

ISABELLA BANK CORP  
Form 10-Q  
May 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 March 31, 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 7,839,650 as of May 5, 2016.

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ISABELLA BANK CORPORATION  
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” 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   | JOBS Act: Jumpstart our Business Startups Act       |
| ATM: Automated Teller Machine   | LIBOR: London Interbank Offered Rate                |
| BHC Act: Bank Holding Company Act of 1956   | N/A: Not applicable                                 |
| CFPB: Consumer Financial Protection Bureau  | N/M: Not meaningful                                 |
| CIK: Central Index Key  | NASDAQ: NASDAQ Stock Market Index                   |
| CRA: Community Reinvestment Act   | NASDAQ Banks: NASDAQ Bank Stock Index               |
| DIF: Deposit Insurance Fund   | NAV: Net asset value                                |
| DIFS: Department of Insurance and Financial Services  | NOW: Negotiable order of withdrawal                 |
| Directors Plan: Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors                      | NSF: Non-sufficient funds                           |
| Dividend Reinvestment Plan: Isabella Bank Corporation Stockholder Dividend Reinvestment Plan and Employee Stock Purchase Plan | OCI: Other comprehensive income (loss)              |
| Dodd-Frank Act: Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010   | OMSR: Originated mortgage servicing rights          |
| ESOP: Employee Stock Ownership Plan   | OREO: Other real estate owned                       |
| Exchange Act: Securities Exchange Act of 1934   | OTTI: Other-than-temporary impairment               |
| FASB: Financial Accounting Standards Board  | PBO: Projected benefit obligation                   |
| FDI Act: Federal Deposit Insurance Act  | PCAOB: Public Company Accounting Oversight Board    |
| 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

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)

|  | March 31<br>2016    | December 31<br>2015 |
|--|---------------------|---------------------|
| <b>ASSETS</b>  |                     |                     |
| Cash and cash equivalents  |                     |                     |
| Cash and demand deposits due from banks  | \$ 16,670           | \$ 18,810           |
| Interest bearing balances due from banks   | 11,457              | 2,759               |
| Total cash and cash equivalents  | 28,127              | 21,569              |
| AFS securities (amortized cost of \$636,797 in 2016 and \$654,348 in 2015)   | 649,859             | 660,136             |
| Mortgage loans AFS   | 1,240               | 1,187               |
| Loans  |                     |                     |
| Commercial   | 470,305             | 448,381             |
| Agricultural   | 115,686             | 115,911             |
| Residential real estate  | 249,318             | 251,501             |
| Consumer   | 34,982              | 34,699              |
| Gross loans  | 870,291             | 850,492             |
| Less allowance for loan and lease losses   | 7,500               | 7,400               |
| Net loans  | 862,791             | 843,092             |
| Premises and equipment   | 28,269              | 28,331              |
| Corporate owned life insurance policies  | 26,611              | 26,423              |
| Accrued interest receivable  | 6,995               | 6,269               |
| Equity securities without readily determinable fair values   | 22,226              | 22,286              |
| Goodwill and other intangible assets   | 48,785              | 48,828              |
| Other assets   | 6,915               | 9,991               |
| <b>TOTAL ASSETS</b>  | <b>\$ 1,681,818</b> | <b>\$ 1,668,112</b> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                     |                     |
| <b>Deposits</b>  |                     |                     |
| Noninterest bearing  | \$ 183,820          | \$ 191,376          |
| NOW accounts   | 215,327             | 212,666             |
| Certificates of deposit under \$100 and other savings  | 534,022             | 521,793             |
| Certificates of deposit over \$100   | 240,338             | 238,728             |
| Total deposits   | 1,173,507           | 1,164,563           |
| Borrowed funds   | 307,896             | 309,732             |
| Accrued interest payable and other liabilities   | 10,168              | 9,846               |
| Total liabilities  | 1,491,571           | 1,484,141           |
| <b>Shareholders' equity</b>  |                     |                     |
| Common stock — no par value 15,000,000 shares authorized; issued and outstanding<br>7,809,079 shares (including 15,764 shares held in the Rabbi Trust) in 2016 and 7,799,867<br>shares (including 19,401 shares held in the Rabbi Trust) in 2015 | 139,501             | 139,198             |
| Shares to be issued for deferred compensation obligations  | 4,623               | 4,592               |
| Retained earnings  | 41,105              | 39,960              |
| Accumulated other comprehensive income   | 5,018               | 221                 |
| Total shareholders' equity   | 190,247             | 183,971             |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>  | <b>\$ 1,681,818</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<br>Ended<br>March 31 |         |
|---|-----------------------------------|---------|
|   | 2016                              | 2015    |
| Interest income                                     |                                   |         |
| Loans, including fees                               | \$9,038                           | \$9,025 |
| AFS securities                                      |                                   |         |
| Taxable   | 2,400                             | 2,107   |
| Nontaxable  | 1,485                             | 1,482   |
| Federal funds sold and other                        | 158                               | 139     |
| Total interest income                               | 13,081                            | 12,753  |
| Interest expense                                    |                                   |         |
| Deposits  | 1,399                             | 1,466   |
| Borrowings  | 1,215                             | 1,022   |
| Total interest expense                              | 2,614                             | 2,488   |
| Net interest income                                 | 10,467                            | 10,265  |
| Provision for loan losses                           | 156                               | (726 )  |
| Net interest income after provision for loan losses | 10,311                            | 10,991  |
| Noninterest income                                  |                                   |         |
| Service charges and fees                            | 1,213                             | 1,163   |
| Net gain on sale of mortgage loans                  | 82                                | 149     |
| Earnings on corporate owned life insurance policies | 188                               | 187     |
| Other   | 740                               | 629     |
| Total noninterest income                            | 2,223                             | 2,128   |
| Noninterest expenses                                |                                   |         |
| Compensation and benefits                           | 4,788                             | 4,766   |
| Furniture and equipment                             | 1,468                             | 1,314   |
| Occupancy   | 758                               | 721     |
| Other   | 2,066                             | 1,874   |
| Total noninterest expenses                          | 9,080                             | 8,675   |
| Income before federal income tax expense            | 3,454                             | 4,444   |
| Federal income tax expense                          | 437                               | 771     |
| NET INCOME  | \$3,017                           | \$3,673 |
| Earnings per common share                           |                                   |         |
| Basic   | \$0.39                            | \$0.47  |
| Diluted   | \$0.38                            | \$0.46  |
| Cash dividends per common share                     | \$0.24                            | \$0.23  |

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





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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

(Dollars in thousands)

|  | Three Months |          |
|--|--------------|----------|
|  | Ended        |          |
|  | March 31     |          |
|  | 2016         | 2015     |
| Net income   | \$3,017      | \$3,673  |
| Unrealized gains on AFS securities arising during the period | 7,274        | 4,356    |
| Tax effect (1)   | (2,477 )     | (1,366 ) |
| Other comprehensive income, net of tax                       | 4,797        | 2,990    |
| Comprehensive income   | \$7,814      | \$6,663  |

(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<br>Shares to be<br>Issued for<br>Deferred<br>Compensation<br>Obligations | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Totals    |
|--|---------------------------------|-----------|---|----------------------|---|-----------|
|  | Common<br>Shares<br>Outstanding | Amount    |   |                      |   |           |
| Balance, January 1, 2015   | 7,776,274                       | \$138,755 | \$ 4,242  | \$32,103             | \$ (506 )   | \$174,594 |
| Comprehensive income (loss)  | —                               | —         | —   | 3,673                | 2,990   | 6,663     |
| Issuance of common stock   | 41,217                          | 945       | —   | —                    | —   | 945       |
| Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations | —                               | 123       | (123 )  | —                    | —   | —         |
| Share-based payment awards under equity compensation plan                                  | —                               | —         | 146   | —                    | —   | 146       |
| Common stock purchased for deferred compensation obligations                               | —                               | (100 )    | —   | —                    | —   | (100 )    |
| Common stock repurchased pursuant to publicly announced repurchase plan                    | (35,671 )                       | (820 )    | —   | —                    | —   | (820 )    |
| Cash dividends paid (\$0.23 per common share)  | —                               | —         | —   | (1,775 )             | —   | (1,775 )  |
| Balance, March 31, 2015  | 7,781,820                       | \$138,903 | \$ 4,265  | \$34,001             | \$ 2,484  | \$179,653 |
| Balance, January 1, 2016   | 7,799,867                       | \$139,198 | \$ 4,592  | \$39,960             | \$ 221  | \$183,971 |
| Comprehensive income (loss)  | —                               | —         | —   | 3,017                | 4,797   | 7,814     |
| Issuance of common stock   | 37,465                          | 1,072     | —   | —                    | —   | 1,072     |
| Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations | —                               | 127       | (127 )  | —                    | —   | —         |
| Share-based payment awards under equity compensation plan                                  | —                               | —         | 158   | —                    | —   | 158       |
| Common stock purchased for deferred compensation obligations                               | —                               | (97 )     | —   | —                    | —   | (97 )     |
| Common stock repurchased pursuant to publicly announced repurchase plan                    | (28,253 )                       | (799 )    | —   | —                    | —   | (799 )    |
| Cash dividends paid (\$0.24 per common share)  | —                               | —         | —   | (1,872 )             | —   | (1,872 )  |
| Balance, March 31, 2016  | 7,809,079                       | \$139,501 | \$ 4,623  | \$41,105             | \$ 5,018  | \$190,247 |

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

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

(Dollars in thousands)

|   | Three Months<br>Ended<br>March 31 |          |
|---|-----------------------------------|----------|
|   | 2016                              | 2015     |
| <b>OPERATING ACTIVITIES</b>   |                                   |          |
| Net income  | \$3,017                           | \$3,673  |
| Reconciliation of net income to net cash provided by operating activities:  |                                   |          |
| Provision for loan losses   | 156                               | (726 )   |
| Depreciation  | 727                               | 654      |
| Amortization of OMSR  | 64                                | 70       |
| Amortization of acquisition intangibles                                     | 43                                | 38       |
| Net amortization of AFS securities  | 705                               | 478      |
| Net gain on sale of mortgage loans  | (82 )                             | (149 )   |
| Increase in cash value of corporate owned life insurance policies           | (188 )                            | (187 )   |
| Share-based payment awards under equity compensation plan                   | 158                               | 146      |
| Origination of loans held-for-sale  | (4,499 )                          | (11,209) |
| Proceeds from loan sales  | 4,528                             | 11,202   |
| Net changes in operating assets and liabilities which provided (used) cash: |                                   |          |
| Accrued interest receivable   | (726 )                            | (947 )   |
| Other assets  | 450                               | (207 )   |
| Accrued interest payable and other liabilities                              | 322                               | (810 )   |
| Net cash provided by (used in) operating activities                         | 4,675                             | 2,026    |
| <b>INVESTING ACTIVITIES</b>   |                                   |          |
| Activity in AFS securities  |                                   |          |
| Maturities, calls, and principal payments                                   | 19,452                            | 14,419   |
| Purchases   | (2,606 )                          | (48,215) |
| Net loan principal (originations) collections                               | (19,944)                          | 18,149   |
| Proceeds from sales of foreclosed assets                                    | 234                               | 302      |
| Purchases of premises and equipment   | (665 )                            | (943 )   |
| Purchases of corporate owned life insurance policies                        | —                                 | (500 )   |
| Net cash provided by (used in) investing activities                         | (3,529 )                          | (16,788) |

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

(Dollars in thousands)

|  | Three Months<br>Ended<br>March 31 |          |
|--|-----------------------------------|----------|
|  | 2016                              | 2015     |
| <b>FINANCING ACTIVITIES</b>                                  |                                   |          |
| Net increase (decrease) in deposits                          | \$8,944                           | \$24,171 |
| Net increase (decrease) in borrowed funds                    | (1,836 )                          | (6,388 ) |
| Cash dividends paid on common stock                          | (1,872 )                          | (1,775 ) |
| Proceeds from issuance of common stock                       | 1,072                             | 945      |
| Common stock repurchased                                     | (799 )                            | (820 )   |
| Common stock purchased for deferred compensation obligations | (97 )                             | (100 )   |
| Net cash provided by (used in) financing activities          | 5,412                             | 16,033   |
| Increase (decrease) in cash and cash equivalents             | 6,558                             | 1,271    |
| Cash and cash equivalents at beginning of period             | 21,569                            | 19,906   |
| Cash and cash equivalents at end of period                   | \$28,127                          | \$21,177 |
| <b>SUPPLEMENTAL CASH FLOWS INFORMATION:</b>                  |                                   |          |
| Interest paid  | \$2,574                           | \$2,462  |
| Income taxes paid  | —                                 | 1,393    |
| <b>SUPPLEMENTAL NONCASH INFORMATION:</b>                     |                                   |          |
| Transfers of loans to foreclosed assets                      | \$89                              | \$134    |

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 month period ended March 31, 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 month period ended March 31, 2015 and Consolidated Statements of Cash Flows for the three month period ended March 31, 2015; and
2. Notes to Consolidated Financial Statements for the three month period ended March 31, 2015.

On the Consolidated Statements of Income, the effects of the restatement reduced loan interest and fee income by \$659 and compensation and benefits were reduced by \$659 for the three months ended March 31, 2015. The restatement did not impact net income for the three month period ended March 31, 2015.

All amounts in this Quarterly Report on Form 10-Q affected by the restatement adjustments reflect such amounts as restated. 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 |           |
|---|--------------------|-----------|
|   | March 31           |           |
|   | 2016               | 2015      |
| Average number of common shares outstanding for basic calculation                               | 7,795,297          | 7,773,428 |
| Average potential effect of common shares in the Directors Plan (1)                             | 184,461            | 177,001   |
| Average number of common shares outstanding used to calculate diluted earnings per common share | 7,979,758          | 7,950,429 |
| Net income  | \$3,017            | \$ 3,673  |
| Earnings per common share   |                    |           |
| Basic   | \$0.39             | \$ 0.47   |
| Diluted   | \$0.38             | \$ 0.46   |

(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 expected to have an impact on financial statement disclosures due to existing equity investments.

ASU No. 2016-02: “Leases (Topic 842)”

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

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

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

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

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



or financial statement disclosures.

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

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

## Note 4 – AFS Securities

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

|                                     | March 31, 2016    |                              |                               |               |
|-------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
|                                     | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| Government sponsored enterprises    | \$24,383          | \$ 57                        | \$ 12                         | \$24,428      |
| States and political subdivisions   | 222,835           | 8,649                        | 12                            | 231,472       |
| Auction rate money market preferred | 3,200             | —                            | 393                           | 2,807         |
| Preferred stocks                    | 3,800             | —                            | 454                           | 3,346         |
| Mortgage-backed securities          | 255,009           | 3,409                        | 134                           | 258,284       |
| Collateralized mortgage obligations | 127,570           | 2,206                        | 254                           | 129,522       |
| Total                               | \$636,797         | \$ 14,321                    | \$ 1,259                      | \$649,859     |
|                                     | December 31, 2015 |                              |                               |               |
|                                     | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>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 March 31, 2016 are as follows:

|                                     | Maturing                         |   |   |                    |   |           |
|-------------------------------------|----------------------------------|---|---|--------------------|---|-----------|
|                                     | Due in<br>One<br>Year<br>or Less | After One<br>Year But<br>Within<br>Five Years | After<br>Five<br>Years<br>But<br>Within<br>Ten<br>Years | After<br>Ten Years | Securities with<br>Variable<br>Monthly<br>Payments or<br>Noncontractual<br>Maturities | Total     |
| Government sponsored enterprises    | \$—                              | \$ 24,029                                     | \$354   | \$—                | \$—   | \$24,383  |
| States and political subdivisions   | 31,685                           | 66,833  | 91,042  | 33,275             | —   | 222,835   |
| Auction rate money market preferred | —                                | —   | —   | —                  | 3,200   | 3,200     |
| Preferred stocks                    | —                                | —   | —   | —                  | 3,800   | 3,800     |
| Mortgage-backed securities          | —                                | —   | —   | —                  | 255,009   | 255,009   |
| Collateralized mortgage obligations | —                                | —   | —   | —                  | 127,570   | 127,570   |
| Total amortized cost                | \$31,685                         | \$ 90,862                                     | \$91,396  | \$ 33,275          | \$ 389,579  | \$636,797 |
| Fair value                          | \$31,742                         | \$ 93,332                                     | \$96,031  | \$ 34,795          | \$ 393,959  | \$649,859 |

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.

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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.

Information pertaining to AFS securities with gross unrealized losses at March 31, 2016 and December 31, 2015, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

|  | March 31, 2016          |            |                         |            |                         |
|--|-------------------------|------------|-------------------------|------------|-------------------------|
|  | Less Than Twelve Months |            | Twelve Months or More   |            | Total Unrealized Losses |
|  | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value |                         |
| Government sponsored enterprises                     | \$12                    | \$8,985    | \$ —                    | \$ —       | \$ 12                   |
| States and political subdivisions                    | 1                       | 576        | 11                      | 681        | 12                      |
| Auction rate money market preferred                  | —                       | —          | 393                     | 2,807      | 393                     |
| Preferred stocks                                     | —                       | —          | 454                     | 3,346      | 454                     |
| Mortgage-backed securities                           | 12                      | 6,955      | 122                     | 25,526     | 134                     |
| Collateralized mortgage obligations                  | —                       | —          | 254                     | 30,281     | 254                     |
| Total  | \$25                    | \$16,516   | \$ 1,234                | \$ 62,641  | \$ 1,259                |
| Number of securities in an unrealized loss position: | 4                       |            | 17                      |            | 21                      |
|  | December 31, 2015       |            |                         |            |                         |
|  | Less Than Twelve Months |            | Twelve Months or More   |            | Total Unrealized Losses |
|  | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value |                         |
| Government sponsored enterprises                     | \$—                     | \$—        | \$ 75                   | \$ 4,925   | \$ 75                   |
| States and political subdivisions                    | 14                      | 3,355      | 32                      | 2,623      | 46                      |
| Auction rate money market preferred                  | —                       | —          | 334                     | 2,866      | 334                     |
| Preferred stocks                                     | —                       | —          | 501                     | 3,299      | 501                     |
| Mortgage-backed securities                           | 882                     | 131,885    | 999                     | 37,179     | 1,881                   |
| Collateralized mortgage obligations                  | 415                     | 53,441     | 776                     | 26,717     | 1,191                   |
| Total  | \$1,311                 | \$188,681  | \$ 2,717                | \$ 77,609  | \$ 4,028                |
| Number of securities in an unrealized loss position: | 36                      |            | 26                      |            | 62                      |

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

• Has the value of the investment declined more than what is deemed to be reasonable based on a risk and maturity adjusted discount rate?

• Is the investment credit rating below investment grade?

• Is it probable the issuer will be unable to pay the amount when due?

• Is it more likely than not that we will have to sell the security before recovery of its cost basis?

• Has the duration of the investment been extended?

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

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Note 5 – Loans and ALLL

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

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

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

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

Underwriting criteria for residential real estate loans include:

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

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

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

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

- Verification of acceptable credit reports.

- Verification of employment, income, and financial information.

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

Loan Committee, or the Board of Directors.

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

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

The appropriateness of the ALLL is evaluated on a quarterly basis and is based upon a periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The primary factors behind the determination of the level of the ALLL are specific allocations for impaired loans, historical loss percentages, as well as unallocated components. Specific allocations for impaired loans are primarily determined based on the difference between the loan's outstanding balance to the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral, less cost to sell. Historical loss allocations are calculated at the loan class and segment levels based on a migration analysis of the loan portfolio over the preceding five years. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

|                                       | Allowance for Loan Losses                                  |              |                            |           |             |            |
|---------------------------------------|--|--------------|----------------------------|-----------|-------------|------------|
|                                       | Three months ended March 31, 2016                          |              |                            |           |             |            |
|                                       | Commercial   | Agricultural | Residential<br>Real Estate | Consumer  | Unallocated | Total      |
| January 1, 2016                       | \$ 2,171   | \$ 329       | \$ 3,330                   | \$ 522    | \$ 1,048    | \$ 7,400   |
| Charge-offs                           | (16)   | —            | (241)                      | (84)      | —           | (341)      |
| Recoveries                            | 89   | 92           | 50                         | 54        | —           | 285        |
| Provision for loan losses             | 177  | (85)         | (9)                        | 48        | 25          | 156        |
| March 31, 2016                        | \$ 2,421   | \$ 336       | \$ 3,130                   | \$ 540    | \$ 1,073    | \$ 7,500   |
|                                       | Allowance for Loan Losses and Recorded Investment in Loans |              |                            |           |             |            |
|                                       | March 31, 2016   |              |                            |           |             |            |
|                                       | Commercial   | Agricultural | Residential<br>Real Estate | Consumer  | Unallocated | Total      |
| ALLL                                  |  |              |                            |           |             |            |
| Individually evaluated for impairment | \$ 908   | \$ —         | \$ 1,823                   | \$ —      | \$ —        | \$ 2,731   |
| Collectively evaluated for impairment | 1,513  | 336          | 1,307                      | 540       | 1,073       | 4,769      |
| Total                                 | \$ 2,421   | \$ 336       | \$ 3,130                   | \$ 540    | \$ 1,073    | \$ 7,500   |
| Loans                                 |  |              |                            |           |             |            |
| Individually evaluated for impairment | \$ 6,840   | \$ 4,065     | \$ 10,088                  | \$ 34     |             | \$ 21,027  |
| Collectively evaluated for impairment | 463,465  | 111,621      | 239,230                    | 34,948    |             | 849,264    |
| Total                                 | \$ 470,305   | \$ 115,686   | \$ 249,318                 | \$ 34,982 |             | \$ 870,291 |

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Allowance for Loan Losses  
Three Months Ended March 31, 2015

|                           | Commercial | Agricultural | Residential<br>Real Estate | Consumer | Unallocated | Total    |
|---------------------------|------------|--------------|----------------------------|----------|-------------|----------|
| January 1, 2015           | \$3,821    | \$ 216       | \$ 4,235                   | \$ 645   | \$ 1,183    | \$10,100 |
| Charge-offs               | (17 )      | —            | (50 )                      | (93 )    | —           | (160 )   |
| Recoveries                | 213        | 72           | 33                         | 68       | —           | 386      |
| Provision for loan losses | (209 )     | (82 )        | (490 )                     | 91       | (36 )       | (726 )   |
| March 31, 2015            | \$3,808    | \$ 206       | \$ 3,728                   | \$ 711   | \$ 1,147    | \$9,600  |

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

|                                       | Commercial | Agricultural | Residential<br>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 |

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

| Rating                | March 31, 2016            |           |           | March 31, 2016              |          |           |
|-----------------------|---------------------------|-----------|-----------|-----------------------------|----------|-----------|
|                       | Commercial<br>Real Estate | Other     | Total     | Agricultural<br>Real Estate | Other    | Total     |
| 1 - Excellent         | \$—                       | \$729     | \$729     | \$—                         | \$—      | \$—       |
| 2 - High quality      | 10,638                    | 9,950     | 20,588    | 4,469                       | 1,608    | 6,077     |
| 3 - High satisfactory | 99,591                    | 25,599    | 125,190   | 27,867                      | 11,771   | 39,638    |
| 4 - Low satisfactory  | 238,565                   | 72,438    | 311,003   | 37,292                      | 21,809   | 59,101    |
| 5 - Special mention   | 4,069                     | 483       | 4,552     | 3,742                       | 4,266    | 8,008     |
| 6 - Substandard       | 7,834                     | 241       | 8,075     | 2,113                       | 603      | 2,716     |
| 7 - Vulnerable        | 168                       | —         | 168       | 146                         | —        | 146       |
| 8 - Doubtful          | —                         | —         | —         | —                           | —        | —         |
| Total                 | \$360,865                 | \$109,440 | \$470,305 | \$75,629                    | \$40,057 | \$115,686 |



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| Rating                | December 31, 2015 |           |           |              |          |           |
|-----------------------|-------------------|-----------|-----------|--------------|----------|-----------|
|                       | Commercial        |           |           | Agricultural |          |           |
|                       | Real Estate       | Other     | Total     | Real Estate  | Other    | Total     |
| 1 - Excellent         | \$—               | \$499     | \$499     | \$—          | \$—      | \$—       |
| 2 - High quality      | 7,397             | 11,263    | 18,660    | 4,647        | 2,150    | 6,797     |
| 3 - High satisfactory | 99,136            | 29,286    | 128,422   | 28,886       | 13,039   | 41,925    |
| 4 - Low satisfactory  | 222,431           | 62,987    | 285,418   | 37,279       | 22,166   | 59,445    |
| 5 - Special mention   | 4,501             | 473       | 4,974     | 3,961        | 1,875    | 5,836     |
| 6 - Substandard       | 9,941             | 256       | 10,197    | 1,623        | 139      | 1,762     |
| 7 - Vulnerable        | 211               | —         | 211       | 146          | —        | 146       |
| 8 - Doubtful          | —                 | —         | —         | —            | —        | —         |
| Total                 | \$343,617         | \$104,764 | \$448,381 | \$76,542     | \$39,369 | \$115,911 |

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

**1. EXCELLENT – Substantially Risk Free**

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

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

Experienced management, with management succession in place.

Secured by cash.

**2. HIGH QUALITY – Limited Risk**

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

Favorable liquidity and leverage ratios.

Ability to meet all obligations when due.

Management with successful track record.

Steady and satisfactory earnings history.

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

Access to alternative financing.

Well defined primary and secondary source of repayment.

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

**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.

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4. LOW SATISFACTORY – Acceptable Risk

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

• Would include most start-up businesses.

• Occasional instances of trade slowness or repayment delinquency – may have been 10-30 days slow within the past year.

• Management’s abilities are apparent, yet unproven.

• Weakness in primary source of repayment with adequate secondary source of repayment.

• Loan structure generally in accordance with policy.

• If secured, loan collateral coverage is marginal.

• Adequate cash flow to service debt, but coverage is low.

To be classified as less than satisfactory, only one of the following criteria must be met.

5. SPECIAL MENTION – Criticized

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

• Downward trend in sales, profit levels, and margins.

• Impaired working capital position.

• Cash flow is strained in order to meet debt repayment.

• Loan delinquency (30-60 days) and overdrafts may occur.

• Shrinking equity cushion.

• Diminishing primary source of repayment and questionable secondary source.

• Management abilities are questionable.

• Weak industry conditions.

• Litigation pending against the borrower.

• Collateral or guaranty offers limited protection.

• Negative debt service coverage, however the credit is well collateralized and payments are current.

6. SUBSTANDARD – Classified

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

• Sustained losses have severely eroded the equity and cash flow.

• Deteriorating liquidity.

• Serious management problems or internal fraud.

• Original repayment terms liberalized.

• Likelihood of bankruptcy.

• Inability to access other funding sources.

• Reliance on secondary source of repayment.

• Litigation filed against borrower.

• Collateral provides little or no value.

• Requires excessive attention of the loan officer.

• Borrower is uncooperative with loan officer.

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.

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## 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:

|                               | March 31, 2016                     |               |                    |            | Total<br>Past Due<br>and<br>Nonaccrual | Current   | Total     |
|-------------------------------|------------------------------------|---------------|--------------------|------------|--|-----------|-----------|
|                               | Accruing Interest<br>and Past Due: |               |                    |            |  |           |           |
|                               | 30-59<br>Days                      | 60-89<br>Days | 90 Days<br>or More | Nonaccrual |  |           |           |
| Commercial                    |                                    |               |                    |            |  |           |           |
| Commercial real estate        | \$859                              | \$—           | \$ 55              | \$ 168     | \$ 1,082                               | \$359,783 | \$360,865 |
| Commercial other              | 231                                | —             | —                  | —          | 231                                    | 109,209   | 109,440   |
| Total commercial              | 1,090                              | —             | 55                 | 168        | 1,313                                  | 468,992   | 470,305   |
| Agricultural                  |                                    |               |                    |            |  |           |           |
| Agricultural real estate      | 629                                | —             | —                  | 146        | 775                                    | 74,854    | 75,629    |
| Agricultural other            | 79                                 | —             | —                  | —          | 79                                     | 39,978    | 40,057    |
| Total agricultural            | 708                                | —             | —                  | 146        | 854                                    | 114,832   | 115,686   |
| Residential real estate       |                                    |               |                    |            |  |           |           |
| Senior liens                  | 1,665                              | 134           | —                  | 702        | 2,501                                  | 199,836   | 202,337   |
| Junior liens                  | 43                                 | —             | —                  | —          | 43                                     | 8,941     | 8,984     |
| Home equity lines of credit   | 303                                | —             | —                  | —          | 303                                    | 37,694    | 37,997    |
| Total residential real estate | 2,011                              | 134           | —                  | 702        | 2,847                                  | 246,471   | 249,318   |
| Consumer                      |                                    |               |                    |            |  |           |           |
| Secured                       | 24                                 | —             | —                  | —          | 24                                     | 31,500    | 31,524    |
| Unsecured                     | 4                                  | —             | —                  | —          | 4                                      | 3,454     | 3,458     |
| Total consumer                | 28                                 | —             | —                  | —          | 28                                     | 34,954    | 34,982    |
| Total                         | \$3,837                            | \$ 134        | \$ 55              | \$ 1,016   | \$ 5,042                               | \$865,249 | \$870,291 |

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

## Impaired Loans

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

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

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

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

|  | March 31, 2016         |                                |                        | December 31, 2015      |                                |                        |
|--|------------------------|--------------------------------|------------------------|------------------------|--------------------------------|------------------------|
|  | Outstanding<br>Balance | Unpaid<br>Principal<br>Balance | Valuation<br>Allowance | Outstanding<br>Balance | Unpaid<br>Principal<br>Balance | Valuation<br>Allowance |
| Impaired loans with a valuation allowance          |                        |                                |                        |                        |                                |                        |
| Commercial real estate                             | \$5,856                | \$5,976                        | \$ 906                 | \$5,659                | \$5,777                        | \$ 818                 |
| Commercial other                                   | 96                     | 96                             | 2                      | 8                      | 8                              | 11                     |
| Agricultural real estate                           | —                      | —                              | —                      | —                      | —                              | —                      |
| Agricultural other                                 | —                      | —                              | —                      | 335                    | 335                            | 2                      |
| Residential real estate senior liens               | 9,832                  | 10,596                         | 1,796                  | 9,996                  | 10,765                         | 1,959                  |
| Residential real estate junior liens               | 135                    | 145                            | 27                     | 143                    | 163                            | 30                     |
| Home equity lines of credit                        | —                      | —                              | —                      | —                      | —                              | —                      |
| Consumer secured                                   | —                      | —                              | —                      | —                      | —                              | —                      |
| Total impaired loans with a valuation allowance    | 15,919                 | 16,813                         | 2,731                  | 16,141                 | 17,048                         | 2,820                  |
| Impaired loans without a valuation allowance       |                        |                                |                        |                        |                                |                        |
| Commercial real estate                             | 807                    | 940                            |                        | 2,122                  | 2,256                          |                        |
| Commercial other                                   | 81                     | 92                             |                        | 180                    | 191                            |                        |
| Agricultural real estate                           | 3,546                  | 3,546                          |                        | 3,549                  | 3,549                          |                        |
| Agricultural other                                 | 519                    | 519                            |                        | 184                    | 184                            |                        |
| Home equity lines of credit                        | 121                    | 421                            |                        | 127                    | 434                            |                        |
| Consumer secured                                   | 34                     | 34                             |                        | 35                     | 35                             |                        |
| Total impaired loans without a valuation allowance | 5,108                  | 5,552                          |                        | 6,197                  | 6,649                          |                        |
| Impaired loans                                     |                        |                                |                        |                        |                                |                        |
| Commercial   | 6,840                  | 7,104                          | 908                    | 7,969                  | 8,232                          | 829                    |
| Agricultural                                       | 4,065                  | 4,065                          | —                      | 4,068                  | 4,068                          | 2                      |
| Residential real estate                            | 10,088                 | 11,162                         | 1,823                  | 10,266                 | 11,362                         | 1,989                  |
| Consumer   | 34                     | 34                             | —                      | 35                     | 35                             | —                      |
| Total impaired loans                               | \$21,027               | \$22,365                       | \$ 2,731               | \$22,338               | \$23,697                       | \$ 2,820               |

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The following is a summary of information pertaining to impaired loans for the three month periods ended:

|  | March 31, 2016                             |                      | March 31, 2015                             |                      |
|--|--|----------------------|--|----------------------|
|  | Average Interest<br>Outstanding<br>Balance | Recognized<br>Income | Average Interest<br>Outstanding<br>Balance | Recognized<br>Income |
| Impaired loans with a valuation allowance          |  |                      |  |                      |
| Commercial real estate                             | \$5,758                                    | \$ 84                | \$7,277                                    | \$ 91                |
| Commercial other                                   | 52   | 1                    | 594  | 10                   |
| Agricultural real estate                           | —  | —                    | 44   | 1                    |
| Agricultural other                                 | 168  | —                    | —  | —                    |
| Residential real estate senior liens               | 9,914                                      | 100                  | 11,611                                     | 118                  |
| Residential real estate junior liens               | 139  | 1                    | 258  | 2                    |
| Home equity lines of credit                        | —  | —                    | 125  | —                    |
| Consumer secured                                   | —  | —                    | 52   | 1                    |
| Total impaired loans with a valuation allowance    | 16,031                                     | 186                  | 19,961                                     | 223                  |
| Impaired loans without a valuation allowance       |  |                      |  |                      |
| Commercial real estate                             | 1,465                                      | 19                   | 3,405                                      | 61                   |
| Commercial other                                   | 131  | 2                    | 130  | 3                    |
| Agricultural real estate                           | 3,548                                      | 45                   | 1,481                                      | 21                   |
| Agricultural other                                 | 352  | 6                    | 56   | 1                    |
| Home equity lines of credit                        | 124  | 4                    | 120  | 6                    |
| Consumer secured                                   | 35   | 1                    | 5  | —                    |
| Total impaired loans without a valuation allowance | 5,655                                      | 77                   | 5,197                                      | 92                   |
| Impaired loans                                     |  |                      |  |                      |
| Commercial   | 7,406                                      | 106                  | 11,406                                     | 165                  |
| Agricultural                                       | 4,068                                      | 51                   | 1,581                                      | 23                   |
| Residential real estate                            | 10,177                                     | 105                  | 12,114                                     | 126                  |
| Consumer   | 35   | 1                    | 57   | 1                    |
| Total impaired loans                               | \$21,686                                   | \$ 263               | \$25,158                                   | \$ 315               |

As of March 31, 2016 and December 31, 2015, we had no commitments to advance 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 March 31, 2016 |                                       | Three Months Ended March 31, 2015 |                                       |
|-------------------------------|-----------------------------------|---------------------------------------|-----------------------------------|---------------------------------------|
|                               | Number of Recorded Loans Modified | Post-Modification Recorded Investment | Number of Recorded Loans Modified | Post-Modification Recorded Investment |
| Commercial other              | —                                 | \$ —                                  | 4                                 | \$ 514                                |
| Residential real estate       |                                   |                                       |                                   |                                       |
| Senior liens                  | 2                                 | 26                                    | 2                                 | 238                                   |
| Home equity lines of credit   | —                                 | —                                     | 1                                 | 94                                    |
| Total residential real estate | 2                                 | 26                                    | 3                                 | 332                                   |
| Consumer unsecured            | 1                                 | 2                                     | —                                 | —                                     |
| Total                         | 3                                 | \$ 28                                 | 7                                 | \$ 846                                |

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

|                               | Three Months Ended March 31, 2016 |   | Three Months Ended March 31, 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 Modified | Number of Recorded Loans Pre-Modification Investment            | Number of Recorded Loans Modified | Number of Recorded Loans Pre-Modification Investment            |
| Commercial other              | —                                 | \$ —  | 2                                 | \$ 183  |
| Residential real estate       |                                   |   |                                   |   |
| Senior liens                  | 2                                 | 26  | 1                                 | 189   |
| Home equity lines of credit   | —                                 | —   | —                                 | 94  |
| Total residential real estate | 2                                 | 26  | 1                                 | 283   |
| Consumer unsecured            | —                                 | 1   | —                                 | 2   |
| Total                         | 2                                 | \$ 26   | 3                                 | \$ 232  |
|                               |                                   | 1   | 4                                 | \$ 614  |

We did not restructure any loans by forgiving principal or accrued interest in the three month periods ended March 31, 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 month periods ended March 31, 2016 and 2015 which were modified within 12 months prior to the default date.

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

|      | March 31 2016 | December 31 2015 |
|------|---------------|------------------|
| TDRs | \$ 19,988     | \$ 21,325        |



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## 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:

|                                     | March 31<br>2016 | December 31<br>2015 |
|-------------------------------------|------------------|---------------------|
| FHLB Stock                          | \$ 11,700        | \$ 11,700           |
| Corporate Settlement Solutions, LLC | 7,192            | 7,249               |
| FRB Stock                           | 1,999            | 1,999               |
| Valley Financial Corporation        | 1,000            | 1,000               |
| Other                               | 335              | 338                 |
| Total                               | \$ 22,226        | \$ 22,286           |

## 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:

|   | March 31<br>2016 | December 31<br>2015 |
|---|------------------|---------------------|
| Consumer mortgage loans collateralized by residential real estate foreclosed as a result of obtaining physical possession | \$ 35            | \$ —                |
| All other foreclosed assets   | 241              | 421                 |
| Total   | \$ 276           | \$ 421              |

Changes in foreclosed assets are summarized as follows during the three months ended March 31:

|                        | 2016   | 2015   |
|------------------------|--------|--------|
| Balance, January 1     | \$421  | \$885  |
| Properties transferred | 89     | 134    |
| Proceeds from sale     | (234 ) | (302 ) |
| Balance, March 31      | \$276  | \$717  |

There were no consumer mortgage loans collateralized by residential real estate in the process of foreclosure as of March 31, 2016.

## Note 8 – Borrowed Funds

Borrowed funds consist of the following obligations as of:

|  | March 31, 2016 |       | December 31,<br>2015 |       |
|--|----------------|-------|----------------------|-------|
|  | Amount         | Rate  | Amount               | Rate  |
| FHLB advances  | \$245,000      | 1.94% | \$235,000            | 1.93% |
| Securities sold under agreements to repurchase without stated maturity dates | 58,096         | 0.13% | 70,532               | 0.12% |
| Federal funds purchased  | 4,800          | 0.64% | 4,200                | 0.75% |
| Total  | \$307,896      | 1.58% | \$309,732            | 1.50% |

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

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

|                        | March 31, 2016 |       | December 31, 2015 |       |
|------------------------|----------------|-------|-------------------|-------|
|                        | Amount         | Rate  | Amount            | Rate  |
| Fixed rate due 2016    | \$20,000       | 1.62% | \$30,000          | 1.25% |
| Variable rate due 2016 | 15,000         | 0.76% | 15,000            | 0.62% |
| Fixed rate due 2017    | 50,000         | 1.56% | 50,000            | 1.56% |
| Fixed rate due 2018    | 50,000         | 2.16% | 50,000            | 2.16% |
| Fixed rate due 2019    | 60,000         | 1.99% | 40,000            | 2.35% |
| Fixed rate due 2020    | 10,000         | 1.98% | 10,000            | 1.98% |
| Fixed rate due 2021    | 30,000         | 2.26% | 30,000            | 2.26% |
| Fixed rate due 2023    | 10,000         | 3.90% | 10,000            | 3.90% |
| Total                  | \$245,000      | 1.94% | \$235,000         | 1.93% |

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

|  | March 31, 2016            |                 |  | March 31, 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                  | \$61,051        | 0.12 %   | \$84,859                  | \$79,052        | 0.13 %   |
| Federal funds purchased  | 4,800                     | 4,696           | 0.69 %   | 2,300                     | 5,706           | 0.48 %   |

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

|   | March 31 2016 | December 31 2015 |
|---|---------------|------------------|
| Pledged to secure borrowed funds  | \$335,570     | \$ 339,078       |
| Pledged to secure repurchase agreements   | 58,137        | 70,555           |
| Pledged for public deposits and for other purposes necessary or required by law | 38,465        | 39,038           |
| Total   | \$432,172     | \$ 448,671       |

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

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

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

As of March 31, 2016, we had the ability to borrow up to an additional \$107,598, based on assets pledged as collateral. We had no investment securities that are restricted to be pledged for specific purposes.



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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 |         |
|-----------------------------------|--------------|---------|
|                                   | Ended        |         |
|                                   | March 31     |         |
|                                   | 2016         | 2015    |
| Director fees                     | \$209        | \$198   |
| FDIC insurance premiums           | 205          | 212     |
| Audit and related fees            | 159          | 184     |
| Marketing costs                   | 155          | 112     |
| Education and travel              | 123          | 92      |
| Donations and community relations | 111          | 143     |
| Loan underwriting fees            | 108          | 88      |
| Consulting fees                   | 173          | 84      |
| Postage and freight               | 106          | 98      |
| Printing and supplies             | 78           | 102     |
| All other                         | 639          | 561     |
| Total other                       | \$2,066      | \$1,874 |

## 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 |         |
|---|--------------|---------|
|   | Ended        |         |
|   | March 31     |         |
|   | 2016         | 2015    |
| Income taxes at 34% statutory rate                  | \$1,174      | \$1,511 |
| Effect of nontaxable income                         |              |         |
| Interest income on tax exempt municipal securities  | (502 )       | (500 )  |
| Earnings on corporate owned life insurance policies | (64 )        | (64 )   |
| Effect of tax credits                               | (194 )       | (186 )  |
| Other   | (18 )        | (26 )   |
| Total effect of nontaxable income                   | (778 )       | (776 )  |
| Effect of nondeductible expenses                    | 41           | 36      |
| Federal income tax expense                          | \$437        | \$771   |

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## Note 11 – Fair Value

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

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

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

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

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

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

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

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

| Valuation Technique                | March 31, 2016 |   | Range     |
|------------------------------------|----------------|---|-----------|
|                                    | Fair Value     | Unobservable Input                        |           |
|                                    |                | Discount applied to collateral appraisal: |           |
|                                    |                | Real Estate                               | 20% - 30% |
|                                    |                | Equipment                                 | 35%       |
| Discounted appraisal value \$7,825 |                | Furniture, fixtures & equipment           | 35% - 45% |
|                                    |                | Cash crop inventory                       | 40%       |
|                                    |                | Other inventory                           | 50%       |
|                                    |                | Accounts receivable                       | 50%       |
|                                    |                | Liquor license                            | 75%       |



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

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

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

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

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

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

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

| March 31, 2016                   |   |           |
|----------------------------------|---|-----------|
| Valuation Technique              | Fair Value Unobservable Input             | Range     |
|                                  | Discount applied to collateral appraisal: |           |
| Discounted appraisal value \$276 | Real Estate                               | 20% - 30% |
| December 31, 2015                |   |           |
| Valuation Technique              | Fair Value Unobservable Input             | Range     |
|                                  | Discount applied to collateral appraisal: |           |
| Discounted appraisal value \$421 | Real Estate                               | 20% - 30% |

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

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

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

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

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

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

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

The preceding methods described may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Although we believe our valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement.



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

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

|  | March 31, 2016    |           |          |         |         |
|--|-------------------|-----------|----------|---------|---------|
|  | Carrying          | Estimated | (Level   | (Level  | (Level  |
|  | Value             | Fair      | 1)       | 2)      | 3)      |
|  |                   | Value     |          |         |         |
| <b>ASSETS</b>  |                   |           |          |         |         |
| Cash and cash equivalents                                      | \$28,127          | \$ 28,127 | \$28,127 | \$ —    | —       |
| Mortgage loans AFS   | 1,240             | 1,250     | —        | 1,250   | —       |
| Gross loans  | 870,291           | 861,103   | —        | —       | 861,103 |
| Less allowance for loan and lease losses                       | 7,500             | 7,500     | —        | —       | 7,500   |
| Net loans  | 862,791           | 853,603   | —        | —       | 853,603 |
| Accrued interest receivable                                    | 6,995             | 6,995     | 6,995    | —       | —       |
| Equity securities without readily determinable fair values (1) | 22,226            | N/A       | —        | —       | —       |
| OMSR   | 2,403             | 2,403     | —        | 2,403   | —       |
| <b>LIABILITIES</b>   |                   |           |          |         |         |
| Deposits without stated maturities                             | 751,262           | 751,262   | 751,262  | —       | —       |
| Deposits with stated maturities                                | 422,245           | 422,049   | —        | 422,049 | —       |
| Borrowed funds   | 307,896           | 311,927   | —        | 311,927 | —       |
| Accrued interest payable                                       | 585               | 585       | 585      | —       | —       |
|  | December 31, 2015 |           |          |         |         |
|  | Carrying          | Estimated | (Level   | (Level  | (Level  |
|  | Value             | Fair      | 1)       | 2)      | 3)      |
|  |                   | Value     |          |         |         |
| <b>ASSETS</b>  |                   |           |          |         |         |
| Cash and cash equivalents                                      | \$21,569          | \$ 21,569 | \$21,569 | \$ —    | —       |
| Mortgage loans AFS   | 1,187             | 1,210     | —        | 1,210   | —       |
| Gross loans  | 850,492           | 839,398   | —        | —       | 839,398 |
| Less allowance for loan and lease losses                       | 7,400             | 7,400     | —        | —       | 7,400   |
| Net loans  | 843,092           | 831,998   | —        | —       | 831,998 |
| Accrued interest receivable                                    | 6,269             | 6,269     | 6,269    | —       | —       |
| Equity securities without readily determinable fair values (1) | 22,286            | N/A       | —        | —       | —       |
| OMSR   | 2,505             | 2,518     | —        | 2,518   | —       |
| <b>LIABILITIES</b>   |                   |           |          |         |         |
| Deposits without stated maturities                             | 741,683           | 741,683   | 741,683  | —       | —       |
| Deposits with stated maturities                                | 422,880           | 421,429   | —        | 421,429 | —       |
| Borrowed funds   | 309,732           | 312,495   | —        | 312,495 | —       |
| Accrued interest payable                                       | 545               | 545       | 545      | —       | —       |

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



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## Financial Instruments Recorded at Fair Value

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

|  | March 31, 2016 |           |           |           | December 31, 2015 |           |           |           |
|--|----------------|-----------|-----------|-----------|-------------------|-----------|-----------|-----------|
|  | Total          | (Level 1) | (Level 2) | (Level 3) | Total             | (Level 1) | (Level 2) | (Level 3) |
| Recurring items  |                |           |           |           |                   |           |           |           |
| AFS securities   |                |           |           |           |                   |           |           |           |
| Government-sponsored enterprises                         | \$24,428       | \$—       | \$24,428  | \$—       | \$24,345          | \$—       | \$24,345  | \$—       |
| States and political subdivisions                        | 231,472        | —         | 231,472   | —         | 232,217           | —         | 232,217   | —         |
| Auction rate money market preferred                      | 2,807          | —         | 2,807     | —         | 2,866             | —         | 2,866     | —         |
| Preferred stocks   | 3,346          | 3,346     | —         | —         | 3,299             | 3,299     | —         | —         |
| Mortgage-backed securities                               | 258,284        | —         | 258,284   | —         | 263,384           | —         | 263,384   | —         |
| Collateralized mortgage obligations                      | 129,522        | —         | 129,522   | —         | 134,025           | —         | 134,025   | —         |
| Total AFS securities                                     | 649,859        | 3,346     | 646,513   | —         | 660,136           | 3,299     | 656,837   | —         |
| Nonrecurring items                                       |                |           |           |           |                   |           |           |           |
| Impaired loans (net of the ALLL)                         | 7,825          | —         | —         | 7,825     | 9,301             | —         | —         | 9,301     |
| Foreclosed assets  | 276            | —         | —         | 276       | 421               | —         | —         | 421       |
| Total  | \$657,960      | \$3,346   | \$646,513 | \$8,101   | \$669,858         | \$3,299   | \$656,837 | \$9,722   |
| Percent of assets and liabilities measured at fair value |                |           |           |           |                   |           |           |           |
|  |                | 0.51      | % 98.26   | % 1.23    |                   | 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 March 31, 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 March 31, 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 March 31                         |                              |          | Three Months Ended March 31                         |                              |           |
|--------------------------------|---|------------------------------|----------|---|------------------------------|-----------|
|                                | 2016  |                              | Total    | 2015  |                              | Total     |
|                                | Unrealized Holding Gains (Losses) on AFS Securities | Defined Benefit Pension Plan |          | Unrealized Holding Gains (Losses) on AFS Securities | Defined Benefit Pension Plan |           |
| Balance, January 1             | \$3,536   | \$ (3,315 )                  | \$ 221   | \$3,302   | \$ (3,808 )                  | \$ (506 ) |
| OCI before reclassifications   | 7,274   | —                            | 7,274    | 4,356   | —                            | 4,356     |
| Amounts reclassified from AOCI | —   | —                            | —        | —   | —                            | —         |
| Subtotal                       | 7,274   | —                            | 7,274    | 4,356   | —                            | 4,356     |
| Tax effect                     | (2,477 )  | —                            | (2,477 ) | (1,366 )  | —                            | (1,366 )  |
| OCI, net of tax                | 4,797   | —                            | 4,797    | 2,990   | —                            | 2,990     |
| Balance, March 31              | \$8,333   | \$ (3,315 )                  | \$ 5,018 | \$ 6,292  | \$ (3,808 )                  | \$ 2,484  |

Included in OCI for the three month periods ended March 31, 2016 and 2015 are changes in unrealized holding gains and losses related to auction rate money market preferred and preferred stocks. For federal income tax purposes, these securities are considered equity investments. As such, no deferred federal income taxes related to unrealized holding gains or losses are expected or recorded.

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

|   | Three Months Ended March 31                              |                          |          | Three Months Ended March 31                              |                          |          |
|---|--|--------------------------|----------|--|--------------------------|----------|
|   | 2016   |                          | Total    | 2015   |                          | Total    |
|   | Auction Rate Money Market Preferred and Preferred Stocks | All Other AFS Securities |          | Auction Rate Money Market Preferred and Preferred Stocks | All Other AFS Securities |          |
| Unrealized gains (losses) arising during the period | \$(12)   | \$ 7,286                 | \$ 7,274 | \$ 340   | \$ 4,016                 | \$ 4,356 |
| Tax effect  | —  | (2,477 )                 | (2,477 ) | —  | (1,366 )                 | (1,366 ) |
| Unrealized gains (losses), net of tax               | \$(12)   | \$ 4,809                 | \$ 4,797 | \$ 340   | \$ 2,650                 | \$ 2,990 |

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Interim Condensed Balance Sheets

|   | March 31<br>2016 | December 31<br>2015 |
|---|------------------|---------------------|
| <b>ASSETS</b>                                     |                  |                     |
| Cash on deposit at the Bank                       | \$3,690          | \$ 4,125            |
| AFS securities                                    | 255              | 257                 |
| Investments in subsidiaries                       | 140,596          | 133,883             |
| Premises and equipment                            | 2,018            | 2,014               |
| Other assets                                      | 53,163           | 53,396              |
| <b>TOTAL ASSETS</b>                               | <b>\$199,722</b> | <b>\$ 193,675</b>   |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>       |                  |                     |
| Other liabilities                                 | \$9,475          | \$ 9,704            |
| Shareholders' equity                              | 190,247          | 183,971             |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b> | <b>\$199,722</b> | <b>\$ 193,675</b>   |

## Interim Condensed Statements of Income

|   | Three Months<br>Ended<br>March 31 |                |
|---|-----------------------------------|----------------|
|   | 2016                              | 2015           |
| <b>Income</b>   |                                   |                |
| Dividends from subsidiaries   | \$1,600                           | \$1,600        |
| Interest income   | 4                                 | 36             |
| Management fee and other  | 1,524                             | 1,452          |
| <b>Total income</b>   | <b>3,128</b>                      | <b>3,088</b>   |
| <b>Expenses</b>   |                                   |                |
| Compensation and benefits   | 1,200                             | 1,190          |
| Occupancy and equipment   | 430                               | 410            |
| Audit and related fees  | 96                                | 101            |
| Other   | 546                               | 493            |
| <b>Total expenses</b>   | <b>2,272</b>                      | <b>2,194</b>   |
| Income before income tax benefit and equity in undistributed earnings of subsidiaries | 856                               | 894            |
| Federal income tax benefit  | 246                               | 241            |
| Income before equity in undistributed earnings of subsidiaries                        | 1,102                             | 1,135          |
| Undistributed earnings of subsidiaries  | 1,915                             | 2,538          |
| <b>Net income</b>   | <b>\$3,017</b>                    | <b>\$3,673</b> |

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## Interim Condensed Statements of Cash Flows

|  | Three Months<br>Ended<br>March 31 |          |
|--|-----------------------------------|----------|
|  | 2016                              | 2015     |
| Operating activities   |                                   |          |
| Net income   | \$3,017                           | \$3,673  |
| Adjustments to reconcile net income to cash provided by operations                   |                                   |          |
| Undistributed earnings of subsidiaries   | (1,915 )                          | (2,538 ) |
| Undistributed earnings of equity securities without readily determinable fair values | 61                                | 27       |
| Share-based payment awards under equity compensation plan                            | 158                               | 146      |
| Depreciation   | 41                                | 36       |
| Changes in operating assets and liabilities which provided (used) cash               |                                   |          |
| Other assets   | 173                               | 223      |
| Accrued interest and other liabilities   | (229 )                            | (377 )   |
| Net cash provided by (used in) operating activities                                  | 1,306                             | 1,190    |
| Investing activities   |                                   |          |
| Purchases of premises and equipment  | (45 )                             | (59 )    |
| Net cash provided by (used in) investing activities                                  | (45 )                             | (59 )    |
| Financing activities   |                                   |          |
| Cash dividends paid on common stock  | (1,872 )                          | (1,775 ) |
| Proceeds from the issuance of common stock   | 1,072                             | 945      |
| Common stock repurchased   | (799 )                            | (820 )   |
| Common stock purchased for deferred compensation obligations                         | (97 )                             | (100 )   |
| Net cash provided by (used in) financing activities                                  | (1,696 )                          | (1,750 ) |
| Increase (decrease) in cash and cash equivalents                                     | (435 )                            | (619 )   |
| Cash and cash equivalents at beginning of period                                     | 4,125                             | 1,035    |
| Cash and cash equivalents at end of period   | \$3,690                           | \$416    |

## 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 March 31, 2016 and 2015 and each of the three 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 month periods ended March 31, 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 months ended March 31, 2016 and 2015, we reported net income of \$3,017 and \$3,673 and earnings per common share of \$0.39 and \$0.47, respectively. While interest income for 2016 increased \$328 in comparison to the same period in 2015, our net earnings declined as a result of growth in our commercial loan portfolio which contributed to an increase in the provision for loan losses. For the three month period ended March 31, 2016, the provision for loan losses was \$156. Net loans charged-off during the first three months of 2016 were \$56 as compared to net loan recoveries of \$226 in the first three months of 2015. During the first quarter of 2015, we began to see a significant improvement in loan credit quality indicators through low levels of loans classified as less than satisfactory in addition to those considered to be nonperforming. This improvement along with net recoveries and a reduction in gross loans, resulted in a reversal of provision for loan losses of \$726 for the three month period ended March 31, 2015.

During the three month period ended March 31, 2016, total assets grew by 0.82% to \$1,681,818, and assets under management increased to \$2,372,660 which includes loans sold and serviced, and assets managed by our Investment and Trust Services Department of \$690,842. Total loans increased by \$19,799 from December 31, 2015 which was largely driven by growth in the commercial portfolio. Growth in our residential mortgage and consumer loan portfolios has been challenging; however, we are implementing new products, enhancing our marketing efforts and streamlining delivery channels for direct and indirect loans. These initiatives are designed to generate growth by attracting new customers while expanding our relationships with current customers.

Our net yield on interest earning assets remains historically low at 2.98% for the three month period ended March 31, 2016. The growth in net interest income will increase only through continued growth in loans, investments, and other income earning assets. We do not anticipate that the Federal Reserve Bank will increase short term interest rates significantly in 2016; therefore, we do not anticipate any significant improvements in our net yield on interest earning assets in the short term. We are committed to increasing earnings and dedicated to providing long term sustainable growth to enable us to increase shareholder value.

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 reflect such amounts as restated. For information related 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:

|  | March 31<br>2016 | December 31<br>2015 | September 30<br>2015 | June 30<br>2015 | March 31<br>2015 |   |
|--|------------------|---------------------|----------------------|-----------------|------------------|---|
| <b>INCOME STATEMENT DATA</b>                                   |                  |                     |                      |                 |                  |   |
| Interest income  | \$ 13,081        | \$ 13,023           | \$ 12,967            | \$ 12,759       | \$ 12,753        |   |
| Interest expense   | 2,614            | 2,577               | 2,580                | 2,518           | 2,488            |   |
| Net interest income  | 10,467           | 10,446              | 10,387               | 10,241          | 10,265           |   |
| Provision for loan losses                                      | 156              | (772 )              | (738 )               | (535 )          | (726 )           |   |
| Noninterest income   | 2,223            | 2,501               | 3,101                | 2,629           | 2,128            |   |
| Noninterest expenses   | 9,080            | 9,885               | 9,161                | 8,330           | 8,675            |   |
| Federal income tax expense                                     | 437              | 538                 | 1,002                | 977             | 771              |   |
| Net Income   | \$ 3,017         | \$ 3,296            | \$ 4,063             | \$ 4,098        | \$ 3,673         |   |
| <b>PER SHARE</b>   |                  |                     |                      |                 |                  |   |
| Basic earnings   | \$ 0.39          | \$ 0.42             | \$ 0.52              | \$ 0.53         | \$ 0.47          |   |
| Diluted earnings   | \$ 0.38          | \$ 0.41             | \$ 0.51              | \$ 0.52         | \$ 0.46          |   |
| Dividends  | \$ 0.24          | \$ 0.24             | \$ 0.24              | \$ 0.23         | \$ 0.23          |   |
| Tangible book value*   | \$ 17.47         | \$ 17.30            | \$ 17.06             | \$ 17.17        | \$ 16.84         |   |
| Quoted market value  |                  |                     |                      |                 |                  |   |
| High   | \$ 29.90         | \$ 29.90            | \$ 23.85             | \$ 23.80        | \$ 23.50         |   |
| Low  | \$ 27.25         | \$ 23.50            | \$ 22.75             | \$ 22.70        | \$ 22.00         |   |
| Close*   | \$ 28.25         | \$ 29.90            | \$ 23.69             | \$ 23.75        | \$ 22.90         |   |
| Common shares outstanding*                                     | 7,809,079        | 7,799,867           | 7,765,333            | 7,797,188       | 7,781,820        |   |
| <b>PERFORMANCE RATIOS</b>                                      |                  |                     |                      |                 |                  |   |
| Return on average total assets                                 | 0.72             | % 0.81              | % 1.01               | % 1.04          | % 0.95           | % |
| Return on average shareholders' equity                         | 6.37             | % 7.17              | % 9.03               | % 9.11          | % 8.27           | % |
| Return on average tangible shareholders' equity                | 8.88             | % 9.83              | % 12.18              | % 12.35         | % 11.30          | % |
| Net interest margin yield (FTE)                                | 2.98             | % 3.04              | % 3.09               | % 3.11          | % 3.18           | % |
| <b>BALANCE SHEET DATA*</b>                                     |                  |                     |                      |                 |                  |   |
| Gross loans  | \$ 870,291       | \$ 850,492          | \$ 836,671           | \$ 831,831      | \$ 818,493       |   |
| AFS securities   | \$ 649,859       | \$ 660,136          | \$ 628,612           | \$ 595,318      | \$ 605,208       |   |
| Total assets   | \$ 1,681,818     | \$ 1,668,112        | \$ 1,619,250         | \$ 1,586,975    | \$ 1,571,575     |   |
| Deposits   | \$ 1,173,507     | \$ 1,164,563        | \$ 1,128,003         | \$ 1,090,469    | \$ 1,098,655     |   |
| Borrowed funds   | \$ 307,896       | \$ 309,732          | \$ 297,610           | \$ 307,599      | \$ 283,321       |   |
| Shareholders' equity   | \$ 190,247       | \$ 183,971          | \$ 182,998           | \$ 178,025      | \$ 179,653       |   |
| Gross loans to deposits  | 74.16            | % 73.03             | % 74.17              | % 76.28         | % 74.50          | % |
| <b>ASSETS UNDER MANAGEMENT*</b>                                |                  |                     |                      |                 |                  |   |
| Loans sold with servicing retained                             | \$ 282,618       | \$ 287,029          | \$ 289,268           | \$ 289,089      | \$ 288,448       |   |
| Assets managed by our Investment and Trust Services Department | \$ 408,224       | \$ 405,109          | \$ 392,124           | \$ 400,827      | \$ 396,802       |   |
| Total assets under management                                  | \$ 2,372,660     | \$ 2,360,250        | \$ 2,300,642         | \$ 2,276,891    | \$ 2,256,825     |   |
| <b>ASSET QUALITY*</b>  |                  |                     |                      |                 |                  |   |
| Nonperforming loans to gross loans                             | 0.12             | % 0.09              | % 0.10               | % 0.19          | % 0.44           | % |
| Nonperforming assets to total assets                           | 0.08             | % 0.07              | % 0.09               | % 0.15          | % 0.27           | % |
| ALLL to gross loans  | 0.86             | % 0.87              | % 0.98               | % 1.09          | % 1.17           | % |
| <b>CAPITAL RATIOS*</b>   |                  |                     |                      |                 |                  |   |



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|                                |       |         |         |         |         |   |
|--------------------------------|-------|---------|---------|---------|---------|---|
| Shareholders' equity to assets | 11.31 | % 11.03 | % 11.30 | % 11.22 | % 11.43 | % |
| Tier 1 leverage                | 8.44  | % 8.52  | % 8.54  | % 8.77  | % 8.74  | % |
| Common equity tier 1 capital   | 13.24 | % 13.44 | % 13.57 | % 13.93 | % 13.71 | % |
| Tier 1 risk-based capital      | 13.24 | % 13.44 | % 13.57 | % 13.93 | % 13.71 | % |
| Total risk-based capital       | 13.97 | % 14.17 | % 14.41 | % 14.86 | % 14.71 | % |

\* 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 three month periods ended:

|  | March 31<br>2016 | March 31<br>2015 | March 31<br>2014 | March 31<br>2013 | March 31<br>2012 |   |
|--|------------------|------------------|------------------|------------------|------------------|---|
| <b>INCOME STATEMENT DATA</b>                                   |                  |                  |                  |                  |                  |   |
| Interest income  | \$ 13,081        | \$ 12,753        | \$ 12,693        | \$ 12,602        | \$ 13,532        |   |
| Interest expense   | 2,614            | 2,488            | 2,500            | 2,821            | 3,704            |   |
| Net interest income  | 10,467           | 10,265           | 10,193           | 9,781            | 9,828            |   |
| Provision for loan losses                                      | 156              | (726 )           | (242 )           | 300              | 461              |   |
| Noninterest income   | 2,223            | 2,128            | 2,249            | 2,447            | 3,541            |   |
| Noninterest expenses   | 9,080            | 8,675            | 8,815            | 8,265            | 8,901            |   |
| Federal income tax expense                                     | 437              | 771              | 560              | 576              | 773              |   |
| Net Income   | \$3,017          | \$3,673          | \$3,309          | \$3,087          | \$3,234          |   |
| <b>PER SHARE</b>   |                  |                  |                  |                  |                  |   |
| Basic earnings   | \$0.39           | \$0.47           | \$0.43           | \$0.40           | \$0.43           |   |
| Diluted earnings   | \$0.38           | \$0.46           | \$0.42           | \$0.39           | \$0.41           |   |
| Dividends  | \$0.24           | \$0.23           | \$0.22           | \$0.21           | \$0.20           |   |
| Tangible book value*   | \$17.47          | \$16.84          | \$15.82          | \$14.95          | \$14.15          |   |
| Quoted market value  |                  |                  |                  |                  |                  |   |
| High   | \$29.90          | \$23.50          | \$23.94          | \$25.10          | \$24.50          |   |
| Low  | \$27.25          | \$22.00          | \$22.25          | \$21.55          | \$22.30          |   |
| Close*   | \$28.25          | \$22.90          | \$23.00          | \$25.00          | \$24.00          |   |
| Common shares outstanding*                                     | 7,809,079        | 7,781,820        | 7,727,547        | 7,688,928        | 7,596,772        |   |
| <b>PERFORMANCE RATIOS</b>                                      |                  |                  |                  |                  |                  |   |
| Return on average total assets                                 | 0.72             | % 0.95           | % 0.88           | % 0.86           | % 0.95           | % |
| Return on average shareholders' equity                         | 6.37             | % 8.27           | % 8.04           | % 7.51           | % 8.29           | % |
| Return on average tangible shareholders' equity                | 8.88             | % 11.30          | % 10.92          | % 10.86          | % 12.19          | % |
| Net interest margin yield (FTE)                                | 2.98             | % 3.18           | % 3.21           | % 3.25           | % 3.47           | % |
| <b>BALANCE SHEET DATA*</b>                                     |                  |                  |                  |                  |                  |   |
| Gross loans  | \$870,291        | \$818,493        | \$811,242        | \$769,574        | \$744,427        |   |
| AFS securities   | \$649,859        | \$605,208        | \$555,144        | \$520,931        | \$471,655        |   |
| Total assets   | \$1,681,818      | \$1,571,575      | \$1,513,371      | \$1,434,705      | \$1,369,220      |   |
| Deposits   | \$1,173,507      | \$1,098,655      | \$1,065,935      | \$1,029,760      | \$989,126        |   |
| Borrowed funds   | \$307,896        | \$283,321        | \$272,536        | \$232,410        | \$214,493        |   |
| Shareholders' equity   | \$190,247        | \$179,653        | \$165,971        | \$165,308        | \$157,307        |   |
| Gross loans to deposits  | 74.16            | % 74.50          | % 76.11          | % 74.73          | % 75.26          | % |
| <b>ASSETS UNDER MANAGEMENT*</b>                                |                  |                  |                  |                  |                  |   |
| Loans sold with servicing retained                             | \$282,618        | \$288,448        | \$292,382        | \$301,476        | \$304,235        |   |
| Assets managed by our Investment and Trust Services Department | \$408,224        | \$396,802        | \$358,811        | \$336,632        | \$312,304        |   |
| Total assets under management                                  | \$2,372,660      | \$2,256,825      | \$2,164,564      | \$2,072,813      | \$1,985,759      |   |
| <b>ASSET QUALITY*</b>  |                  |                  |                  |                  |                  |   |
| Nonperforming loans to gross loans                             | 0.12             | % 0.44           | % 0.65           | % 0.90           | % 0.94           | % |
| Nonperforming assets to total assets                           | 0.08             | % 0.27           | % 0.42           | % 0.56           | % 0.64           | % |
| ALLL to gross loans  | 0.86             | % 1.17           | % 1.37           | % 1.55           | % 1.66           | % |
| <b>CAPITAL RATIOS*</b>   |                  |                  |                  |                  |                  |   |
| Shareholders' equity to assets                                 | 11.31            | % 11.43          | % 10.97          | % 11.52          | % 11.49          | % |
| Tier 1 leverage  | 8.44             | % 8.74           | % 8.38           | % 8.28           | % 8.19           | % |

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|                              |       |         |         |         |         |   |
|------------------------------|-------|---------|---------|---------|---------|---|
| Common equity tier 1 capital | 13.24 | % 13.71 | % N/A   | N/A     | N/A     |   |
| Tier 1 risk-based capital    | 13.24 | % 13.71 | % 13.89 | % 13.62 | % 13.20 | % |
| Total risk-based capital     | 13.97 | % 14.71 | % 15.14 | % 14.87 | % 14.45 | % |

\* At end of period

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

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

|   | March 31, 2016  |                         |                      | December 31, 2015 |                         |                      | March 31, 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                                   | \$857,784       | \$9,038                 | 4.21 %               | \$840,849         | \$8,969                 | 4.27 %               | \$825,025       | \$9,025                 | 4.38 %               |
| Taxable investment securities           | 432,747         | 2,400                   | 2.22 %               | 416,451           | 2,398                   | 2.30 %               | 370,586         | 2,107                   | 2.27 %               |
| Nontaxable investment securities        | 211,695         | 2,424                   | 4.58 %               | 213,885           | 2,447                   | 4.58 %               | 197,597         | 2,471                   | 5.00 %               |
| Other                                   | 26,929          | 158                     | 2.35 %               | 26,430            | 156                     | 2.36 %               | 24,421          | 139                     | 2.28 %               |
| Total earning assets                    | 1,529,155       | 14,020                  | 3.67 %               | 1,497,615         | 13,970                  | 3.73 %               | 1,417,629       | 13,742                  | 3.88 %               |
| <b>NONEARNING ASSETS</b>                |                 |                         |                      |                   |                         |                      |                 |                         |                      |
| Allowance for loan losses               | (7,439 )        |                         |                      | (8,252 )          |                         |                      | (10,308 )       |                         |                      |
| Cash and demand deposits due from banks | 17,769          |                         |                      | 18,254            |                         |                      | 17,624          |                         |                      |
| Premises and equipment                  | 28,253          |                         |                      | 28,408            |                         |                      | 26,307          |                         |                      |
| Accrued income and other assets         | 100,770         |                         |                      | 100,563           |                         |                      | 97,795          |                         |                      |
| Total assets                            | \$1,668,508     |                         |                      | \$1,636,588       |                         |                      | \$1,549,047     |                         |                      |
| <b>INTEREST BEARING LIABILITIES</b>     |                 |                         |                      |                   |                         |                      |                 |                         |                      |
| Interest bearing demand deposits        | \$208,309       | 42                      | 0.08 %               | \$197,043         | 39                      | 0.08 %               | \$194,636       | 39                      | 0.08 %               |
| Savings deposits                        | 342,540         | 144                     | 0.17 %               | 319,903           | 138                     | 0.17 %               | 270,792         | 92                      | 0.14 %               |
| Time deposits                           | 420,913         | 1,213                   | 1.15 %               | 426,229           | 1,268                   | 1.19 %               | 437,210         | 1,335                   | 1.22 %               |
| Borrowed funds                          | 310,637         | 1,215                   | 1.56 %               | 305,970           | 1,132                   | 1.48 %               | 283,535         | 1,022                   | 1.44 %               |
| Total interest bearing liabilities      | 1,282,399       | 2,614                   | 0.82 %               | 1,249,145         | 2,577                   | 0.83 %               | 1,186,173       | 2,488                   | 0.84 %               |
| <b>NONINTEREST BEARING LIABILITIES</b>  |                 |                         |                      |                   |                         |                      |                 |                         |                      |
| Demand deposits                         | 187,067         |                         |                      | 191,974           |                         |                      | 174,037         |                         |                      |
| Other                                   | 9,592           |                         |                      | 11,466            |                         |                      | 11,087          |                         |                      |
| Shareholders' equity                    | 189,450         |                         |                      | 184,003           |                         |                      | 177,750         |                         |                      |
|   | \$1,668,508     |                         |                      | \$1,636,588       |                         |                      | \$1,549,047     |                         |                      |

|  |           |           |           |
|--|-----------|-----------|-----------|
| Total liabilities and shareholders' equity |           |           |           |
| Net interest income (FTE)                  | \$ 11,406 | \$ 11,393 | \$ 11,254 |
| Net yield on interest earning assets (FTE) | 2.98 %    | 3.04 %    | 3.18 %    |

#### Net Interest Income

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         |         |      | Three Months Ended         |         |       |
|-------------------------------------|----------------------------|---------|------|----------------------------|---------|-------|
|                                     | March 31, 2016             |         |      | March 31, 2016             |         |       |
|                                     | Compared to                |         |      | Compared to                |         |       |
|                                     | December 31, 2015          |         |      | March 31, 2015             |         |       |
|                                     | Increase (Decrease) Due to |         |      | Increase (Decrease) Due to |         |       |
|                                     | Volume                     | Rate    | Net  | Volume                     | Rate    | Net   |
| Changes in interest income          |                            |         |      |                            |         |       |
| Loans                               | \$179                      | \$(110) | \$69 | \$352                      | \$(339) | \$13  |
| Taxable investment securities       | 92                         | (90)    | 2    | 346                        | (53)    | 293   |
| Nontaxable investment securities    | (25)                       | 2       | (23) | 169                        | (216)   | (47)  |
| Other                               | 3                          | (1)     | 2    | 15                         | 4       | 19    |
| Total changes in interest income    | 249                        | (199)   | 50   | 882                        | (604)   | 278   |
| Changes in interest expense         |                            |         |      |                            |         |       |
| Interest bearing demand deposits    | 2                          | 1       | 3    | 3                          | —       | 3     |
| Savings deposits                    | 10                         | (4)     | 6    | 27                         | 25      | 52    |
| Time deposits                       | (16)                       | (39)    | (55) | (49)                       | (73)    | (122) |
| Borrowed funds                      | 17                         | 66      | 83   | 102                        | 91      | 193   |
| Total changes in interest expense   | 13                         | 24      | 37   | 83                         | 43      | 126   |
| Net change in interest margin (FTE) | \$236                      | \$(223) | \$13 | \$799                      | \$(647) | \$152 |

Our net yield on interest earning assets remains at historically low levels. The persistent low interest rate environment coupled with an increase in the concentration of AFS securities as a percentage of earning assets has also placed downward pressure on net interest margin yield. During the remainder of 2016, we do not expect any significant change in our net yield on interest earning assets as the rates paid on interest bearing liabilities will likely increase as fast as those of interest earning assets. Net interest income will increase only through continued balance sheet growth.

## Average Yield / Rate for the Three Month Periods Ended:

|  | March 31 2016 | December 31 2015 | September 30 2015 | June 30 2015 | March 31 2015 |
|--|---------------|------------------|-------------------|--------------|---------------|
| Total earning assets                       | 3.67%         | 3.73%            | 3.79%             | 3.81%        | 3.88%         |
| Total interest bearing liabilities         | 0.82%         | 0.83%            | 0.84%             | 0.84%        | 0.84%         |
| Net yield on interest earning assets (FTE) | 2.98%         | 3.04%            | 3.09%             | 3.11%        | 3.18%         |

## Quarter to Date Net Interest Income (FTE)

|                             | March 31 2016 | December 31 2015 | September 30 2015 | June 30 2015 | March 31 2015 |
|-----------------------------|---------------|------------------|-------------------|--------------|---------------|
| Total interest income (FTE) | \$14,020      | \$13,970         | \$13,919          | \$13,748     | \$13,742      |
| Total interest expense      | 2,614         | 2,577            | 2,580             | 2,518        | 2,488         |
| Net interest income (FTE)   | \$11,406      | \$11,393         | \$11,339          | \$11,230     | \$11,254      |



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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 month periods ended March 31:

|   | 2016    | 2015     | Variance  |
|---|---------|----------|-----------|
| ALLL at beginning of period                       | \$7,400 | \$10,100 | \$(2,700) |
| Charge-offs                                       |         |          |           |
| Commercial and agricultural                       | 16      | 17       | (1 )      |
| Residential real estate                           | 241     | 50       | 191       |
| Consumer  | 84      | 93       | (9 )      |
| Total charge-offs                                 | 341     | 160      | 181       |
| Recoveries  |         |          |           |
| Commercial and agricultural                       | 181     | 285      | (104 )    |
| Residential real estate                           | 50      | 33       | 17        |
| Consumer  | 54      | 68       | (14 )     |
| Total recoveries                                  | 285     | 386      | (101 )    |
| Net loan charge-offs                              | 56      | (226 )   | 282       |
| Provision for loan losses                         | 156     | (726 )   | 882       |
| ALLL at end of period                             | \$7,500 | \$9,600  | \$(2,100) |
| Net loan charge-offs to average loans outstanding | 0.01 %  | (0.03 )% | 0.04 %    |

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

|  | March 31<br>2016 | December 31<br>2015 | September 30<br>2015 | June 30<br>2015 | March 31<br>2015 |
|--|------------------|---------------------|----------------------|-----------------|------------------|
| Total charge-offs                                      | \$341            | \$238               | \$210                | \$296           | \$160            |
| Total recoveries                                       | 285              | 210                 | 148                  | 231             | 386              |
| Net loan charge-offs                                   | 56               | 28                  | 62                   | 65              | (226 )           |
| Net loan charge-offs to average loans outstanding      | 0.01 %           | — %                 | 0.01 %               | 0.01 %          | (0.03 )%         |
| Provision for loan losses                              | \$156            | \$(772 )            | \$(738 )             | \$(535 )        | \$(726 )         |
| Provision for loan losses to average loans outstanding | 0.02 %           | (0.09 )%            | (0.09 )%             | (0.07 )%        | (0.09 )%         |
| ALLL   | \$7,500          | \$7,400             | \$8,200              | \$9,000         | \$9,600          |
| ALLL as a % of loans at end of period                  | 0.86 %           | 0.87 %              | 0.98 %               | 1.08 %          | 1.17 %           |

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. Loan growth during 2016 and an increase in net loans charged-off led to an increase in the level of ALLL as of March 31, 2016.



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

|                                       | March 31<br>2016 | December 31<br>2015 | September 30<br>2015 | June 30<br>2015 | March 31<br>2015 |
|---------------------------------------|------------------|---------------------|----------------------|-----------------|------------------|
| <b>ALLL</b>                           |                  |                     |                      |                 |                  |
| Individually evaluated for impairment | \$2,731          | \$ 2,820            | \$ 3,217             | \$3,202         | \$3,361          |
| Collectively evaluated for impairment | 4,769            | 4,580               | 4,983                | 5,798           | 6,239            |
| <b>Total</b>                          | <b>\$7,500</b>   | <b>\$ 7,400</b>     | <b>\$ 8,200</b>      | <b>\$9,000</b>  | <b>\$9,600</b>   |
| <b>ALLL to gross loans</b>            |                  |                     |                      |                 |                  |
| Individually evaluated for impairment | 0.31             | % 0.33              | % 0.38               | % 0.38          | % 0.41           |
| Collectively evaluated for impairment | 0.55             | % 0.54              | % 0.60               | % 0.70          | % 0.76           |
| <b>Total</b>                          | <b>0.86</b>      | <b>% 0.87</b>       | <b>% 0.98</b>        | <b>% 1.08</b>   | <b>% 1.17</b>    |

While more volatile, loans individually evaluated for impairment have been relatively flat in recent quarters. The decline in loans collectively impaired during 2015 illustrates the downward trend we are experiencing in our overall level of ALLL to gross loans in 2015. 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 changes 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> |                     |                      |                 |                  |
|---|--|---------------------|----------------------|-----------------|------------------|
|   | March 31<br>2016                           | December 31<br>2015 | September 30<br>2015 | June 30<br>2015 | March 31<br>2015 |
| Commercial and agricultural                               | \$2,167                                    | \$ 2,247            | \$ 1,709             | \$2,407         | \$4,017          |
| Residential real estate                                   | 2,847                                      | 2,520               | 2,030                | 2,995           | 2,965            |
| Consumer  | 28   | 31                  | 60                   | 126             | 106              |
| <b>Total</b>  | <b>\$5,042</b>                             | <b>\$ 4,798</b>     | <b>\$ 3,799</b>      | <b>\$5,528</b>  | <b>\$7,088</b>   |
| <b>Total past due and nonaccrual loans to gross loans</b> | <b>0.58</b>                                | <b>% 0.56</b>       | <b>% 0.45</b>        | <b>% 0.66</b>   | <b>% 0.87</b>    |

Lower levels of past due and nonaccrual status loans are the result of strengthened loan performance. 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.

**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 allowed 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 March 31, 2016 or December 31, 2015.



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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 TDR for the:

|                                | Three Months Ended March 31, 2016 |          |                 |         |                 |          |
|--------------------------------|-----------------------------------|----------|-----------------|---------|-----------------|----------|
|                                | Accruing Interest                 |          | Nonaccrual      |         | Total           |          |
|                                | Number of Loans                   | Balance  | Number of Loans | Balance | Number of Loans | Balance  |
|                                |                                   |          |                 |         |                 |          |
| January 1, 2016                | 155                               | \$20,931 | 5               | \$ 394  | 160             | \$21,325 |
| New modifications              | 3                                 | 28       | —               | —       | 3               | 28       |
| Principal advances (payments)  | —                                 | (277 )   | —               | (8 )    | —               | (285 )   |
| Loans paid-off                 | (4 )                              | (978 )   | —               | —       | (4 )            | (978 )   |
| Partial charge-offs            | —                                 | —        | —               | (52 )   | —               | (52 )    |
| Balances charged-off           | (1 )                              | (15 )    | —               | —       | (1 )            | (15 )    |
| Transfers to OREO              | —                                 | —        | (1)             | (35 )   | (1 )            | (35 )    |
| Transfers to accrual status    | —                                 | —        | —               | —       | —               | —        |
| Transfers to nonaccrual status | (2 )                              | (278 )   | 2               | 278     | —               | —        |
| March 31, 2016                 | 151                               | \$19,411 | 6               | \$ 577  | 157             | \$19,988 |

|                                | Three Months Ended March 31, 2015 |          |                 |         |                 |          |
|--------------------------------|-----------------------------------|----------|-----------------|---------|-----------------|----------|
|                                | Accruing Interest                 |          | Nonaccrual      |         | Total           |          |
|                                | Number of Loans                   | Balance  | Number of Loans | Balance | Number of Loans | Balance  |
|                                |                                   |          |                 |         |                 |          |
| January 1, 2015                | 156                               | \$20,931 | 13              | \$2,410 | 169             | \$23,341 |
| New modifications              | 5                                 | 525      | 2               | 321     | 7               | 846      |
| Principal advances (payments)  | —                                 | (198 )   | —               | (37 )   | —               | (235 )   |
| Loans paid-off                 | (8 )                              | (920 )   | (3 )            | (500 )  | (11 )           | (1,420 ) |
| Partial charge-offs            | —                                 | —        | —               | (47 )   | —               | (47 )    |
| Balances charged-off           | —                                 | —        | —               | —       | —               | —        |
| Transfers to OREO              | —                                 | —        | (2 )            | (97 )   | (2 )            | (97 )    |
| Transfers to accrual status    | —                                 | —        | —               | —       | —               | —        |
| Transfers to nonaccrual status | (1 )                              | (83 )    | 1               | 83      | —               | —        |
| March 31, 2015                 | 152                               | \$20,255 | 11              | \$2,133 | 163             | \$22,388 |

The following table summarizes our TDRs as of:

|                          | March 31, 2016    |            |          | December 31, 2015 |            |          | Total Change |
|--------------------------|-------------------|------------|----------|-------------------|------------|----------|--------------|
|                          | Accruing Interest | Nonaccrual | Total    | Accruing Interest | Nonaccrual | Total    |              |
| Current                  | \$18,038          | \$ 226     | \$18,264 | \$20,550          | \$ 146     | \$20,696 | \$(2,432)    |
| Past due 30-59 days      | 1,373             | 130        | 1,503    | 357               | —          | 357      | 1,146        |
| Past due 60-89 days      | —                 | —          | —        | 24                | —          | 24       | (24 )        |
| Past due 90 days or more | —                 | 221        | 221      | —                 | 248        | 248      | (27 )        |
| Total                    | \$19,411          | \$ 577     | \$19,988 | \$20,931          | \$ 394     | \$21,325 | \$(1,337)    |

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:

|                                      | March 31, 2016         |                                |                        | December 31, 2015      |                                |                        |
|--------------------------------------|------------------------|--------------------------------|------------------------|------------------------|--------------------------------|------------------------|
|                                      | Outstanding<br>Balance | Unpaid<br>Principal<br>Balance | Valuation<br>Allowance | Outstanding<br>Balance | Unpaid<br>Principal<br>Balance | Valuation<br>Allowance |
| <b>TDRs</b>                          |                        |                                |                        |                        |                                |                        |
| Commercial real estate               | \$6,539                | \$6,778                        | \$ 905                 | \$7,619                | \$7,858                        | \$ 818                 |
| Commercial other                     | 177                    | 188                            | 2                      | 188                    | 199                            | 11                     |
| Agricultural real estate             | 3,546                  | 3,546                          | —                      | 3,549                  | 3,549                          | —                      |
| Agricultural other                   | 519                    | 519                            | —                      | 519                    | 519                            | 2                      |
| Residential real estate senior liens | 8,920                  | 9,254                          | 1,726                  | 9,155                  | 9,457                          | 1,851                  |
| Residential real estate junior liens | 132                    | 132                            | 26                     | 133                    | 133                            | 28                     |
| Home equity lines of credit          | 121                    | 421                            | —                      | 127                    | 427                            | —                      |
| Consumer secured                     | 34                     | 34                             | —                      | 35                     | 35                             | —                      |
| <b>Total TDRs</b>                    | <b>19,988</b>          | <b>20,872</b>                  | <b>2,659</b>           | <b>21,325</b>          | <b>22,177</b>                  | <b>2,710</b>           |
| <b>Other impaired loans</b>          |                        |                                |                        |                        |                                |                        |
| Commercial real estate               | 124                    | 138                            | 1                      | 162                    | 175                            | —                      |
| Commercial other                     | —                      | —                              | —                      | —                      | —                              | —                      |
| Agricultural real estate             | —                      | —                              | —                      | —                      | —                              | —                      |
| Agricultural other                   | —                      | —                              | —                      | —                      | —                              | —                      |
| Residential real estate senior liens | 912                    | 1,341                          | 70                     | 841                    | 1,308                          | 108                    |
| Residential real estate junior liens | 3                      | 14                             | 1                      | 10                     | 30                             | 2                      |
| Home equity lines of credit          | —                      | —                              | —                      | —                      | 7                              | —                      |
| Consumer secured                     | —                      | —                              | —                      | —                      | —                              | —                      |
| <b>Total other impaired loans</b>    | <b>1,039</b>           | <b>1,493</b>                   | <b>72</b>              | <b>1,013</b>           | <b>1,520</b>                   | <b>110</b>             |
| <b>Total impaired loans</b>          | <b>\$21,027</b>        | <b>\$22,365</b>                | <b>\$ 2,731</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.

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## Nonperforming Assets

The following table summarizes our nonperforming assets as of:

|   | March 31<br>2016 | December 31<br>2015 | September 30<br>2015 | June 30<br>2015 | March 31<br>2015 |
|---|------------------|---------------------|----------------------|-----------------|------------------|
| Nonaccrual status loans                     | \$ 1,016         | \$ 792              | \$ 796               | \$ 1,530        | \$ 3,422         |
| Accruing loans past due 90 days or more     | 55               | —                   | —                    | 19              | 173              |
| Total nonperforming loans                   | 1,071            | 792                 | 796                  | 1,549           | 3,595            |
| Foreclosed assets                           | 276              | 421                 | 601                  | 873             | 717              |
| Total nonperforming assets                  | \$ 1,347         | \$ 1,213            | \$ 1,397             | \$ 2,422        | \$ 4,312         |
| Nonperforming loans as a % of total loans   | 0.12 %           | 0.09 %              | 0.10 %               | 0.19 %          | 0.44 %           |
| Nonperforming assets as a % of total assets | 0.08 %           | 0.07 %              | 0.09 %               | 0.15 %          | 0.27 %           |

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 continue to improve with current levels reflecting historic lows.

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

|                             | March 31<br>2016 | December 31<br>2015 |
|-----------------------------|------------------|---------------------|
| Commercial and agricultural | \$ 226           | \$ 232              |
| Residential real estate     | 351              | 162                 |
| Total                       | \$ 577           | \$ 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 March 31, 2016.

We believe that the level of the ALLL is appropriate as of March 31, 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.

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## Noninterest Income and Noninterest Expenses

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

|   | Three Months Ended March 31 |         |        |          |
|---|-----------------------------|---------|--------|----------|
|   | 2016                        | 2015    | Change |          |
|   |                             |         | \$     | %        |
| Service charges and fees                            |                             |         |        |          |
| ATM and debit card fees                             | \$597                       | \$526   | \$71   | 13.50 %  |
| NSF and overdraft fees                              | 418                         | 447     | (29 )  | (6.49 )% |
| Freddie Mac servicing fee                           | 183                         | 179     | 4      | 2.23 %   |
| Service charges on deposit accounts                 | 85                          | 82      | 3      | 3.66 %   |
| Net OMSR income (loss)                              | (102 )                      | (104 )  | 2      | N/M      |
| All other   | 32                          | 33      | (1 )   | (3.03 )% |
| Total service charges and fees                      | 1,213                       | 1,163   | 50     | 4.30 %   |
| Net gain on sale of mortgage loans                  | 82                          | 149     | (67 )  | (44.97)% |
| Earnings on corporate owned life insurance policies | 188                         | 187     | 1      | 0.53 %   |
| Other   |                             |         |        |          |
| Trust and brokerage advisory fees                   | 526                         | 512     | 14     | 2.73 %   |
| Other   | 214                         | 117     | 97     | 82.91 %  |
| Total other   | 740                         | 629     | 111    | 17.65 %  |
| Total noninterest income                            | \$2,223                     | \$2,128 | \$95   | 4.46 %   |

Significant changes in noninterest income are detailed below:

ATM and debit card fees have increased as a result of marketing incentives. While we do not anticipate significant changes to our ATM and debit fees, we do expect that fees will continue to increase in the remainder of 2016 as the usage of ATM and debit cards continues to increase.

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, decline in loan demand, and increased prepayment speeds have been the most significant drivers behind fluctuations in the gain on sale of mortgage loans and net OMSR income (loss).

Mortgage rates are expected to approximate current levels in the foreseeable future and purchase money mortgage activity is anticipated to increase as a result of our various initiatives to drive growth. As such, we anticipate increases in origination volumes and in turn, gains on sale of mortgage loans if these loans are sold to the secondary market.

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 March 31 |         |         |           |   |
|-----------------------------------|-----------------------------|---------|---------|-----------|---|
|                                   | 2016                        | 2015    | Change  |           |   |
|                                   |                             |         | \$      | %         |   |
| Compensation and benefits         |                             |         |         |           |   |
| Employee salaries                 | \$3,394                     | \$3,441 | \$(47 ) | (1.37 )%  |   |
| Employee benefits                 | 1,394                       | 1,325   | 69      | 5.21      | % |
| Total compensation and benefits   | 4,788                       | 4,766   | 22      | 0.46      | % |
| Furniture and equipment           |                             |         |         |           |   |
| Service contracts                 | 720                         | 671     | 49      | 7.30      | % |
| Depreciation                      | 533                         | 475     | 58      | 12.21     | % |
| ATM and debit card fees           | 189                         | 155     | 34      | 21.94     | % |
| All other                         | 26                          | 13      | 13      | 100.00    | % |
| Total furniture and equipment     | 1,468                       | 1,314   | 154     | 11.72     | % |
| Occupancy                         |                             |         |         |           |   |
| Depreciation                      | 194                         | 179     | 15      | 8.38      | % |
| Outside services                  | 193                         | 189     | 4       | 2.12      | % |
| Property taxes                    | 145                         | 132     | 13      | 9.85      | % |
| Utilities                         | 141                         | 160     | (19 )   | (11.88 )% |   |
| All other                         | 85                          | 61      | 24      | 39.34     | % |
| Total occupancy                   | 758                         | 721     | 37      | 5.13      | % |
| Other                             |                             |         |         |           |   |
| Director fees                     | 209                         | 198     | 11      | 5.56      | % |
| FDIC insurance premiums           | 205                         | 212     | (7 )    | (3.30 )%  |   |
| Audit and related fees            | 159                         | 184     | (25 )   | (13.59 )% |   |
| Marketing costs                   | 155                         | 112     | 43      | 38.39     | % |
| Education and travel              | 123                         | 92      | 31      | 33.70     | % |
| Donations and community relations | 111                         | 143     | (32 )   | (22.38 )% |   |
| Loan underwriting fees            | 108                         | 88      | 20      | 22.73     | % |
| Consulting fees                   | 173                         | 84      | 89      | 105.95    | % |
| Postage and freight               | 106                         | 98      | 8       | 8.16      | % |
| Printing and supplies             | 78                          | 102     | (24 )   | (23.53 )% |   |
| All other                         | 639                         | 561     | 78      | 13.90     | % |
| Total other                       | 2,066                       | 1,874   | 192     | 10.25     | % |
| Total noninterest expenses        | \$9,080                     | \$8,675 | \$405   | 4.67      | % |

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 with the exception of marketing costs due to increased marketing efforts within the new markets.

We place a strong emphasis on employee development through continuous education. Education and travel expenses vary from year to year based on the timing of various programs that our employees attend.

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.

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

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





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## Analysis of Changes in Financial Condition

|  | March 31<br>2016   | December 31<br>2015 | \$ Change       | % Change<br>(unannualized) |          |
|--|--------------------|---------------------|-----------------|----------------------------|----------|
| <b>ASSETS</b>  |                    |                     |                 |                            |          |
| Cash and cash equivalents                                  | \$28,127           | \$ 21,569           | \$6,558         | 30.40                      | %        |
| AFS securities   |                    |                     |                 |                            |          |
| Amortized cost of AFS securities                           | 636,797            | 654,348             | (17,551 )       | (2.68                      | )%       |
| Unrealized gains (losses) on AFS securities                | 13,062             | 5,788               | 7,274           | 125.67                     | %        |
| AFS securities   | 649,859            | 660,136             | (10,277 )       | (1.56                      | )%       |
| Mortgage loans AFS   | 1,240              | 1,187               | 53              | 4.47                       | %        |
| Loans  |                    |                     |                 |                            |          |
| Gross loans  | 870,291            | 850,492             | 19,799          | 2.33                       | %        |
| Less allowance for loan and lease losses                   | 7,500              | 7,400               | 100             | 1.35                       | %        |
| Net loans  | 862,791            | 843,092             | 19,699          | 2.34                       | %        |
| Premises and equipment                                     | 28,269             | 28,331              | (62 )           | (0.22                      | )%       |
| Corporate owned life insurance policies                    | 26,611             | 26,423              | 188             | 0.71                       | %        |
| Accrued interest receivable                                | 6,995              | 6,269               | 726             | 11.58                      | %        |
| Equity securities without readily determinable fair values | 22,226             | 22,286              | (60 )           | (0.27                      | )%       |
| Goodwill and other intangible assets                       | 48,785             | 48,828              | (43 )           | (0.09                      | )%       |
| Other assets   | 6,915              | 9,991               | (3,076 )        | (30.79                     | )%       |
| <b>TOTAL ASSETS</b>  | <b>\$1,681,818</b> | <b>\$ 1,668,112</b> | <b>\$13,706</b> | <b>0.82</b>                | <b>%</b> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                |                    |                     |                 |                            |          |
| <b>Liabilities</b>   |                    |                     |                 |                            |          |
| Deposits   | \$1,173,507        | \$ 1,164,563        | \$8,944         | 0.77                       | %        |
| Borrowed funds   | 307,896            | 309,732             | (1,836 )        | (0.59                      | )%       |
| Accrued interest payable and other liabilities             | 10,168             | 9,846               | 322             | 3.27                       | %        |
| Total liabilities  | 1,491,571          | 1,484,141           | 7,430           | 0.50                       | %        |
| Shareholders' equity                                       | 190,247            | 183,971             | 6,276           | 3.41                       | %        |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>          | <b>\$1,681,818</b> | <b>\$ 1,668,112</b> | <b>\$13,706</b> | <b>0.82</b>                | <b>%</b> |

The following table outlines the changes in loans:

|                         | March 31<br>2016 | December 31<br>2015 | \$ Change | % Change<br>(unannualized) |    |
|-------------------------|------------------|---------------------|-----------|----------------------------|----|
| Commercial              | \$470,305        | \$ 448,381          | \$21,924  | 4.89                       | %  |
| Agricultural            | 115,686          | 115,911             | (225 )    | (0.19                      | )% |
| Residential real estate | 249,318          | 251,501             | (2,183 )  | (0.87                      | )% |
| Consumer                | 34,982           | 34,699              | 283       | 0.82                       | %  |
| Total                   | \$870,291        | \$ 850,492          | \$19,799  | 2.33                       | %  |

The following table displays loan balances as of:

|                         | March 31<br>2016 | December 31<br>2015 | September 30<br>2015 | June 30<br>2015 | March 31<br>2015 |
|-------------------------|------------------|---------------------|----------------------|-----------------|------------------|
| Commercial              | \$470,305        | \$ 448,381          | \$ 434,823           | \$432,641       | \$419,722        |
| Agricultural            | 115,686          | 115,911             | 116,293              | 113,134         | 107,299          |
| Residential real estate | 249,318          | 251,501             | 251,324              | 251,679         | 259,034          |
| Consumer                | 34,982           | 34,699              | 34,231               | 34,377          | 32,438           |
| Total                   | \$870,291        | \$ 850,492          | \$ 836,671           | \$831,831       | \$818,493        |

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While competition for commercial loans continues to be strong, we experienced growth in this segment of the portfolio during the first quarter of 2016 and anticipate continued growth in the remainder of 2016. Residential real estate loans were relatively flat and we anticipate growth in 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:

|                                     | March 31<br>2016 | December 31<br>2015 | \$<br>Change | %<br>(unannualized) | %<br>Change |
|-------------------------------------|------------------|---------------------|--------------|---------------------|-------------|
| Noninterest bearing demand deposits | \$ 183,820       | \$ 191,376          | \$(7,556)    | (3.95)              | %           |
| Interest bearing demand deposits    | 215,327          | 212,666             | 2,661        | 1.25                | %           |
| Savings deposits                    | 352,115          | 337,641             | 14,474       | 4.29                | %           |
| Certificates of deposit             | 323,350          | 324,101             | (751)        | (0.23)              | %           |
| Brokered certificates of deposit    | 76,014           | 73,815              | 2,199        | 2.98                | %           |
| Internet certificates of deposit    | 22,881           | 24,964              | (2,083)      | (8.34)              | %           |
| Total                               | \$1,173,507      | \$ 1,164,563        | \$8,944      | 0.77                | %           |

The following table displays deposit balances as of:

|                                     | March 31<br>2016 | December 31<br>2015 | September 30<br>2015 | June 30<br>2015 | March 31<br>2015 |
|-------------------------------------|------------------|---------------------|----------------------|-----------------|------------------|
| Noninterest bearing demand deposits | \$ 183,820       | \$ 191,376          | \$ 181,782           | \$ 182,259      | \$ 176,160       |
| Interest bearing demand deposits    | 215,327          | 212,666             | 197,476              | 193,680         | 197,364          |
| Savings deposits                    | 352,115          | 337,641             | 316,590              | 278,105         | 286,741          |
| Certificates of deposit             | 323,350          | 324,101             | 328,806              | 330,226         | 333,554          |
| Brokered certificates of deposit    | 76,014           | 73,815              | 76,948               | 78,853          | 76,671           |
| Internet certificates of deposit    | 22,881           | 24,964              | 26,401               | 27,346          | 28,165           |
| Total                               | \$1,173,507      | \$ 1,164,563        | \$ 1,128,003         | \$ 1,090,469    | \$ 1,098,655     |

Deposit demand continues to be driven by non-contractual deposits while certificates of deposit gradually decline. Our significant growth in savings deposits during 2015 is the result of branch acquisitions. Growth is anticipated to continue to come in the form of non-contractual deposits, while certificates of deposit are expected to continue to decline but at a slower rate than the previous year.

The current interest rate environment has made it almost impossible to increase net interest income without increasing earning assets. When deposit growth outpaced loan demand, we deployed funds from deposit growth into purchases of AFS securities to provide additional interest income. In addition to utilizing deposits, we have also utilized borrowings and brokered deposits to fund earning assets. We anticipate that future increases in our AFS securities will be in the form of mortgage-backed securities and collateralized mortgage obligations. The following table displays fair values of AFS securities as of:

|                                     | March 31<br>2016 | December 31<br>2015 | September 30<br>2015 | June 30<br>2015 | March 31<br>2015 |
|-------------------------------------|------------------|---------------------|----------------------|-----------------|------------------|
| Government sponsored enterprises    | \$24,428         | \$ 24,345           | \$ 24,368            | \$24,203        | \$24,397         |
| States and political subdivisions   | 231,472          | 232,217             | 232,374              | 216,647         | 222,479          |
| Auction rate money market preferred | 2,807            | 2,866               | 2,707                | 2,719           | 2,775            |
| Preferred stocks                    | 3,346            | 3,299               | 3,192                | 3,230           | 6,324            |
| Mortgage-backed securities          | 258,284          | 263,384             | 234,258              | 210,194         | 201,997          |
| Collateralized mortgage obligations | 129,522          | 134,025             | 131,713              | 138,325         | 147,236          |
| Total                               | \$649,859        | \$ 660,136          | \$ 628,612           | \$595,318       | \$605,208        |

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The following table displays borrowed funds balances as of:

|  | March 31<br>2016 | December 31<br>2015 | September 30<br>2015 | June 30<br>2015 | March 31<br>2015 |
|--|------------------|---------------------|----------------------|-----------------|------------------|
| FHLB advances  | \$245,000        | \$ 235,000          | \$ 215,000           | \$240,000       | \$217,000        |
| Securities sold under agreements to repurchase without stated maturity dates | 58,096           | 70,532              | 69,510               | 67,599          | 66,321           |
| Federal funds purchased  | 4,800            | 4,200               | 13,100               | —               | —                |
| Total  | \$307,896        | \$ 309,732          | \$ 297,610           | \$307,599       | \$283,321        |

## 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 37,465 shares or \$1,072 of common stock during the first three months of 2016, as compared to 41,217 shares or \$945 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 \$158 and \$146 during the three month periods ended March 31, 2016 and 2015, respectively.

We have approved a publicly announced common stock repurchase plan. Pursuant to this plan, we repurchased 28,253 shares or \$799 of common stock compared to 35,671 shares for \$820 during the first three months of 2016 and 2015, respectively. As of March 31, 2016, we were authorized to repurchase up to an additional 130,405 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 8.44% as of March 31, 2016.

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:

|                              | March 31<br>2016 | December 31<br>2015 | Required |
|------------------------------|------------------|---------------------|----------|
| Common equity tier 1 capital | 13.24 %          | 13.44 %             | 4.50 %   |
| Tier 1 capital               | 13.24 %          | 13.44 %             | 6.00 %   |
| Tier 2 capital               | 0.73 %           | 0.73 %              | 2.00 %   |
| Total Capital                | 13.97 %          | 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 March 31, 2016, the Bank exceeded these minimum capital requirements.



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## 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:

|  | March 31   | December 31 |
|--|------------|-------------|
|  | 2016       | 2015        |
| Unfunded commitments under lines of credit | \$ 141,658 | \$ 134,412  |
| Commitments to grant loans                 | 65,951     | 53,946      |
| Commercial and standby letters of credit   | 937        | 915         |
| Total                                      | \$ 208,546 | \$ 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.

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.

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.

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.

## 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 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 \$677,986 or 40.31% of assets as of March 31, 2016 as compared to \$681,705 or 40.87% as of December 31, 2015. 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.

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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 March 31, 2016, we had available lines of credit of \$107,598.

The following table summarizes our sources and uses of cash for the three month periods ended March 31:

|   | 2016     | 2015      | \$<br>Variance |
|---|----------|-----------|----------------|
| Net cash provided by (used in) operating activities | \$4,675  | \$2,026   | \$ 2,649       |
| Net cash provided by (used in) investing activities | (3,529 ) | (16,788 ) | 13,259         |
| Net cash provided by (used in) financing activities | 5,412    | 16,033    | (10,621 )      |
| Increase (decrease) in cash and cash equivalents    | 6,558    | 1,271     | 5,287          |
| Cash and cash equivalents January 1                 | 21,569   | 19,906    | 1,663          |
| Cash and cash equivalents March 31                  | \$28,127 | \$21,177  | \$ 6,950       |

**Market Risk**

Our primary market risks are interest rate risk and liquidity risk. We have no significant foreign exchange risk and do not utilize interest rate swaps or derivatives, except for interest rate locks and forward loan commitments, 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 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 March 31, 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 real estate residential 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.

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

|  | March 31, 2016 |       |       |       |       | 24 Months |       |       |       |       |
|--|----------------|-------|-------|-------|-------|-----------|-------|-------|-------|-------|
|  | 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 | (2.14)%        | 0.78% | 1.67% | 1.93% | 2.42% | (1.64)%   | 1.14% | 2.90% | 3.67% | 4.58% |

  

|  | December 31, 2015 |       |       |       |       | 24 Months |       |       |       |       |
|--|-------------------|-------|-------|-------|-------|-----------|-------|-------|-------|-------|
|  | 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 March 31, 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.

## March 31, 2016

|  | 2017      | 2018      | 2019     | 2020     | 2021     | Thereafter | Total     | Fair Value |
|--|-----------|-----------|----------|----------|----------|------------|-----------|------------|
| Rate sensitive assets                          |           |           |          |          |          |            |           |            |
| Other interest bearing assets                  | \$11,457  | \$—       | \$—      | \$—      | \$—      | \$—        | \$11,457  | \$11,456   |
| Average interest rates                         | 0.04%     | —%        | —%       | —%       | —%       | —%         | 0.04%     | %          |
| AFS securities                                 | \$172,251 | \$102,215 | \$77,930 | \$68,877 | \$70,050 | \$158,536  | \$649,859 | \$649,859  |
| Average interest rates                         | 2.00%     | 2.19%     | 2.11%    | 2.26%    | 2.39%    | 2.29%      | 2.18%     | %          |
| Fixed interest rate loans (1)                  | \$127,134 | \$120,745 | \$99,780 | \$92,816 | \$87,306 | \$175,073  | \$702,854 | \$693,666  |
| Average interest rates                         | 4.54%     | 4.32%     | 4.30%    | 4.27%    | 4.24%    | 4.25%      | 4.32%     | %          |
| Variable interest rate loans (1)               | \$62,220  | \$24,993  | \$22,743 | \$15,136 | \$14,742 | \$27,603   | \$167,437 | \$167,437  |
| Average interest rates                         | 4.51%     | 4.31%     | 4.24%    | 3.62%    | 3.70%    | 3.69%      | 4.16%     | %          |
| Rate sensitive liabilities                     |           |           |          |          |          |            |           |            |
| Fixed rate borrowed funds                      | \$102,896 | \$60,000  | \$60,000 | \$20,000 | \$10,000 | \$40,000   | \$292,896 | \$296,927  |
| Average interest rates                         | 0.76%     | 1.96%     | 2.01%    | 1.60%    | 1.98%    | 2.67%      | 1.62%     | %          |
| Variable rate borrowed funds                   | \$15,000  | \$—       | \$—      | \$—      | \$—      | \$—        | \$15,000  | \$15,000   |
| Average interest rates                         | 0.76%     | —%        | —%       | —%       | —%       | —%         | 0.76%     | %          |
| Savings and NOW accounts                       | \$82,197  | \$43,136  | \$38,732 | \$34,809 | \$31,317 | \$337,251  | \$567,442 | \$567,442  |
| Average interest rates                         | 0.59%     | 0.11%     | 0.11%    | 0.11%    | 0.11%    | 0.10%      | 0.18%     | %          |
| Fixed interest rate certificates of deposit    | \$198,667 | \$73,494  | \$63,312 | \$26,590 | \$33,997 | \$23,635   | \$419,695 | \$419,499  |
| Average interest rates                         | 0.93%     | 1.22%     | 1.28%    | 1.53%    | 1.59%    | 1.84%      | 1.18%     | %          |
| Variable interest rate certificates of deposit | \$1,088   | \$1,462   | \$—      | \$—      | \$—      | \$—        | \$2,550   | \$2,550    |
| Average interest rates                         | 0.52%     | 0.66%     | —%       | —%       | —%       | —%         | 0.60%     | %          |



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|  | December 31, 2015 |           |           |          |          |            |           | Fair Value |
|--|-------------------|-----------|-----------|----------|----------|------------|-----------|------------|
|  | 2016              | 2017      | 2018      | 2019     | 2020     | Thereafter | Total     |            |
| Rate sensitive assets                          |                   |           |           |          |          |            |           |            |
| Other interest bearing assets                  | \$2,659           | \$100     | \$—       | \$—      | \$—      | \$—        | \$2,759   | \$2,758    |
| 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.

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.



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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 March 31, 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 March 31, 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 March 31, 2016, with respect to this plan:

|                      | Common Shares<br>Repurchased | Average Price<br>Number Per Common<br>Share | Total Number of<br>Common Shares<br>Purchased<br>as Part of Publicly<br>Announced Plan<br>or Program | Maximum Number of<br>Common<br>Shares That May Yet Be<br>Purchased Under the<br>Plans or Programs |
|----------------------|------------------------------|---|--|---|
| Balance, December 31 |                              |   |  | 158,658   |
| January 1 - 31       | 12,874                       | \$ 28.43                                    | 12,874   | 145,784   |
| February 1 - 29      | 11,672                       | 28.36                                       | 11,672   | 134,112   |
| March 1 - 31         | 3,707                        | 27.79                                       | 3,707  | 130,405   |
| Balance, March 31    | 28,253                       | \$ 28.32                                    | 28,253   | 130,405   |

## 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<br>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: May 9, 2016 /s/ Jae A. Evans  
Jae A. Evans  
Chief Executive Officer  
(Principal Executive Officer)

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