind fluctuations in net OMSR income (loss). While mortgage rates are expected to approximate current levels in the foreseeable future, we anticipate increases in our originations in purchase money mortgage activity as a result of our various initiatives to drive growth. As such, we anticipate net OMSR income (loss) to improve during the remainder of 2016 based on volume.

• We are continually analyzing our AFS security portfolio for potential sale opportunities. During the second quarter of 2016, we identified several mortgage-backed securities with unrealized gains that had less than desirable yields. There were none identified during the third quarter; however, we may continue to sell AFS securities with low yields during the remainder of 2016.

• We continue to invest considerable efforts to increase our market share in trust and brokerage advisory services. These efforts have translated into increases in trust fees and brokerage and advisory fees. We anticipate that these fees will continue to increase during the remainder of 2016 but not at the same rate as the third quarter.

• The fluctuations in all other income is spread throughout various categories, none of which are individually significant.

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Significant noninterest expense account balances are highlighted in the following table with additional descriptions of significant fluctuations:

	Three Months Ended September 30				Change	
	2016	2015	\$		%	
Compensation and benefits						
Employee salaries	\$3,431	\$3,427	\$4	0.12	%	
Employee benefits	1,509	1,323	\$186	14.06	%	
Total compensation and benefits	4,940	4,750	190	4.00	%	
Furniture and equipment						
Service contracts	822	780	42	5.38	%	
Depreciation	483	473	10	2.11	%	
ATM and debit card fees	210	232	(22 )	(9.48 )	%	
All other	28	26	2	7.69	%	
Total furniture and equipment	1,543	1,511	32	2.12	%	
Occupancy						
Depreciation	195	180	15	8.33	%	
Outside services	171	167	4	2.40	%	
Utilities	168	130	38	29.23	%	
Property taxes	141	135	6	4.44	%	
All other	115	116	(1 )	(0.86 )	%	
Total occupancy	790	728	62	8.52	%	
Other						
Audit and related fees	319	223	96	43.05	%	
FDIC insurance premiums	224	204	20	9.80	%	
Director fees	207	204	3	1.47	%	
Consulting fees	198	124	74	59.68	%	
Loan underwriting fees	142	98	44	44.90	%	
Donations and community relations	134	155	(21 )	(13.55 )	%	
Marketing costs	101	124	(23 )	(18.55 )	%	
Education and travel	90	91	(1 )	(1.10 )	%	
Postage and freight	95	94	1	1.06	%	
Printing and supplies	103	111	(8 )	(7.21 )	%	
Legal fees	68	121	(53 )	(43.80 )	%	
All other	479	623	(144 )	(23.11 )	%	
Total other	2,160	2,172	(12 )	(0.55 )	%	
Total noninterest expenses	\$9,433	\$9,161	\$272	2.97	%	

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	Nine Months Ended September 30				
	2016	2015	Change		
			\$	%	
Compensation and benefits					
Employee salaries	\$10,056	\$10,059	\$(3)	(0.03)	%
Employee benefits	4,356	3,797	559	14.72	%
Total compensation and benefits	14,412	13,856	556	4.01	%
Furniture and equipment					
Service contracts	2,314	2,220	94	4.23	%
Depreciation	1,533	1,390	143	10.29	%
ATM and debit card fees	627	564	63	11.17	%
All other	90	77	13	16.88	%
Total furniture and equipment	4,564	4,251	313	7.36	%
Occupancy					
Depreciation	583	535	48	8.97	%
Outside services	555	542	13	2.40	%
Utilities	429	404	25	6.19	%
Property taxes	429	400	29	7.25	%
All other	284	240	44	18.33	%
Total occupancy	2,280	2,121	159	7.50	%
Other					
Audit and related fees	664	582	82	14.09	%
FDIC insurance premiums	646	619	27	4.36	%
Director fees	630	608	22	3.62	%
Consulting fees	567	341	226	66.28	%
Loan underwriting fees	377	248	129	52.02	%
Donations and community relations	374	412	(38)	(9.22)	%
Marketing costs	359	350	9	2.57	%
Education and travel	351	319	32	10.03	%
Postage and freight	292	284	8	2.82	%
Printing and supplies	286	309	(23)	(7.44)	%
Legal fees	226	273	(47)	(17.22)	%
All other	1,703	1,593	110	6.91	%
Total other	6,475	5,938	537	9.04	%
Total noninterest expenses	\$27,731	\$26,166	\$1,565	5.98	%

Significant changes in noninterest expenses are detailed below:

We acquired two branches in mid-2015 which resulted in increased expenses in 2016 for most of the categories presented above. None of the increases are individually significant.

Employee benefits were low in 2015 due to lower than anticipated medical coverage costs. We anticipate expense to continue to increase slightly during the remainder of 2016.

Consulting fees in 2016 increased as a result of outsourced operational functions related to our investment and trust services, consulting services to streamline processes, and talent recruitment services. As such, fees in 2016 are expected to exceed 2015 levels.

The increase in loan underwriting fees is related to the increase in loan volume throughout 2016 and, such fees are expected to continue to increase during the remainder of 2016.

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We have consistently been a strong supporter of the various communities, schools, and charities in the markets we serve. Donations and community relations fluctuate from period-to-period with 2016 expenses expected to approximate 2015 levels.

The fluctuations in all other expenses are spread throughout various categories, none of which are individually significant.

## Analysis of Changes in Financial Condition

	September 30 2016	December 31 2015	\$ Change	% Change (unannualized)	
<b>ASSETS</b>					
Cash and cash equivalents	\$ 21,335	\$ 21,569	\$(234 )	(1.08 )	%
AFS securities					
Amortized cost of AFS securities	549,893	654,348	(104,455)	(15.96 )	%
Unrealized gains (losses) on AFS securities	14,336	5,788	8,548	147.68	%
AFS securities	564,229	660,136	(95,907 )	(14.53 )	%
Mortgage loans AFS	685	1,187	(502 )	(42.29 )	%
Loans					
Gross loans	989,366	850,492	138,874	16.33	%
Less allowance for loan and lease losses	7,800	7,400	400	5.41	%
Net loans	981,566	843,092	138,474	16.42	%
Premises and equipment	28,986	28,331	655	2.31	%
Corporate owned life insurance policies	25,985	26,423	(438 )	(1.66 )	%
Accrued interest receivable	6,868	6,269	599	9.55	%
Equity securities without readily determinable fair values	22,573	22,286	287	1.29	%
Goodwill and other intangible assets	48,700	48,828	(128 )	(0.26 )	%
Other assets	5,571	9,991	(4,420 )	(44.24 )	%
<b>TOTAL ASSETS</b>	<b>\$ 1,706,498</b>	<b>\$ 1,668,112</b>	<b>\$ 38,386</b>	<b>2.30</b>	<b>%</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>					
<b>Liabilities</b>					
Deposits	\$ 1,175,833	\$ 1,164,563	\$ 11,270	0.97	%
Borrowed funds	325,409	309,732	15,677	5.06	%
Accrued interest payable and other liabilities	10,072	9,846	226	2.30	%
Total liabilities	1,511,314	1,484,141	27,173	1.83	%
Shareholders' equity	195,184	183,971	11,213	6.09	%
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 1,706,498</b>	<b>\$ 1,668,112</b>	<b>\$ 38,386</b>	<b>2.30</b>	<b>%</b>

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The following table outlines the changes in loans:

	September 30 2016	December 31 2015	\$ Change	% Change (unannualized)	
Commercial	\$ 554,847	\$ 448,381	\$ 106,466	23.74	%
Agricultural	133,637	115,911	17,726	15.29	%
Residential real estate	260,122	251,501	8,621	3.43	%
Consumer	40,760	34,699	6,061	17.47	%
Total	\$ 989,366	\$ 850,492	\$ 138,874	16.33	%

The following table displays loan balances as of:

	September 30 2016	June 30 2016	March 31 2016	December 31 2015	September 30 2015
Commercial	\$ 554,847	\$ 500,374	\$ 470,305	\$ 448,381	\$ 434,823
Agricultural	133,637	126,517	115,686	115,911	116,293
Residential real estate	260,122	255,116	249,318	251,501	251,324
Consumer	40,760	37,587	34,982	34,699	34,231
Total	\$ 989,366	\$ 919,594	\$ 870,291	\$ 850,492	\$ 836,671

While competition for commercial and agricultural loans continues to be strong, we experienced growth in these segments of the portfolio during 2016 and anticipate continued growth in the remainder of 2016. During the third quarter of 2016, we entered into a participation agreement to provide advances to mortgage brokers which contributed \$27,832 of commercial loan growth as of September 30, 2016. Residential real estate and consumer loans continued to increase during the third quarter of 2016. We anticipate continued growth in both portfolios during the remainder of 2016 as a result of initiatives designed to increase loan volume and the number of originations.

The following table outlines the changes in deposits:

	September 30 2016	December 31 2015	\$ Change	% Change (unannualized)	
Noninterest bearing demand deposits	\$ 201,804	\$ 191,376	\$ 10,428	5.45	%
Interest bearing demand deposits	205,817	212,666	(6,849 )	(3.22 )	%
Savings deposits	331,414	337,641	(6,227 )	(1.84 )	%
Certificates of deposit	324,910	324,101	809	0.25	%
Brokered certificates of deposit	87,583	73,815	13,768	18.65	%
Internet certificates of deposit	24,305	24,964	(659 )	(2.64 )	%
Total	\$ 1,175,833	\$ 1,164,563	\$ 11,270	0.97	%

The following table displays deposit balances as of:

	September 30 2016	June 30 2016	March 31 2016	December 31 2015	September 30 2015
Noninterest bearing demand deposits	\$ 201,804	\$ 192,194	\$ 183,820	\$ 191,376	\$ 181,782
Interest bearing demand deposits	205,817	197,590	215,327	212,666	197,476
Savings deposits	331,414	331,144	352,115	337,641	316,590
Certificates of deposit	324,910	328,771	323,350	324,101	328,806
Brokered certificates of deposit	87,583	83,677	76,014	73,815	76,948
Internet certificates of deposit	24,305	23,494	22,881	24,964	26,401
Total	\$ 1,175,833	\$ 1,156,870	\$ 1,173,507	\$ 1,164,563	\$ 1,128,003

Deposit growth during 2016 continues to be driven by noninterest bearing demand deposits and brokered certificates of deposit. We continue to see a gradual decline in certificates of deposits and interest bearing deposit accounts. Growth is anticipated to continue to come in the form of non-contractual deposits, while certificates of deposit are expected to continue to decline.

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Our strong loan growth in 2016, coupled with softer deposit growth, led to sales of AFS securities during the year. Additionally, we have slowed our purchases of mortgage-backed securities and collateralized mortgage obligations in response to loan growth. We remain active in investments with our local schools and municipalities; therefore, future growth is anticipated in state and political subdivisions AFS securities. The following table displays fair values of AFS securities as of:

	September 30 2016	June 30 2016	March 31 2016	December 31 2015	September 30 2015
Government sponsored enterprises	\$ 344	\$ 10,371	\$ 24,428	\$ 24,345	\$ 24,368
States and political subdivisions	219,689	226,047	231,472	232,217	232,374
Auction rate money market preferred	3,145	3,119	2,807	2,866	2,707
Preferred stocks	3,588	3,406	3,346	3,299	3,192
Mortgage-backed securities	226,649	240,195	258,284	263,384	234,258
Collateralized mortgage obligations	110,814	119,325	129,522	134,025	131,713
Total	\$ 564,229	\$ 602,463	\$ 649,859	\$ 660,136	\$ 628,612

The following table displays borrowed funds balances as of:

	September 30 2016	June 30 2016	March 31 2016	December 31 2015	September 30 2015
FHLB advances	\$ 250,000	\$ 265,000	\$ 245,000	\$ 235,000	\$ 215,000
Securities sold under agreements to repurchase without stated maturity dates	54,809	53,596	58,096	70,532	69,510
Federal funds purchased	20,600	—	4,800	4,200	13,100
Total	\$ 325,409	\$ 318,596	\$ 307,896	\$ 309,732	\$ 297,610

**Capital**

Capital consists solely of common stock, retained earnings, and accumulated other comprehensive income (loss). We are authorized to raise capital through dividend reinvestment, employee and director stock purchases, and shareholder stock purchases. Pursuant to these authorizations, we issued 131,697 shares or \$3,683 of common stock during the first nine months of 2016, as compared to 142,388 shares or \$3,310 of common stock during the same period in 2015. We also offer the Directors Plan in which participants either directly purchase stock or purchase stock units through deferred fees, in lieu of cash payments. Pursuant to this plan, we increased shareholders' equity by \$443 and \$425 during the nine month periods ended September 30, 2016 and 2015, respectively.

We have approved a publicly announced common stock repurchase plan. Pursuant to this plan, we repurchased 98,083 shares or \$2,749 of common stock compared to 153,329 shares for \$3,588 during the first nine months of 2016 and 2015, respectively. As of September 30, 2016, we were authorized to repurchase up to an additional 60,575 shares of common stock.

The FRB has established minimum risk based capital guidelines. Pursuant to these guidelines, a framework has been established that assigns risk weights to each category of on and off-balance-sheet items to arrive at risk adjusted total assets. Regulatory capital is divided by the risk adjusted assets with the resulting ratio compared to the minimum standard to determine whether a corporation has adequate capital. On July 2, 2013, the FRB published revised BASEL III Capital standards for banks. The final rules redefine what is included or deducted from equity capital, changes risk weighting for certain on and off-balance sheet assets, increases the minimum required equity capital to be considered well capitalized, and introduces a capital cushion buffer. The rules, which are being gradually phased in between 2015 and 2019, are not expected to have a material impact on the Corporation but will require us to hold more capital than we have historically.

There are no significant regulatory constraints placed on our capital. The FRB's current recommended minimum primary capital to assets requirement is 6.00%. Our primary capital to adjusted average assets, or tier 1 leverage ratio, was 8.59% as of September 30, 2016.



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Effective January 1, 2015, the minimum standard for primary, or tier 1, capital increased from 4.00% to 6.00%. The minimum standard for total capital remains at 8.00%. Also effective January 1, 2015 is the new common equity tier 1 capital ratio which has a minimum requirement of 4.50%. The following table sets forth the percentages required under the Risk Based Capital guidelines and our values as of:

	September 30		December 31		Required	
	2016		2015			
Common equity tier 1 capital	12.41	%	13.44	%	4.50	%
Tier 1 capital	12.41	%	13.44	%	6.00	%
Tier 2 capital	0.69	%	0.73	%	2.00	%
Total Capital	13.10	%	14.17	%	8.00	%

Tier 2 capital, or secondary capital, includes only the ALLL. The percentage for the secondary capital under the required column is the maximum amount allowed from all sources.

The FRB and FDIC also prescribe minimum capital requirements for Isabella Bank. At September 30, 2016, the Bank exceeded these minimum capital requirements.

**Contractual Obligations and Loan Commitments**

We are party to credit related financial instruments with off-balance-sheet risk. These financial instruments are entered into in the normal course of business to meet the financing needs of our customers. These financial instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated balance sheets. The contract or notional amounts of these instruments reflect the extent of involvement we have in a particular class of financial instrument.

The following table summarizes our credit related financial instruments with off-balance-sheet risk as of:

	September 30	December 31
	2016	2015
Unfunded commitments under lines of credit	\$ 166,007	\$ 134,412
Commitments to grant loans	44,981	53,946
Commercial and standby letters of credit	1,106	915
Total	\$ 212,094	\$ 189,273

Unfunded commitments under lines of credit are commitments for possible future extensions of credit to existing customers. These commitments may expire without being drawn upon and do not necessarily represent future cash requirements. Advances to mortgage brokers are also included in unfunded commitments under lines of credit. The balance is the difference between our outstanding balances and the maximum outstanding aggregate amount.

Commitments to grant loans are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The amount of collateral obtained, if it is deemed necessary, is based on management's credit evaluation of the customer. Commitments to grant loans include residential mortgage loans with the majority being loans committed to be sold to the secondary market.

Commercial and standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support private borrowing arrangements, including commercial paper, bond financing, and similar transactions. These commitments to extend credit and letters of credit generally mature within one year. The credit risk involved in these transactions is essentially the same as that involved in extending loans to customers. We evaluate each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon the extension of credit, is based on a credit evaluation of the borrower. While we consider standby letters of credit to be guarantees, the amount of the liability related to such guarantees on the commitment date is not significant and a liability related to such guarantees is not recorded on the consolidated balance sheets.

Our exposure to credit-related loss in the event of nonperformance by the counter parties to the financial instruments for commitments to extend credit and standby letters of credit could be up to the contractual notional amount of those instruments. We use the same credit policies as we do for extending loans to customers. No significant losses are

anticipated as a result of these commitments.

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## Fair Value

We utilize fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. AFS securities, cash flow hedge derivative instruments and certain liabilities are recorded at fair value on a recurring basis. Additionally, from time-to-time, we may be required to record at fair value other assets on a nonrecurring basis, such as mortgage loans AFS, foreclosed assets, OMSR, and certain other assets and liabilities. These nonrecurring fair value adjustments typically involve the application of lower of cost or market accounting or write-downs of individual assets.

For further information regarding fair value measurements see “Note 11 – Fair Value” of our notes to the interim condensed consolidated financial statements.

## Liquidity

Liquidity is monitored regularly by our Market Risk Committee, which consists of members of senior management. The committee reviews projected cash flows, key ratios, and liquidity available from both primary and secondary sources.

Our primary sources of liquidity are cash and cash equivalents and AFS securities. These categories totaled \$585,564 or 34.31% of assets as of September 30, 2016 as compared to \$681,705 or 40.87% as of December 31, 2015. The decline in primary liquidity is a direct result of our sale of AFS securities during 2016. Liquidity is important for financial institutions because of their need to meet loan funding commitments, depositor withdrawal requests, and various other commitments including expansion of operations, investment opportunities, and payment of cash dividends. Liquidity varies significantly daily, based on customer activity.

Our primary source of funds is through deposit accounts. We also have the ability to borrow from the FHLB, the FRB, and through various correspondent banks in the form of federal funds purchased and a line of credit. These funding methods typically carry a higher interest rate than traditional market deposit accounts. Some borrowed funds, including FHLB advances, FRB Discount Window advances, and repurchase agreements, require us to pledge assets, typically in the form of AFS securities or loans, as collateral. As of September 30, 2016, we had available lines of credit of \$15,173.

The following table summarizes our sources and uses of cash for the nine month period ended September 30:

	2016	2015	\$ Variance
Net cash provided by (used in) operating activities	\$ 15,565	\$ 7,081	\$ 8,484
Net cash provided by (used in) investing activities	(37,704 )	(64,112 )	26,408
Net cash provided by (used in) financing activities	21,905	55,447	(33,542 )
Increase (decrease) in cash and cash equivalents	(234 )	(1,584 )	1,350
Cash and cash equivalents January 1	21,569	19,906	1,663
Cash and cash equivalents September 30	\$ 21,335	\$ 18,322	\$ 3,013

## Market Risk

Our primary market risks are interest rate risk and liquidity risk. We have no significant foreign exchange risk in the management of IRR. Any changes in foreign exchange rates or commodity prices would have an insignificant impact on our interest income and cash flows.

IRR is the exposure of our net interest income to changes in interest rates. IRR results from the difference in the maturity or repricing frequency of a financial institution's interest earning assets and its interest bearing liabilities. IRR is the fundamental method by which financial institutions earn income and create shareholder value. Excessive exposure to IRR could pose a significant risk to our earnings and capital.

The FRB has adopted a policy requiring us to effectively manage the various risks that can have a material impact on our safety and soundness. The risks include credit, interest rate, liquidity, operational, and reputational. We have policies, procedures, and internal controls for measuring and managing these risks. Specifically, our Funds Management policy and procedures include defining acceptable types and terms of investments and funding sources, liquidity requirements, limits on investments in long term assets, limiting the mismatch in repricing opportunity of assets and liabilities, and the frequency of measuring and reporting to our Board.

The primary technique to measure IRR is simulation analysis. Simulation analysis forecasts the effects on the balance sheet structure and net interest income under a variety of scenarios that incorporate changes in interest rates, the shape of yield curves, interest rate relationships, loan prepayments, and changes in funding sources. These forecasts are compared against net

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interest income projected in a stable interest rate environment. While many assets and liabilities reprice either at maturity or in accordance with their contractual terms, several balance sheet components demonstrate characteristics that require an evaluation to more accurately reflect their repricing behavior. Key assumptions in the simulation analysis include prepayments on loans, probable calls of investment securities, changes in market conditions, loan volumes and loan pricing, deposit sensitivity, and customer preferences. These assumptions are inherently uncertain as they are subject to fluctuation and revision in a dynamic environment. As a result, the simulation analysis cannot precisely forecast the impact of rising and falling interest rates on net interest income. Actual results will differ from simulated results due to many other factors, including changes in balance sheet components, interest rate changes, changes in market conditions, and management strategies.

Our interest rate sensitivity is estimated by first forecasting the next 12 and 24 months of net interest income under an assumed environment of a constant balance sheet and constant market interest rates (base case). We then compare the results of various simulation analyses to the base case. At September 30, 2016, we projected the change in net interest income during the next 12 and 24 months assuming market interest rates were to immediately decrease by 100 basis points and increase by 100, 200, 300, and 400 basis points in a parallel fashion over the entire yield curve during the same time period. We did not project scenarios showing decreases in interest rates beyond 100 basis points as this is considered extremely unlikely given current interest rate levels. These projections were based on our assets and liabilities remaining static over the next 12 and 24 months, while factoring in probable calls and prepayments of certain investment securities and residential real estate and consumer loans. While it is extremely unlikely that interest rates would immediately increase to these levels, we feel that these extreme scenarios help us identify potential gaps and mismatches in the repricing characteristics of assets and liabilities. We regularly monitor our projected net interest income sensitivity to ensure that it remains within established limits.

The following tables summarize our interest rate sensitivity for the next 12 and 24 months as of:

	September 30, 2016									
	12 Months					24 Months				
Immediate basis point change assumption (short-term)	-100	+100	+200	+300	+400	-100	+100	+200	+300	+400
Percent change in net interest income vs. constant rates	2.16%	1.58%	4.22%	5.75%	6.83%	(1.59)%	2.05%	6.00%	8.43%	10.23%
	December 31, 2015									
	12 Months					24 Months				
Immediate basis point change assumption (short-term)	-100	+100	+200	+300	+400	-100	+100	+200	+300	+400
Percent change in net interest income vs. constant rates	(2.08)%	1.27%	2.00%	2.11%	2.23%	(1.77)%	2.00%	3.47%	4.02%	4.39%

The following tables provide information about assets and liabilities that are sensitive to changes in interest rates as of September 30, 2016 and December 31, 2015. The principal amounts of investments, loans, other interest earning assets, borrowings, and time deposits maturing were calculated based on the contractual maturity dates. Estimated cash flows for savings and NOW accounts are based on our estimated deposit decay rates.

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	September 30, 2016							Fair Value
	2017	2018	2019	2020	2021	Thereafter	Total	
Rate sensitive assets								
Other interest bearing assets	\$2,061	\$—	\$—	\$—	\$—	\$—	\$2,061	\$2,060
Average interest rates	0.23	% —	% —	% —	% —	% —	% 0.23	%
AFS securities	\$177,551	\$111,006	\$84,152	\$57,432	\$37,220	\$96,868	\$564,229	\$564,229
Average interest rates	1.57	% 1.42	% 1.68	% 2.30	% 2.72	% 2.22	% 1.82	%
Fixed interest rate loans (1)	\$166,013	\$120,093	\$103,839	\$99,242	\$114,484	\$192,540	\$796,211	\$786,490
Average interest rates	4.10	% 4.26	% 4.31	% 4.15	% 4.21	% 4.13	% 4.18	%
Variable interest rate loans (1)	\$64,158	\$29,852	\$33,955	\$14,661	\$20,277	\$30,252	\$193,155	\$193,155
Average interest rates	4.54	% 4.27	% 4.00	% 3.58	% 3.64	% 3.91	% 4.14	%
Rate sensitive liabilities								
Fixed rate borrowed funds	\$125,409	\$60,000	\$70,000	\$10,000	\$20,000	\$30,000	\$315,409	\$320,077
Average interest rates	0.77	% 1.89	% 1.90	% 1.98	% 1.80	% 2.77	% 1.53	%
Variable rate borrowed funds	\$—	\$—	\$—	\$—	\$10,000	\$—	\$10,000	\$10,000
Average interest rates	—	% —	% —	% —	% 0.93	% —	% 0.93	%
Savings and NOW accounts	\$144,685	\$38,027	\$34,016	\$30,450	\$27,279	\$262,774	\$537,231	\$537,231
Average interest rates	0.40	% 0.10	% 0.10	% 0.10	% 0.10	% 0.09	% 0.18	%
Fixed interest rate certificates of deposit	\$196,912	\$85,975	\$45,914	\$30,815	\$49,741	\$24,582	\$433,939	\$433,033
Average interest rates	0.89	% 1.20	% 1.30	% 1.59	% 1.65	% 1.81	% 1.19	%
Variable interest rate certificates of deposit	\$1,121	\$1,738	\$—	\$—	\$—	\$—	\$2,859	\$2,859
Average interest rates	0.47	% 0.71	% —	% —	% —	% —	% 0.61	%
	December 31, 2015							Fair Value
	2016	2017	2018	2019	2020	Thereafter	Total	
Rate sensitive assets	\$2,659	\$100	\$—	\$—	\$—	\$—	\$2,759	\$2,758

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Other interest bearing assets								
Average interest rates	0.23	% 0.35	% —	% —	% —	% —	% 0.24	%
AFS securities	\$148,692	\$120,692	\$81,726	\$73,541	\$71,083	\$164,402	\$660,136	\$660,136
Average interest rates	2.16	% 2.11	% 2.18	% 2.25	% 2.37	% 2.43	% 2.25	%
Fixed interest rate loans (1)	\$116,143	\$130,873	\$103,265	\$83,457	\$91,436	\$156,784	\$681,958	\$670,864
Average interest rates	4.56	% 4.42	% 4.27	% 4.36	% 4.18	% 4.28	% 4.35	%
Variable interest rate loans (1)	\$61,672	\$24,289	\$24,359	\$14,398	\$16,842	\$26,974	\$168,534	\$168,534
Average interest rates	4.08	% 4.12	% 4.19	% 3.45	% 3.40	% 3.69	% 3.92	%
Rate sensitive liabilities								
Fixed rate borrowed funds	\$104,732	\$50,000	\$50,000	\$40,000	\$10,000	\$40,000	\$294,732	\$297,495
Average interest rates	0.47	% 1.56	% 2.16	% 2.35	% 1.98	% 2.67	% 1.55	%
Variable rate borrowed funds	\$15,000	\$—	\$—	\$—	\$—	\$—	\$15,000	\$15,000
Average interest rates	0.62	% —	% —	% —	% —	% —	% 0.62	%
Savings and NOW accounts	\$80,242	\$42,064	\$37,773	\$33,950	\$30,548	\$325,730	\$550,307	\$550,307
Average interest rates	0.59	% 0.11	% 0.11	% 0.11	% 0.11	% 0.11	% 0.18	%
Fixed interest rate certificates of deposit	\$190,500	\$89,689	\$63,167	\$23,883	\$33,012	\$21,028	\$421,279	\$419,828
Average interest rates	0.92	% 1.26	% 1.27	% 1.50	% 1.59	% 1.84	% 1.18	%
Variable interest rate certificates of deposit	\$1,358	\$243	\$—	\$—	\$—	\$—	\$1,601	\$1,601
Average interest rates	0.49	% 0.40	% —	% —	% —	% —	% 0.48	%

(1) The fair value reported is exclusive of the allocation of the ALLL.

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We do not believe that there has been a material change in the nature or categories of our primary market risk exposure, or the particular markets that present the primary risk of loss. As of the date of this report, we do not know of or expect there to be any material change in the general nature of our primary market risk exposure in the near term and we do not expect to make material changes in those methods in the near term. We may change those methods in the future to adapt to changes in circumstances or to implement new techniques.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

The information presented in the section captioned “Market Risk” in Management's Discussion and Analysis of Financial Condition and Results of Operations is incorporated herein by reference.

Item 4. Controls and Procedures.

**DISCLOSURE CONTROLS AND PROCEDURES**

We carried out an evaluation, under the supervision and with the participation of the Principal Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15(d)-15(e) under the Exchange Act) as of September 30, 2016, pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures as of September 30, 2016, were effective to ensure that information required to be disclosed in reports that we file or submit under the Exchange Act are recorded, processed, summarized and reported within the time periods specified in SEC rules and forms.

**CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

During the most recent fiscal quarter, no change occurred in our internal control over financial reporting that materially affected, or is likely to materially effect, our internal control over financial reporting.



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## PART II – OTHER INFORMATION

## Item 1. Legal Proceedings.

We are not involved in any material legal proceedings. We are involved in ordinary, routine litigation incidental to our business; however, no such routine proceedings are expected to result in any material adverse effect on operations, earnings, financial condition, or cash flows.

## Item 1A. Risk Factors.

There have been no material changes to the risk factors disclosed in Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2015.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

(A)None

(B)None

## (C)Repurchases of Common Stock

We have adopted and publicly announced a common stock repurchase plan. The plan was last amended on September 23, 2015, to allow for the repurchase of an additional 200,000 shares of common stock after that date. These authorizations do not have expiration dates. As common shares are repurchased under this plan, they are retired and revert back to the status of authorized, but unissued common shares.

The following table provides information for the three month period ended September 30, 2016, with respect to this plan:

	Common Shares Repurchased	Average Price NumberPer Common Share	Total Number of Common Shares Purchased as Part of Publicly Announced Plan or Program	Maximum Number of Common Shares That May Yet Be Purchased Under the Plans or Programs
Balance, June 30				106,748
July 1 - 31	11,664	\$ 27.86	11,664	95,084
August 1 - 31	20,927	27.91	20,927	74,157
September 1 - 30	13,582	27.90	13,582	60,575
Balance, September 30	46,173	\$ 27.90	46,173	60,575

## Item 3. Defaults Upon Senior Securities.

Not applicable.

## Item 4. Mine Safety Disclosures.

Not applicable.

## Item 5. Other Information.

Not applicable.

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Item 6. Exhibits.

(a) Exhibits

Exhibit Number	Exhibits
31(a)	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by the Principal Executive Officer
31(b)	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by the Principal Financial Officer
32	Section 1350 Certification of Principal Executive Officer and Principal Financial Officer
101.1*	101.INS (XBRL Instance Document)
	101.SCH (XBRL Taxonomy Extension Schema Document)
	101.CAL (XBRL Calculation Linkbase Document)
	101.LAB (XBRL Taxonomy Label Linkbase Document)
	101.DEF (XBRL Taxonomy Linkbase Document)
	101.PRE (XBRL Taxonomy Presentation Linkbase Document)

In accordance with Rule 406T of Regulations S-T, the XBRL related information shall not be deemed to be “filed” for \*purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be part of any registration statement or other document filed under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific reference in such filing.

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SIGNATURES

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

Isabella Bank Corporation

Date: November 9, 2016 /s/ Jae A. Evans  
Jae A. Evans  
Chief Executive Officer  
(Principal Executive Officer)

Date: November 9, 2016 /s/ Dennis P. Angner  
Dennis P. Angner  
President, Chief Financial Officer  
(Principal Financial Officer, Principal Accounting Officer)