MACKINAC FINANCIAL CORP /MI/
Form 10-Q
November 14, 2016
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2016

OR

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

For the transition period from <> to <>

Commission file number: 0-20167

MACKINAC FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

MICHIGAN	38-2062816
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

130 SOUTH CEDAR STREET, MANISTIQUE, MI	49854
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (888) 343-8147

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 periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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	Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes No

As of November 10, 2016, there were outstanding 6,263,371 shares of the registrant’s common stock, no par value.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands)

	September 30, 2016 (Unaudited)	December 31, 2015
ASSETS		
Cash and due from banks	$ 46,200	$ 25,005
Federal funds sold	2,415	3
Cash and cash equivalents	48,615	25,008
Interest-bearing deposits in other financial institutions	14,047	5,089
Securities available for sale	88,886	53,728
Federal Home Loan Bank stock	2,926	2,169
Loans:		
Commercial	513,266	450,275
Mortgage	222,840	152,272
Consumer	20,698	15,847
Total Loans	756,804	618,394
Allowance for loan losses	(4,862)	(5,004)
Net loans	751,942	613,390
Premises and equipment	16,028	12,524
Other real estate held for sale	3,269	2,324
Deferred tax asset	9,287	9,213
Deposit based intangibles	2,235	1,076
Goodwill	5,694	3,805
Other assets	16,192	10,943
TOTAL ASSETS	$ 959,121	$ 739,269
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES:		
Deposits:		
Noninterest bearing deposits	$ 163,278	$ 122,775
NOW, money market, interest checking	287,097	202,784

Savings	60,322	30,882
CDs<$250,000	150,170	124,084
CDs>$250,000	9,015	8,532
Brokered	137,298	121,266
Total deposits	807,180	610,323
Borrowings	67,730	45,754
Other liabilities	5,926	6,590
Total liabilities	880,836	662,667
SHAREHOLDERS’ EQUITY:		
Preferred stock - No par value:		
Authorized - 500,000 shares, Issued and outstanding - none	—	—
Common stock and additional paid in capital - No par value Authorized - 18,000,000 shares Issued and outstanding - 6,263,371 and 6,217,620, respectively	61,433	61,133
Retained earnings	16,115	15,221
Accumulated other comprehensive income		
Unrealized gains on available for sale securities	786	297
Minimum pension liability	(49)	(49)
Total shareholders’ equity	78,285	76,602
TOTAL LIABILITIES AND SHAREHOLDERS’ EQUITY	$ 959,121	$ 739,269

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CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in Thousands, Except per Share Data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016 (Unaudited)	2015 (Unaudited)	2016 (Unaudited)	2015 (Unaudited)
INTEREST INCOME:				
Interest and fees on loans:				
Taxable	$ 9,441	$ 8,019	$ 26,085	$ 23,986
Tax-exempt	19	3	34	9
Interest on securities:				
Taxable	387	282	953	845
Tax-exempt	57	35	114	129
Other interest income	91	46	212	148
Total interest income	9,995	8,385	27,398	25,117
INTEREST EXPENSE:				
Deposits	870	843	2,410	2,467
Borrowings	429	307	1,008	895
Total interest expense	1,299	1,150	3,418	3,362
Net interest income	8,696	7,235	23,980	21,755
Provision for loan losses	200	350	350	855
Net interest income after provision for loan losses	8,496	6,885	23,630	20,900
OTHER INCOME:				
Deposit service fees	259	196	723	624
Income from loans sold on the secondary market	512	301	1,118	750
SBA/USDA loan sale gains	551	40	717	440
Mortgage servicing (amortization) income	(12)	9	(74)	239
Net realized security gains	40	133	149	402
Other	139	94	379	292
Total other income	1,489	773	3,012	2,747
OTHER EXPENSE:				
Salaries and employee benefits	3,687	3,139	10,592	9,102
Occupancy	680	602	1,960	1,804
Furniture and equipment	440	370	1,248	1,159
Data processing	440	327	1,118	1,041
Advertising	157	153	494	399

Professional service fees	309	348	807	928
Loan and deposit	152	136	434	399
Writedowns and (gains) losses on other real estate held for sale	60	104	62	141
FDIC insurance assessment	131	135	356	383
Telephone	140	108	374	346
Transaction related expenses	359	—	2,928	—
Other	730	692	2,003	1,868
Total other expenses	7,285	6,114	22,376	17,570
Income before provision for income taxes	2,700	1,544	4,266	6,077
Provision for income taxes	922	526	1,481	2,074
NET INCOME AVAILABLE TO COMMON SHAREHOLDERS	$ 1,778	$ 1,018	$ 2,785	$ 4,003
INCOME PER COMMON SHARE:				
Basic	$ 0.29	$ 0.16	$ .45	$ .64
Diluted	$ 0.28	$ 0.16	$ .45	$ .64

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CONDENSED CONSOLIDATED STATEMENTS COMPREHENSIVE INCOME

(Dollars in Thousands)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income	$ 1,778	$ 1,018	$ 2,785	$ 4,003
Other comprehensive income				
Change in securities available for sale:				
Unrealized gains (losses) arising during the period	(79)	297	890	370
Reclassification adjustment for securities gains included in net income	(40)	(133)	(149)	(402)
Tax effect	40	(56)	(252)	61
Net change in unrealized gains on available for sale securities	(79)	108	489	29
Total comprehensive income	$ 1,699	$ 1,126	$ 3,274	$ 4,032

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CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(Dollars in Thousands)

(Unaudited)

	Nine Months Ended September 30, 2016				
	Shares of Common Stock	Common Stock and Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance, beginning of period	6,217,620	$ 61,133	$ 15,221	$ 248	$ 76,602
Net income for period	—	—	2,785	—	2,785
Other comprehensive income					
Net unrealized gain on securities available for sale	—	—	—	489	489
Actuarial loss on defined benefit pension obligation	—	—	—	—	—
Total comprehensive income	—	—	2,785	489	3,274
Stock compensation	—	450	—	—	450
Issuance of common stock:					
Restricted stock award vesting	59,751	—	—	—	—
Repurchase of common stock	(14,000)	(150)	—	—	(150)
Dividend on common stock	—	—	(1,891)	—	(1,891)
Balance, end of period	6,263,371	$ 61,433	$ 16,115	$ 737	$ 78,285

	Nine Months Ended September 30, 2015				
	Shares of Common Stock	Common Stock and Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance, beginning of period	6,266,756	$ 61,679	$ 11,804	$ 513	$ 73,996
Net income for period	—	—	4,003	—	4,003
Other comprehensive income					
Net unrealized gain on securities available for sale	—	—	—	29	29
Actuarial loss on defined benefit pension obligation	—	—	—	—	—
Total comprehensive income	—	—	4,003	29	4,032
Stock compensation	—	432	—	—	432
Issuance of common stock:					
Restricted stock award vesting	53,319	—	—	—	—
Repurchase of common stock	(70,480)	(791)	—	—	(791)
Dividend on common stock	—	—	(1,578)	—	(1,578)
Balance, end of period	6,249,595	$ 61,320	$ 14,229	$ 542	$ 76,091

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in Thousands)

(Unaudited)

	Nine Months Ended September 30, 2016	2015
Cash Flows from Operating Activities:		
Net income	$ 2,785	$ 4,003
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,336	1,265
Provision for loan losses	350	855
Deferred income taxes, net	1,481	2,074
Gain on sales/calls of securities	(149)	(402)
Gain on sale of loans sold in the secondary market	(959)	(604)
Origination of loans held for sale in the secondary market	(56,941)	(36,827)
Proceeds from sale of loans in the secondary market	57,900	37,431
(Gain) loss on sale of premises, equipment, and other real estate held for sale	10	6
Writedown of other real estate held for sale	53	135
Stock compensation	450	432
Change in other assets	12,462	7,993
Change in other liabilities	(1,174)	(6,016)
Net cash provided by operating activities	17,604	10,345
Cash Flows from Investing Activities:		
Net increase in loans	(28,118)	(19,185)
Net decrease in interest bearing deposits in other financial institutions	3,015	708
Purchase of securities available for sale	(7,225)	(16,390)
Proceeds from maturities, sales, calls or paydowns of securities available for sale	16,752	27,546
Proceeds from FHLBI repurchases of excess stock	—	804
Capital expenditures	(1,833)	(1,123)
Net cash used in Eagle acquisition and reimbursement of contract termination fee	(12,500)	—
Net cash used in Niagara acquisition	(7,325)	—
Proceeds from sale of premises, equipment, and other real estate	1,143	1,190
Net cash (used in) provided by investing activities	(36,091)	(6,450)
Cash Flows from Financing Activities:		
Net increase (decrease) in deposits	33,159	15,361
Net activity on lines of credit	(8,550)	121
New term debt issuance	19,800	—

Principal payments on borrowings	(274)	(374)
Repurchase of common stock	(150)	(791)
Dividend on common stock	(1,891)	(1,578)
Net cash provided by financing activities	42,094	12,739
Net increase (decrease) in cash and cash equivalents	23,607	16,634
Cash and cash equivalents at beginning of period	25,008	21,947
Cash and cash equivalents at end of period	$ 48,615	$ 38,581
Supplemental Cash Flow Information:		
Cash paid during the year for:		
Interest	$ 3,273	$ 3,345
Income taxes	100	150
Noncash Investing and Financing Activities:		
Transfers of Foreclosures from Loans to Other Real Estate Held for Sale	1,091	674

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1.SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The unaudited condensed consolidated financial statements of Mackinac Financial Corporation (the "Corporation") have been prepared in accordance with generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine-month period ended September 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. The unaudited consolidated financial statements and footnotes thereto should be read in conjunction with the audited consolidated financial statements and footnotes thereto included in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2015.

In order to properly reflect some categories of other income and other expenses, reclassifications of expense and income items have been made to prior period numbers. The "net" other income and other expenses was not changed due to these reclassifications.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the valuation of investment securities, the valuation of foreclosed real estate, deferred tax assets, mortgage servicing rights, and the assessment of goodwill for impairment.

Acquired Loans

Loans acquired with evidence of credit deterioration since inception and for which it is probable that all contractual payments will not be received are accounted for under ASC Topic 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality ("ASC 310-30"). These loans are recorded at fair value at the time of acquisition, with no carryover of the related allowance for loan losses. Fair value of acquired loans is determined using a discounted cash flow methodology based on assumptions about the amount and timing of principal and interest payments, principal prepayments and principal defaults and losses, and current market rates. In recording the fair values of acquired impaired loans at acquisition date, management calculates a non-accretable difference (the credit component of the purchased loans) and an accretable difference (the yield component of the purchased loans).

Over the life of the acquired loans, management continues to estimate cash flows expected to be collected on pools of loans sharing common risk characteristics, which are treated in the aggregate when applying various valuation techniques. Management evaluates at each balance sheet date whether the present value of our pools of loans determined using the effective interest rates has decreased significantly and if so, recognizes a provision for loan loss in our consolidated statement of income. For any significant increases in cash flows expected to be collected, we adjust the amount of the accretable yield recognized on a prospective basis over the pool's remaining life.

Performing acquired loans are accounted for under Financial Accounting Standards Board ("FASB") Topic 310-20, Receivables – Nonrefundable Fees and Other Costs. Performance of certain loans may be monitored and based on management's assessment of the cash flows and other facts available, portions of the accretable difference may be delayed or suspended if management deems appropriate. The Corporation's policy for determining when to discontinue accruing interest on performing acquired loans and the subsequent accounting for such loans is essentially the same as the policy for originated loans.

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Allowance for Loan Losses

The allowance for loan losses includes specific allowances related to commercial loans, when they have been judged to be impaired. A loan is impaired when, based on current information, it is probable that the Corporation will not collect all amounts due in accordance with the contractual terms of the loan agreement. These specific allowances are based on discounted cash flows of expected future payments using the loan's initial effective interest rate or the fair value of the collateral if the loan is collateral dependent.

The Corporation continues to maintain a general allowance for loan losses for loans not considered impaired. The allowance for loan losses is maintained at a level which management believes is adequate to provide for incurred loan losses. Management periodically evaluates the adequacy of the allowance using the Corporation's past loan loss experience, known and inherent risks in the portfolio, composition of the portfolio, current economic conditions, and other factors. The allowance does not include the effects of expected losses related to future events or future changes in economic conditions. This evaluation is inherently subjective since it requires material estimates that may be susceptible to significant change. Loans are charged against the allowance for loan losses when management believes the collectability of the principal is unlikely. In addition, various regulatory agencies periodically review the Corporation's allowance for loan losses. These agencies may require additions to the allowance for loan losses based on their judgments of collectability.

In management's opinion, the allowance for loan losses is adequate to cover probable losses relating to specifically identified loans, as well as probable losses inherent in the balance of the loan portfolio as of the balance sheet date.

Stock Compensation Plans

On May 22, 2012, the Corporation's shareholders approved the Mackinac Financial Corporation 2012 Incentive Compensation Plan, under which current and prospective employees, non-employee directors and consultants may be awarded incentive stock options, non-statutory stock options, shares of restricted stock units ("RSUs"), or stock appreciation rights. The aggregate number of shares of the Company's common stock issuable under the plan is 575,000. Awards are made at the discretion of management and the Board of Directors. Compensation cost equal to the fair value of the award is recognized over the vesting period.

2.RECENT ACCOUNTING PRONOUNCEMENTS

In May 2014, the FASB issued guidance on the recognition of revenue from contracts with customers. Revenue recognition will depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance also requires disclosures regarding the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The guidance permits two methods of adoption: retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application. The guidance is effective January 1, 2018 and early adoption is permitted only as of January 1, 2017. The Corporation is currently evaluating the impact of the new guidance and the method of adoption in the consolidated financial results; however, adoption is not expected to have a material impact on the Corporation's consolidated financial condition and results of operations.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities ("ASU 2016-01"). ASU 2016-01 amends current guidance by requiring companies to recognize changes in fair value for equity investments that have a readily determinable fair value through net income rather than through other comprehensive income. Under ASU 2016-01, equity investments that do not have a readily determinable fair value will either be accounted for the same as equity investments that have a readily determinable fair value, with changes in fair value recognized through net income or carried at cost, adjusted for changes in observable prices based on orderly transactions for identical or similar investments issued by the same issuer and further adjusted for impairment, if applicable. ASU 2016-01 also requires a qualitative assessment of impairment indicators each reporting period. If this assessment indicates that impairment exists, companies must adjust the investment to fair value and recognize an impairment loss in net income, even if the impairment is determined to be temporary. ASU 2016-01 is effective for public companies for interim and annual periods beginning after December 15,

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2017.   The Corporation's adoption of ASU 2016-01 is not expected to have a material impact on the Corporation's consolidated financial condition or results of operations.

In February 2016, the FASB issued ASU 2016-02, Leases, which will supersede the current lease requirements in ASC 840. The ASU requires lessees to recognize an asset with the right of use and related lease liability for all leases, with a limited exception for short-term leases. Leases will be classified as either finance or operating, with the classification affecting the pattern of expense recognition in the statement of operations. Currently, leases are classified as either capital or operating, with only capital leases recognized on the balance sheet. The reporting of lease related expenses in the statements of operations and cash flows will be generally consistent with the current guidance. The new lease guidance will be effective for the Corporation's year ending December 31, 2019 and will be applied using modified retrospective transition method to the beginning of the earliest period presented. The effect of applying the new lease guidance on the financial statements has not yet been determined.

In September, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments ("ASU 2016-13"). ASU 2016-13 changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income.

ASU 2016-13 requires an entity to measure expected credit losses for financial assets over the estimated lifetime of expected credit loss and record an allowance that, when deducted from the amortized cost basis of the financial asset, presents the net amount expected to be collected on the financial asset. The standard includes the following core concepts in determining the expected credit loss. The estimate must: (a) be based on an asset's amortized cost (including premiums or discounts, net deferred fees and costs, foreign exchange and fair value hedge accounting adjustments), (b) reflect losses expected over the remaining contractual life of an asset (considering the effect of voluntary prepayments), (c) consider available relevant information about the estimated collectability of cash flows (including information about past events, current conditions, and reasonable and supportable forecasts), and (d) reflect the risk of loss, even when that risk is remote.

ASU 2016-13 also amends the recording of purchased credit-deteriorated assets. Under the new guidance, an allowance will be recognized at acquisition through a gross-up approach whereby an entity will record as the initial amortized cost the sum of (a) the purchase price and (b) an estimate of credit losses as of the date of acquisition. In addition, the guidance also requires immediate recognition in earnings of any subsequent changes, both favorable and unfavorable, in expected cash flows by adjusting this allowance.

ASU 2016-13 also amends the impairment model for available-for-sale debt securities and requires entities to determine whether all or a portion of the unrealized loss on an available-for-sale debt security is a credit loss. Management may not use the length of time a security has been in an unrealized loss position as a factor in concluding whether a credit loss exists, as is currently permitted. In addition, an entity will recognize an allowance for credit losses on available-for-sale debt securities as a contra-account to the amortized cost basis rather than as a direct reduction of the amortized cost basis of the investment, as is currently required. As a result, entities will recognize improvements to credit losses on available-for-sale debt securities immediately in earnings rather than as interest income over time under current practice.

New disclosures required by ASU 2016-13 include: (a) for financial assets measured at amortized cost, an entity will be required to disclose information about how it developed its allowance, including changes in the factors that influenced management’s estimate of expected credit losses and the reasons for those changes, (b) for financial receivables and net investments in leases measured at amortized cost, an entity will be required to further disaggregate the information it currently discloses about the credit quality of these assets by year or the asset’s origination or vintage for as many as five annual periods, and (c) for available-for-sale debt securities, an entity will be required to provide a roll-forward of the allowance for credit losses and an aging analysis for securities that are past due.

Upon adoption of ASU 2016-13, a cumulative-effect adjustment to retained earnings will be recorded as of the beginning of the first reporting period in which the guidance is effective. ASU 2016-13 is effective for public companies for interim and annual periods beginning after December 15, 2019, with early adoption permitted for annual periods beginning after December 15, 2018. The Corporation is currently evaluating the provisions of ASU 2016-13 to determine the potential impact on the Corporation's consolidated financial condition and results of operations.

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3.EARNINGS PER SHARE

Diluted earnings per share, which reflects the potential dilution that could occur if outstanding stock options were exercised and stock awards were fully vested and resulted in the issuance of common stock that then shared in our earnings, is computed by dividing net income by the weighted average number of common shares outstanding and common stock equivalents, after giving effect for dilutive shares issued.

The following shows the computation of basic and diluted earnings per share for the three and nine months ended September 30, 2016 and 2015 (dollars in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
(Numerator):				
Net income	$ 1,778	$ 1,018	$ 2,785	$ 4,003
(Denominator):				
Weighted average shares outstanding	6,238,756	6,238,963	6,226,900	6,247,416
Effect of dilutive stock options, and vesting of restricted stock units	20,999	39,046	33,525	31,400
Diluted weighted average shares outstanding	6,259,755	6,278,009	6,260,425	6,278,816
Income per common share:				
Basic	$ 0.29	$ 0.16	$ .45	$ .64
Diluted	$ 0.28	$ 0.16	$ .45	$ .64

4.INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities available for sale as of September 30, 2016 and December 31, 2015 are as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value

September 30, 2016				
US Agencies - MBS	$ 16,254	$ 176	$ (73)	$ 16,357
US Agencies	24,148	295	—	24,443
Corporate Bonds	18,403	239	—	18,642
Other	3,033	—	—	3,033
Obligations of states and political subdivisions	25,857	561	(7)	26,411
Total securities available for sale	$ 87,695	$ 1,271	$ (80)	$ 88,886
December 31, 2015				
US Treasury	$ 12,710	$ —	$ (64)	$ 12,646
US Agencies	27,358	62	(43)	27,377
US Agencies - MBS	3,738	31	(10)	3,759
Obligations of states and political subdivisions	9,472	592	(118)	9,946
Total securities available for sale	$ 53,278	$ 685	$ (235)	$ 53,728

The Corporation has evaluated gross unrealized losses that exist within the portfolio and considers them temporary in nature. The Corporation has both the ability and the intent to hold the investment securities until their respective maturities and therefore does not anticipate the realization of the temporary losses.

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The amortized cost and estimated fair value of investment securities pledged to secure FHLB borrowings and customer relationships were $24.168 million and $25.048 million, respectively, at September 30, 2016.

5.LOANS

The composition of loans is as follows (dollars in thousands):

	September 30, 2016	December 31, 2015
Commercial real estate	$ 362,858	$ 312,805
Commercial, financial, and agricultural	136,065	122,140
One to four family residential real estate	211,072	140,502
Construction :		
Consumer	11,768	11,770
Commercial	14,343	15,330
Consumer	20,698	15,847
Total loans	$ 756,804	$ 618,394

The Corporation completed the acquisition of Peninsula Financial Corporation ("PFC") on December 5, 2014, The First National Bank of Eagle River ("Eagle") on April 29, 2016 and Niagara Bancorporation ("Niagara") on August 31, 2016. The acquired loans were divided into loans with evidence of credit quality deterioration, which are accounted for under ASC 310-30 ("acquired impaired") and loans that do not meet that criteria, which are accounted for under ASC 310-20 ("acquired nonimpaired"). The PFC acquired impaired loans totaled $13.290 million, the Eagle acquired impaired loans totaled $3.401 million, and the Niagara acquired impaired loans totaled $2.105 million. The Corporation recorded all acquired loans at fair value taking into account a number of factors, including remaining life, estimated loss, estimated value of the underlying collateral and net present values of cash flows. In the first nine months of 2015, the Corporation had positive resolution of one PFC acquired nonperforming loan which resulted in the recognition of approximately $.429 million of the accretable interest.

The table below details the outstanding balances of the PFC acquired portfolio and the fair value adjustments at acquisition date (dollars in thousands):

	Acquired	Acquired	Acquired

	Impaired	Non-impaired	Total
Loans acquired - contractual payments	$ 13,290	$ 53,849	$ 67,139
Nonaccretable difference	(2,234)	—	(2,234)
Expected cash flows	11,056	53,849	64,905
Accretable yield	(744)	(2,100)	(2,844)
Carrying balance at acquisition date	$ 10,312	$ 51,749	$ 62,061

The table below details the outstanding balances of the Eagle acquired portfolio and the fair value adjustments at acquisition date (dollars in thousands):

	Acquired Impaired	Acquired Non-impaired	Acquired Total
Loans acquired - contractual payments	$ 3,401	$ 82,639	$ 86,040
Nonaccretable difference	(1,172)	—	(1,172)
Expected cash flows	2,229	82,639	84,868
Accretable yield	(391)	(1,700)	(2,091)
Carrying balance at acquisition date	$ 1,838	$ 80,939	$ 82,777

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The table below details the outstanding balances of the Niagara acquired portfolio and the fair value adjustments at acquisition date (dollars in thousands):

	Acquired Impaired	Acquired Non-impaired	Acquired Total
Loans acquired - contractual payments	$ 2,105	$ 29,936	$ 32,041
Nonaccretable difference	(265)	—	(265)
Expected cash flows	1,840	29,936	31,776
Accretable yield	(88)	(600)	(688)
Carrying balance at acquisition date	$ 1,752	$ 29,336	$ 31,088

The table below presents a rollforward of the accretable yield on acquired loans for the nine months ended September 30, 2016 (dollars in thousands):

	Peninsula			Eagle			Niagara		
	Acquired Impaired	Acquired Non-impaired	Acquired Total	Acquired Impaired	Acquired Non-impaired	Acquired Total	Acquired Impaired	Acquired Non-impaired	Acquired Total
Balance, December 31, 2015	$ 426	$ 1,342	$ 1,768	$ —	$ —	$ —	$ —	$ —	$ —
Acquisitions	—	—	—	391	1,700	2,091	88	600	688
Accretion	—	(525)	(525)	—	(299)	(299)	—	(49)	(49)
Reclassification from nonaccretable difference	(80)	—	(80)	(54)	—	(54)	—	—	—
Balance, September 30, 2016	$ 346	$ 817	$ 1,163	$ 337	$ 1,401	$ 1,738	$ 88	$ 551	$ 639

The table below presents a rollforward of the accretable yield on acquired loans for the nine months ended September 30, 2015 (dollars in thousands):

	Acquired Impaired	Acquired Non-impaired	Acquired Total
Balance, December 31, 2014	$ 744	$ 2,042	$ 2,786
Accretion	(429)	(525)	(954)
Reclassification from nonaccretable difference	188	—	188
Balance, September 30, 2015	$ 503	$ 1,517	$ 2,020

An analysis of the allowance for loan losses for the nine months ended September 30, 2016 and the year ended December 31, 2015 is as follows (dollars in thousands):

	September 30, 2016	December 31, 2015
Balance, January 1	$ 5,004	$ 5,140
Recoveries on loans previously charged off	120	690
Loans charged off	(612)	(2,030)
Provision	350	1,204
Balance at end of period	$ 4,862	$ 5,004

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In the first nine months of 2016, net charge-offs were $.492 million, or .10% of average loans, annualized, compared to net charge-offs of $.216 million in the same period in 2015. In the first nine months of 2016, the Corporation recorded a provision for loan loss of $.350 million compared to $.855 million in the first nine months of 2015. The Corporation's allowance for loan loss reserve policy calls for a measurement of the adequacy of the reserve at each quarter end. This process includes an analysis of the loan portfolio to take into account increases in loans outstanding and portfolio composition, historical loss rates, and specific reserve requirements of nonperforming loans.

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A breakdown of the allowance for loan losses and recorded balances in loans at September 30, 2016 is as follows (dollars in thousands):

	Commercial real estate	Commercial, financial and agricultural	Commercial construction	One to four family residential real estate	Consumer construction	Consumer	Unallocated	Total
Three Months Ended September 30, 2016								
Allowance for loan loss reserve:								
Beginning balance ALLR	$ 1,824	700	$ 78	$ 348	$ 5	$ 23	$ 1,755	$ 4,733
Charge-offs	(20)	—	—	(76)	—	(10)	—	(106)
Recoveries	17	4	—	2	—	12	—	35
Provision	(235)	(180)	(16)	133	1	49	448	200
Ending balance ALLR	$ 1,586	$ 524	$ 62	$ 407	$ 6	$ 74	$ 2,203	$ 4,862
Nine Months Ended September 30, 2016								
Allowance for loan loss reserve:								
Beginning balance ALLR	$ 1,611	$ 645	$ 79	$ 274	$ 7	$ 64	$ 2,324	$ 5,004
Charge-offs	(245)	(206)	—	(125)	—	(36)	—	(612)
Recoveries	40	40	—	4	7	29	—	120
Provision	180	45	(17)	254	(8)	17	(121)	350
Ending balance ALLR	$ 1,586	$ 524	$ 62	$ 407	$ 6	$ 74	$ 2,203	$ 4,862
At September 30, 2016								
Loans:								

Ending balance	$ 362,858	$ 136,065	$ 14,343	$ 211,072	$ 11,768	$ 20,698	$ —	$ 756,804
Ending balance ALLR	(1,586)	(524)	(62)	(407)	(6)	(74)	(2,203)	(4,862)
Net loans	$ 361,272	$ 135,541	$ 14,281	$ 210,665	$ 11,762	$ 20,624	$ (2,203)	$ 751,942
Ending balance ALLR:								
Individually evaluated	$ 570	$ 252	$ —	$ 68	$ —	$ 64	$ —	$ 954
Collectively evaluated	1,016	272	62	339	6	10	2,203	3,908
Acquired with deteriorated credit quality	—	—	—	—	—	—	—	—
Total	$ 1,586	$ 524	$ 62	$ 407	$ 6	$ 74	$ 2,203	$ 4,862
Ending balance Loans:								
Individually evaluated	$ 2,035	$ 329	$ —	$ 1,038	$ —	$ 288	$ —	$ 3,690
Collectively evaluated	357,030	135,736	14,343	206,199	11,709	20,410	—	745,427
Acquired with deteriorated credit quality	3,793	—	—	3,835	59	—	—	7,687
Total	$ 362,858	$ 136,065	$ 14,343	$ 211,072	$ 11,768	$ 20,698	$ —	$ 756,804

Impaired loans, by definition, are individually evaluated.

A breakdown of the allowance for loan losses and recorded balances in loans as of and for the twelve months ended December 31, 2015 is as follows (dollars in thousands):

	Commercial real estate	Commercial, financial and agricultural	Commercial construction	One to four family residential real estate	Consumer construction	Consumer	Unallocated	Total
Allowance for loan loss								

reserve:								
Beginning balance ALLR	$ 2,813	$ 1,539	$ 142	$ 285	$ 6	$ 13	$ 342	$ 5,140
Charge-offs	(52)	(1,749)	—	(142)	—	(87)	—	(2,030)
Recoveries	588	22	52	2	—	26	—	690
Provision	(1,738)	833	(115)	129	1	112	1,982	1,204
Ending balance ALLR	$ 1,611	$ 645	$ 79	$ 274	$ 7	$ 64	$ 2,324	$ 5,004
Loans:								
Ending balance	$ 312,805	$ 122,140	$ 15,330	$ 140,502	$ 11,770	$ 15,847	$ —	$ 618,394
Ending balance ALLR	(1,611)	(645)	(79)	(274)	(7)	(64)	(2,324)	(5,004)
Net loans	$ 311,194	$ 121,495	$ 15,251	$ 140,228	$ 11,763	$ 15,783	$ (2,324)	$ 613,390
Ending balance ALLR:								
Individually evaluated	$ 420	$ 192	$ —	$ 60	$ —	$ 55	$ —	$ 727
Collectively evaluated	1,191	453	79	214	7	9	2,324	4,277
Acquired with deteriorated credit quality	—	—	—	—	—	—	—	—
Total	$ 1,611	$ 645	$ 79	$ 274	$ 7	$ 64	$ 2,324	$ 5,004
Ending balance Loans:								
Individually evaluated	$ 1,086	$ 617	$ —	$ 325	$ 83	$ —	$ —	$ 2,111
Collectively evaluated	307,336	121,345	15,330	136,940	11,686	15,845	—	608,482
Acquired with deteriorated credit quality	4,383	178	—	3,237	1	2	—	7,801
Total	$ 312,805	$ 122,140	$ 15,330	$ 140,502	$ 11,770	$ 15,847	$ —	$ 618,394

Impaired loans, by definition, are individually evaluated.

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A breakdown of the allowance for loan losses and recorded balances in loans at September 30, 2015 is as follows (dollars in thousands):

	Commercial real estate	Commercial, financial and agricultural	Commercial construction	One to four family residential real estate	Consumer construction	Consumer	Unallocated	Total
Three Months Ended September 30, 2015								
Allowance for loan loss reserve:								
Beginning balance ALLR	$ 2,550	$ 2,571	$ 128	$ 282	$ 5	$ 27	$ 37	$ 5,600
Charge-offs	(52)	(57)	—	(62)	—	(36)	—	(207)
Recoveries	28	3	—	—	—	5	—	36
Provision	(221)	355	(17)	74	2	46	111	350
Ending balance ALLR	$ 2,305	$ 2,872	$ 111	$ 294	$ 7	$ 42	$ 148	$ 5,779
Nine Months Ended September 30, 2015								
Allowance for loan loss reserve:								
Beginning balance ALLR	$ 2,813	$ 1,539	$ 142	$ 285	$ 6	$ 13	$ 342	$ 5,140
Charge-offs	(52)	(157)	—	(92)	—	(64)	—	(365)
Recoveries	120	3	—	1	1	24	—	149
Provision	(576)	1,487	(31)	100	—	69	(194)	855
Ending balance ALLR	$ 2,305	$ 2,872	$ 111	$ 294	$ 7	$ 42	$ 148	$ 5,779
At September 30, 2015								
Loans:								

Ending balance	$ 310,025	$ 120,804	$ 15,498	$ 144,807	$ 11,957	$ 16,815	$ —	$ 619,906
Ending balance ALLR	(2,305)	(2,872)	(111)	(294)	(7)	(42)	(148)	(5,779)
Net loans	$ 307,720	$ 117,932	$ 15,387	$ 144,513	$ 11,950	$ 16,773	$ (148)	$ 614,127
Ending balance ALLR:								
Individually evaluated	$ 518	$ 1,927	$ —	$ 56	$ —	$ 23	$ —	$ 2,524
Collectively evaluated	1,787	945	111	238	7	19	148	3,255
Total	$ 2,305	$ 2,872	$ 111	$ 294	$ 7	$ 42	$ 148	$ 5,779
Ending balance Loans:								
Individually evaluated	$ 1,924	$ 4,728	$ —	$ 394	$ —	$ 46	$ —	$ 7,092
Collectively evaluated	303,390	115,897	15,496	140,789	11,957	16,767	—	604,296
Acquired with deteriorated credit quality	4,711	179	2	3,624	—	2	—	8,518
Total	$ 310,025	$ 120,804	$ 15,498	$ 144,807	$ 11,957	$ 16,815	$ —	$ 619,906

As part of the management of the loan portfolio, risk ratings are assigned to all commercial loans. Through the loan review process, ratings are modified as believed to be appropriate to reflect changes in the credit. Our ability to manage credit risk depends in large part on our ability to properly identify and manage problem loans.

To do so, we operate a credit risk rating system under which our credit management personnel assign a credit risk rating to each loan at the time of origination and review loans on a regular basis to determine each loan's credit risk rating on a scale of 1 through 8, with higher scores indicating higher risk. The credit risk rating structure used is shown below.

In the context of the credit risk rating structure, the term Classified is defined as a problem loan which may or may not be in a nonaccrual status, dependent upon current payment status and collectability.

Strong (1)

Borrower is not vulnerable to sudden economic or technological changes. They have “strong” balance sheets and are within an industry that is very typical for our markets or type of lending culture. Borrowers also have “strong” financial and cash flow performance and excellent collateral (low loan to value or readily available to liquidate collateral) in conjunction with an impeccable repayment history.

Good (2)

Borrower shows limited vulnerability to sudden economic change. These borrowers have “above average” financial and cash flow performance and a very good repayment history. The balance sheet of the company is also very good as compared to peer and the company is in an industry that is familiar to our markets or our type of lending. The collateral securing the deal is also very good in terms of its type, loan to value, etc.

Average (3)

Borrower is typically a well-seasoned business, however may be susceptible to unfavorable changes in the economy, and could be somewhat affected by seasonal factors. The borrowers within this category exhibit financial and cash flow performance that appear “average” to “slightly above average” when compared to peer standards and they show an adequate payment history. Collateral securing this type of credit is good, exhibiting above average loan to values, etc.

Acceptable/Acceptable Watch (4)

A borrower within this category exhibits financial and cash flow performance that appear adequate and satisfactory when compared to peer standards and they show a satisfactory payment history. The collateral securing the request is within supervisory limits and overall is acceptable. Borrowers rated acceptable could also be newer businesses that are typically susceptible to unfavorable changes in the economy, and more than likely could be affected by seasonal factors.

Special Mention (5)

The borrower may have potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution’s credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. Examples of this type of credit include a start-up company fully based on projections, a documentation issue that needs to be corrected or a general market condition that the borrower is working through to get corrected.

Substandard (6)

Substandard loans are classified assets exhibiting a number of well-defined weaknesses that jeopardize normal repayment. The assets are no longer adequately protected due to declining net worth, lack of earning capacity, or insufficient collateral offering the distinct possibility of the loss of a portion of the loan principal. Loans classified as substandard clearly represent troubled and deteriorating credit situations requiring constant supervision.

Doubtful (7)

Loans in this category exhibit the same, if not more pronounced weaknesses used to describe the substandard credit. Loans are frozen with collection improbable. Such loans are not yet rated as Charge-off because certain actions may yet occur which would salvage the loan.

Charge-off/Loss (8)

Loans in this category are largely uncollectible and should be charged against the loan loss reserve immediately.

General Reserves:

For loans with a credit risk rating of 5 or better and any loans with a risk rating of 6 or 7 with no specific reserve, reserves are established based on the type of loan collateral, if any, and the assigned credit risk rating.

Determination of the allowance is inherently subjective as it requires significant estimates, including the amounts and timing of expected future cash flows on impaired loans, estimated losses on pools of homogenous loans based on historical loss experience, and consideration of current environmental factors and economic trends, all of which may be susceptible to significant change.

Using a historical average loss by loan type as a base, each loan graded as higher risk is assigned a specific percentage. The residential real estate and consumer loan portfolios are assigned a loss percentage as a homogenous group. If, however, on an individual loan the projected loss based on collateral value and payment histories are in excess of the computed allowance, the allocation is increased for the higher anticipated loss. These computations provide the basis for the allowance for loan losses as recorded by the Corporation.

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Below is a breakdown of loans by risk category as of September 30, 2016 (dollars in thousands):

	(1) Strong	(2) Good	(3) Average	(4) Acceptable/ Acceptable Watch	(5) Spl. Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	$ 3,592	$ 24,337	$ 119,657	$ 209,084	$ —	$ 6,188	$ —	$ —	$ 362,858
Commercial, financial and agricultural	9,835	10,946	46,722	67,037	—	1,525	—	—	136,065
Commercial construction	—	912	3,093	4,116	—	404	—	5,818	14,343
One-to-four family residential real estate	545	1,304	3,534	9,133	—	5,284	—	191,272	211,072
Consumer construction	29	—	—	707	—	18	—	11,014	11,768
Consumer	23	—	16	2	—	64	—	20,593	20,698
Total loans	$ 14,024	$ 37,499	$ 173,022	$ 290,079	$ —	$ 13,483	$ —	$ 228,697	$ 756,804

Below is a breakdown of loans by risk category as of December 31, 2015 (dollars in thousands):

	(1) Strong	(2) Good	(3) Average	(4) Acceptable/ Acceptable Watch	(5) Spl. Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	$ 2,072	$ 26,197	$ 113,868	$ 164,954	$ —	$ 5,714	$ —	$ —	$ 312,805
Commercial, financial and agricultural	13,067	5,954	47,194	53,791	—	2,134	—	—	122,140
Commercial construction	—	400	3,869	8,257	—	395	—	2,409	15,330
One-to-four family residential real estate	591	1,222	3,172	4,078	—	4,093	—	127,346	140,502
Consumer construction	—	—	—	—	—	—	—	11,770	11,770

Consumer	24	—	19	—	—	61	—	15,743	15,847
Total loans	$ 15,754	$ 33,773	$ 168,122	$ 231,080	$ —	$ 12,397	$ —	$ 157,268	$ 618,394

Impaired Loans

Nonperforming loans are those which are contractually past due 90 days or more as to interest or principal payments, on nonaccrual status, or loans, the terms of which have been renegotiated to provide a reduction or deferral on interest or principal. There was no interest income recorded during impairment for the three months ended September 30, 2016 and that which was recorded for the nine months ended September 30, 2016 was $.542 million. Interest income that would have been recognized during this period was $.033 million and $.611 million, respectively. For the three months and nine months ended September 30, 2015, interest income recorded during impairment was $.076 million and $.704 million, and the amount that would have been recognized was $.140 million and $.971 million.

The accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Loans are considered impaired when, based on current information and events, it is probable the Corporation will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loans basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if

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necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

Purchased loans acquired in a business combination are recorded at estimated fair value on their purchase date with no carryover of the related allowance for loan losses. In determining the estimated fair value of purchased loans, management considers a number of factors including the remaining life of the acquired loans, estimated prepayments, estimated loss ratios, estimated value of the underlying collateral, net present value of cash flows expected to be received, among others. Purchased loans are accounted for in accordance with guidance for certain loans acquired in a transfer (ASC 310-30), when the loans have evidence of credit deterioration since origination and it is probable at the date of acquisition that the acquirer will not collect all contractually required principal and interest payments. The difference between contractually required payments and the cash flows expected to be collected at acquisition is referred to as the non-accretable difference.   Subsequent decreases to the expected cash flows will generally result in a provision for loan losses. Subsequent increases in expected cash flows will result in a reversal of the provision for loan losses to the extent of prior charges and then an adjustment to accretable yield, which would have a positive impact on interest income.

The following is a summary of impaired loans and their effect on interest income (dollars in thousands):

						Three Months Ended		Nine Months Ended	
	Nonaccrual Basis	Accrual Basis	QTD Average Investment	YTD Average Investment	Related Valuation Reserve	Interest Income Recognized During Impairment	Interest Income on Accrual Basis	Interest Income Recognized During Impairment	Interest Income on Accrual Basis
September 30, 2016									
With no valuation reserve:									
Commercial real estate	$ 593	$ 3,272	$ 4,011	$ 4,273	$ —	$ —	$ 29	$ 295	$ 330
Commercial, financial and agricultural	—	—	109	208	—	—	—	6	10
Commercial construction	—	—	—	—	—	—	—	—	—
One to four family residential real	2,107	3,360	4,697	4,141	—	—	4	237	266

estate									
Consumer construction	18	59	18	19	—	—	—	4	4
Consumer	9	—	84	72	—	—	—	—	1
With a valuation reserve:									
Commercial real estate	$ 1,528	$ —	$ 1,226	$ 702	$ 170	$ —	$ —	—	$ —
Commercial, financial and agricultural	328	—	—	—	231	—	—	—	—
Commercial construction	—	—	—	—	—	—	—	—	—
One to four family residential real estate	—	—	94	91	—	—	—	—	—
Consumer construction	—	—	—	—	—	—	—	—	—
Consumer	54	—	5	6	53	—	—	—	—
Total:									
Commercial real estate	$ 2,121	$ 3,272	$ 5,237	$ 4,975	$ 170	$ —	$ 29	$ 295	$ 330
Commercial, financial and agricultural	328	—	109	208	231	—	—	6	10
Commercial construction	—	—	—	—	—	—	—	—	—
One to four family residential real estate	2,107	3,360	4,791	4,232	—	—	4	237	266
Consumer construction	18	59	18	19	—	—	—	4	4
Consumer	63	—	89	78	53	—	—	—	1
Total	$ 4,637	$ 6,691	$ 10,244	$ 9,512	$ 454	$ —	$ 33	$ 542	$ 611

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December 31, 2015	Nonaccrual Basis	Accrual Basis	Average Investment	Related Valuation Reserve	Interest Income Recognized During Impairment	Interest Income on Accrual Basis
With no valuation reserve:						
Commercial real estate	$ 471	$ 4,051	$ 7,205	$ —	$ 576	$ 655
Commercial, financial and agricultural	—	1,778	4,849	—	78	214
Commercial construction	—	—	260	—	3	6
One to four family residential real estate	1,267	2,385	5,413	—	137	205
Consumer construction	20	2	99	—	—	1
Consumer	50	1	102	—	1	2
With a valuation reserve:						
Commercial real estate	$ —	$ —	$ —	$ —	$ —	$ —
Commercial, financial and agricultural	460	—	699	192	—	36
Commercial construction	—	—	—	—	—	—
One to four family residential real estate	229	—	232	58	—	6
Consumer construction	—	—	—	—	—	—
Consumer	10	0	10	1	0	0
Total:						
Commercial real estate	$ 471	$ 4,051	$ 7,205	$ —	$ 576	$ 655
Commercial, financial and agricultural	460	1,778	5,548	192	78	250
Commercial construction	—	—	260	—	3	6
One to four family residential real estate	1,496	2,385	5,645	58	137	211
Consumer construction	20	2	99	—	—	1
Consumer	60	1	112	1	1	2
Total	$ 2,507	$ 8,217	$ 18,869	$ 251	$ 795	$ 1,125

						Three Months Ended		Nine Months Ended	
September 30, 2015	Nonaccrual Basis	Accrual Basis	QTD Average Investment	YTD Average Investment	Related Valuation Reserve	Interest Income Recognized During Impairment	Interest Income on Accrual Basis	Interest Income Recognized During Impairment	Interest Income on Accrual Basis

With no valuation reserve:									
Commercial real estate	$ 692	$ 3,978	$ 4,740	$ 5,344	$ —	$ 41	$ 45	$ 574	$ 611
Commercial, financial and agricultural	—	179	219	357	—	2	2	21	23
Commercial construction	—	—	—	103	—	—	0	3	7
One to four family residential real estate	1,017	2,584	3,968	4,401	—	33	37	105	150
Consumer construction	21	2	76	117	—	—	—	—	1
Consumer	5	2	20	20	—	—	—	1	1
With a valuation reserve:									
Commercial real estate	$ 929	$ —	$ 929	$ 686	$ 118	$ —	$ 6	$ —	$ 26
Commercial, financial and agricultural	4,706	—	4,747	3,935	1,927	—	50	—	140
Commercial construction	—	—	—	—	—	—	—	—	0
One to four family residential real estate	597	—	576	546	84	—	0	—	12
Consumer construction	—	—	—	—	—	—	—	—	—
Consumer	61	—	20	20	—	—	—	—	—
Total:									
Commercial real estate	$ 1,621	$ 3,978	$ 5,669	$ 6,030	$ 118	$ 41	$ 51	$ 574	$ 637
Commercial, financial and agricultural	4,706	179	4,966	4,292	1,927	2	52	21	163
Commercial construction	—	—	—	103	—	—	—	3	7
One to four family residential real estate	1,614	2,584	4,544	4,947	84	33	37	105	162
Consumer construction	21	2	76	117	—	—	—	—	1

Consumer	66	2	40	40	—	—	—	1	1
Total	$ 8,028	$ 6,745	$ 15,295	$ 15,529	$ 2,129	$ 76	$ 140	$ 704	$ 971

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A summary of past due loans at September 30, 2016 and December 31, 2015 is as follows (dollars in thousands):

	September 30, 2016			December 31, 2015		
	30-89 days Past Due (accruing)	90+ days Past Due/ Nonaccrual	Total	30-89 days Past Due (accruing)	90+ days Past Due/ Nonaccrual	Total
Commercial real estate	$ 1,008	$ 2,122	$ 3,130	$ 521	$ 471	$ 992
Commercial, financial and agricultural	1,710	328	2,038	222	460	682
Commercial construction	678	34	712	270	—	270
One to four family residential real estate	1,381	2,106	3,487	807	1,528	2,335
Consumer construction	—	—	—	—	20	20
Consumer	198	77	275	130	60	190
Total past due loans	$ 4,975	$ 4,667	$ 9,642	$ 1,950	$ 2,539	$ 4,489

Troubled Debt Restructuring

Troubled debt restructurings ("TDR") are determined on a loan-by-loan basis. Generally restructurings are related to interest rate reductions, loan term extensions and short term payment forbearance as means to maximize collectability of troubled credits. If a portion of the TDR loan is uncollectible (including forgiveness of principal), the uncollectible amount will be charged off against the allowance at the time of the restructuring. In general, a borrower must make at least six consecutive timely payments before the Corporation would consider a return of a restructured loan to accruing status in accordance with FDIC guidelines regarding restoration of credits to accrual status.

The Corporation has, in accordance with generally accepted accounting principles and per recently enacted accounting standard updates, evaluated all loan modifications to determine the fair value impact of the underlying asset. The carrying amount of the loan is compared to the expected payments to be received, discounted at the loan's original rate, or for collateral dependent loans, to the fair value of the collateral.

There were no troubled debt restructurings that occurred during the nine months ended September 30, 2016 or September 30, 2015.

Insider Loans

The Bank, in the ordinary course of business, grants loans to the Corporation's executive officers and directors, including their families and firms in which they are principal owners. Activity in such loans is summarized below (dollars in thousands):

	Nine Months Ended September 30, 2016	Year ended December 31, 2015
Loans outstanding, January 1	$ 6,887	$ 8,789
New loans	—	—
Net activity on revolving lines of credit	1,720	778
Repayment	(2,269)	(2,680)
Loans outstanding at end of period	$ 6,338	$ 6,887

There were no loans to related parties classified substandard as of September 30, 2016 or December 31, 2015. In addition to the outstanding balances above, there were unfunded commitments of $1.694 million to related parties at September 30, 2016.

6.GOODWILL AND OTHER INTANGIBLE ASSETS

During the fourth quarter of 2014, the Corporation recorded $3.805 million of goodwill and $1.206 million of deposit based intangible assets associated with the acquisition of PFC. During 2016, the Corporation recorded $1.839 million of goodwill and $.993 million of deposit based intangible assets associated with the acquisition of Eagle. During the third

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quarter of 2016, the Corporation recorded $.050 million of goodwill and $.300 million of deposit based intangible assets associated with the acquisition of Niagara.

The excess of the cost of acquired entities over the fair value of identifiable assets acquired less liabilities assumed is recorded as goodwill. In accordance with FASB ASC 350, amortization of goodwill and indefinite-lived assets is not recorded. However, the recoverability of goodwill and other intangible assets are annually tested for impairment. Intangible assets, including core deposits and customer business relationships, are amortized primarily on a straight-line basis over their estimated useful lives. The Corporation is currently amortizing the deposit based intangible over a ten-year estimated life.

The deposit based intangible is reported net of accumulated amortization at $2.235 million at September 30, 2016. Amortization expense in the first nine months of 2016 is $.129 million. Amortization expense for the next five years is expected to be at $.250 million per year.

7.SERVICING RIGHTS

Mortgage Loans

Mortgage servicing rights ("MSRs") are recorded when loans are sold in the secondary market with servicing retained. As of September 30, 2016, the Corporation had obligations to service approximately $233.356 million of residential first mortgage loans. The valuation of MSRs is based upon the net present value of the projected revenues over the expected life of the loans being serviced, as reduced by estimated internal costs to service these loans. The fair value of the capitalized servicing rights approximates the carrying value. On a quarterly basis, management evaluates the MSRs for impairment. The key economic assumptions used in determining the fair value of the MSRs include an annual constant prepayment speed of 9.45% and a discount rate of 8.97% for September 30, 2016.

The following table summarizes MSRs capitalized and amortized, along with the aggregate activity in related valuation allowances (dollars in thousands):

	Nine Months Ended September 30,	Year Ended December 31,

	2016	2015
Balance at beginning of period	$ 1,965	$ 1,994
Additions from loans sold with servicing retained	—	585
Acquired MSRs	207	—
Amortization	(495)	(614)
Balance at end of period	$ 1,677	$ 1,965
Balance of loan servicing portfolio	$ 233,356	$ 224,612
Mortgage servicing rights as % of portfolio	.72%	.87%

Commercial Loans

The Corporation also retains the servicing on commercial loans that have been sold. These loans were originated and underwritten under the SBA and USDA government guarantee programs, in which the guaranteed portion of the loan was sold to a third party with servicing retained. The balance of these sold loans with servicing retained at September 30, 2016 and December 31, 2015 was approximately $43.2 million and $63.0 million, respectively. The Corporation valued these servicing rights at $.147 million as of September 30, 2016 and at $.170 million as of December 31, 2015. This valuation was established in consideration of the discounted cash flow of expected servicing income over the life of the loans.

8.BORROWINGS

Borrowings consist of the following at September 30, 2016 and December 31, 2015 (dollars in thousands):

	September 30, 2016	December 31, 2015
Federal Home Loan Bank fixed rate advances at September 30, 2016 with a weighted average rate of 2.01% maturing in 2016, 2017, 2018, 2019 and 2020	$ 46,000	$ 35,000
Correspondent bank line of credit - holding company	—	7,750
Correspondent bank term note, current floor rate of 4%, maturing April 30, 2019	21,100	2,300
USDA Rural Development, fixed-rate note payable, maturing August 24, 2024 interest payable at 1%	630	704
	$ 67,730	$ 45,754

The Federal Home Loan Bank borrowings are collateralized at September 30, 2016 by the following: a collateral agreement on the Corporation’s one to four family residential real estate loans with a book value of approximately $47.533 million; mortgage related and municipal securities with an amortized cost and estimated fair value of $11.000 million and $11.094 million, respectively; and Federal Home Loan Bank stock owned by the Bank totaling $2.926 million. Prepayment of the advances is subject to the provisions and conditions of the credit policy of the Federal Home Loan Bank of Indianapolis in effect as of September 30, 2016.

The USDA Rural Development borrowing is collateralized by loans totaling $.108 million originated and held by the Corporation’s wholly owned subsidiary, First Rural Relending, and an assignment of a demand deposit account in the amount of $.583 million, and guaranteed by the Corporation.

The Corporation currently has one banking borrowing relationship. The relationship consists of a non-revolving line of credit and a term note. The line of credit bears interest at 90-day LIBOR plus 2.75%, with a floor rate of 4.00% and has an initial term that expires on April 30, 2018. The term note bears the same interest and matures on April 30, 2019 and requires quarterly principal payments of $550,000 beginning March 31, 2017. This relationship is secured by all of the outstanding mBank stock.

9.DEFINED BENEFIT PENSION PLAN

The Corporation acquired the Peninsula Financial Corporation noncontributory defined benefit pension plan. Effective December 31, 2005, the plan was amended to freeze participation in the plan; therefore, no additional employees are eligible to become participants in the plan. The benefits are based on years of service and the employee's compensation at the time of retirement. The Plan was amended effective December 31, 2010, to freeze benefit accrual for all participants. Expected contributions to the Plan in 2016 are $.063 million. The anticipated distributions over the next five years and through December 31, 2025 are detailed in the table below (dollars in thousands):

2016	$ 134
2017	132
2018	129
2019	126
2020	125
2021-2025	690
Total	$ 1,336

At September 30, 2016, the plan's assets had a fair value of $2.033 million and the Corporation had a net liability of $1.147 million. The accumulated benefit obligation was $3.180 million. At September 30, 2015, the plan's assets had a fair value of $2.107 million and the Corporation had a net liability of $1.183 million. The accumulated benefit obligation at September 30, 2015 was $3.290 million.

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Assumptions in the actuarial valuation are:

	2016
Weighted average discount rate	3.99 %
Rate of increase in future compensation levels	N/A
Expected long-term rate of return on plan assets	8.00 %

The expected long-term rate of return on plan assets reflects management's expectations of long-term average rates of return on funds invested to provide for benefits included in the projected benefit obligation. The expected return is based on the outlook for inflation, fixed income returns and equity returns, while also considering historical returns, asset allocation and investment strategy. The discount rate assumption is based on investment yields available on AA rated long-term corporate bonds.

The primary investment objective is to maximize growth of the pension plan assets to meet the projected obligations to the beneficiaries over a long period of time, and to do so in a manner that is consistent with the Corporation's risk tolerance. The intention of the plan sponsor is to invest the plan assets in mutual funds with the following asset allocation:

	Target Allocation	Actual Allocation
Equity securities	50% to 70%	60%
Fixed income securities	30% to 50%	40%

10.STOCK COMPENSATION PLANS

On May 22, 2012, the Company's shareholders approved the Mackinac Financial Corporation 2012 Incentive Compensation Plan, under which current and prospective employees, non-employee directors and consultants may be awarded incentive stock options, non-statutory stock options, RSUs, or stock appreciation rights. The aggregate number of shares of the Company's common stock issuable under the plan is 575,000. Awards are made at the discretion of management and the Board of Directors. Compensation cost equal to the fair value of the award is recognized over the vesting period.

Restricted Stock Awards

The Corporation's restricted stock awards require certain service-based or performance requirements and have a vesting period of four years. Compensation expense is recognized on a straight-line basis over the vesting period. Shares are subject to certain restrictions and risk of forfeiture by the participants.

The Corporation has historically granted RSUs to members of the Board of Directors and management. Awards granted are set to vest equally over their award terms and are issued at no cost to the recipient. The table below summarizes each of the grant awards:

Date of Award	Units Granted	Market Value at grant date	Vesting Term	Annual Compensation Cost (in thousands)
August, 2012	148,500	$ 7.91	4 years	$ 294
March, 2014	52,774	12.95	4 years	171
March, 2015	37,730	11.15	4 years	105
May, 2015	3,000	10.77	Immediate	32
February, 2016	35,733	9.91	4 years	89

On August 31, 2013, 2014, 2015 and 2016, the Corporation issued 37,125 shares of its common stock for vested RSUs, in each year. In March 2015, the Corporation issued 13,194 shares of its common stock for vested RSUs. In May 2015, the Corporation granted 3,000 shares, which were immediately vested and issued. In March 2016, the Corporation issued 22,626 shares of its common stock for vested RSUs.

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A summary of changes in our nonvested shares for the period follows:

	Number Outstanding	Weighted Average Grant Date Fair Value
Nonvested balance at January 1, 2016	114,435	$ 10.72
Granted during the year	35,733	9.91
Vested during the year	(59,751)	9.53
Nonvested balance at September 30, 2016	90,417	$ 11.19

A summary of stock option transactions for the nine months ended September 30, 2016 and 2015, and the year ended December 31, 2015, is as follows:

	September 30, 2016	December 31, 2015
Outstanding shares at beginning of year	10,000	20,000
Granted during the year	—	—
Exercised during the year	—	—
Expired during the year	—	(10,000)
Outstanding shares at end of period	10,000	10,000
Exercisable shares at end of period	2,000	2,000
Weighted average exercise price per share at end of period	$ 12.00	$ 12.00
Shares available for grant at end of period	—	—

There were no options granted in the first nine months of 2016 and 2015.

Following is a summary of the options outstanding and exercisable at September 30, 2016.

Exercise Price	Number Outstanding	Exercisable	Unvested Options	Weighted Average Remaining Contractual Life-Years

$ 12.00	10,000	2,000	8,000	.25

Options issued since the Corporation's recapitalization in December of 2004 call for 20% immediate vesting upon issue and subsequent vesting to occur over a two to five year period, based upon the market value appreciation of the Corporation's underlying stock. Compensation related to these options was expensed based upon the vesting period without consideration given to market value appreciation. There are no future compensation expenses related to existing option programs.

11.INCOME TAXES

The Corporation has reported deferred tax assets of $9.287 million at September 30, 2016. A valuation allowance is provided against deferred tax assets when it is more likely than not that some or all of the deferred tax asset will not be realized. The Corporation, as of September 30, 2016 had a net operating loss and tax credit carryforwards for tax purposes of approximately $11.200 million, and $2.300 million, respectively. The Corporation evaluated the future benefits from these carryforwards as of September 30, 2016 and determined that it was "more likely than not" that they would be utilized prior to expiration. The net operating loss carryforwards expire twenty years from the date they originated. These carryforwards, if not utilized, will begin to expire in the year 2023. A portion of the NOL and credit carryforwards are subject to the limitations for utilization as set forth in Section 382 of the Internal Revenue Code. The annual limitation is $1.404 million for the NOL and the equivalent value of tax credits, which is approximately $.476 million. These limitations for use were established in conjunction with the recapitalization of the Corporation in December 2004. The Corporation will continue to evaluate the future benefits from these carryforwards in order to determine if any adjustment to the deferred tax asset is warranted.

The Corporation recognized a federal income tax expense of approximately $.922 million for the three months ended September 30, 2016 and an expense of $1.481 million for the nine months ended September 30, 2016 and a deferred tax expense of $.526 million and $2.074 million for the three and nine months ended September 30, 2015.

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12.FAIR VALUE MEASUREMENTS

Fair value estimates, methods, and assumptions are set forth below for the Corporation's financial instruments:

Cash, cash equivalents, and interest-bearing deposits - The carrying values approximate the fair values for these assets.

Securities - Fair values are based on quoted market prices where available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities and other inputs such as interest rates and yield curves that are observable at commonly quoted intervals.

Federal Home Loan Bank stock – Federal Home Loan Bank stock is carried at cost, which is its redeemable value and approximates its fair value, since the market for this stock is limited.

Loans - Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, residential mortgage, and other consumer. The fair value of loans is calculated by discounting scheduled cash flows using discount rates reflecting the credit and interest rate risk inherent in the loan.

The methodology in determining fair value of nonaccrual loans is to average them into the blended interest rate at 0% interest. This has the effect of decreasing the carrying amount below the risk-free rate amount and, therefore, discounts the estimated fair value.

Impaired loans are measured at the estimated fair value of the expected future cash flows at the loan's effective interest rate or the fair value of the collateral for loans which are collateral dependent. Therefore, the carrying values of impaired loans approximate the estimated fair values for these assets.

Deposits - The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits and savings, is equal to the amount payable on demand at the reporting date. The fair value of time deposits is based on the discounted value of contractual cash flows applying interest rates currently being offered on similar time deposits.

Borrowings - Rates currently available for debt with similar terms and remaining maturities are used to estimate the fair value of existing debt. The fair value of borrowed funds due on demand is the amount payable at the reporting date.

Accrued interest - The carrying amount of accrued interest approximates fair value.

Off-balance-sheet instruments - The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements, the current interest rates, and the present creditworthiness of the counterparties. Since the differences in the current fees and those reflected to the off-balance-sheet instruments at year-end are immaterial, no amounts for fair value are presented.

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The following table presents information for financial instruments at September 30, 2016 and December 31, 2015 (dollars in thousands):

		September 30, 2016		December 31, 2015	
	Level in Fair Value Hierarchy	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:					
Cash and cash equivalents	Level 1	$ 48,615	$ 48,615	$ 25,008	$ 25,008
Interest-bearing deposits	Level 2	14,047	14,047	5,089	5,089
Securities available for sale	Level 2	88,886	88,886	53,728	53,728
Federal Home Loan Bank stock	Level 2	2,926	2,926	2,169	2,169
Net loans	Level 3	751,942	756,548	613,390	614,187
Accrued interest receivable	Level 3	1,998	1,998	1,416	1,416
Total financial assets		$ 908,414	$ 913,020	$ 700,800	$ 701,597
Financial liabilities:					
Deposits	Level 2	$ 807,180	$ 805,299	$ 610,323	$ 607,636
Borrowings	Level 2	67,730	69,085	45,754	45,989
Accrued interest payable	Level 3	319	319	174	174
Total financial liabilties		$ 875,229	$ 874,703	$ 656,251	$ 653,799

Limitations - Fair value estimates are made at a specific point in time based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Corporation's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates. Fair value estimates are based on existing on-and off-balance-sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial assets or liabilities include premises and equipment, other assets, and other liabilities. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

The following is information about the Corporation's assets and liabilities measured at fair value on a recurring basis at September 30, 2016, and the valuation techniques used by the Corporation to determine those fair values.

Level 1:	In general, fair values determined by Level 1 inputs use quoted prices in active markets for identical assets or liabilities that the Corporation has the ability to access.
Level 2:	Fair values determined by Level 2 inputs use other inputs that are observable, either directly or indirectly. These Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and other inputs such as interest rates and yield curves that are observable at commonly quoted intervals.
Level 3:	Level 3 inputs are unobservable inputs, including inputs available in situations where there is little, if any, market activity for the related asset or liability.

The fair value of all investment securities at September 30, 2016, December 31, 2015 and September 30, 2015 were based on level 2 inputs. There are no other assets or liabilities measured on a recurring basis at fair value. For additional information regarding investment securities, please refer to "Note 4 Investment Securities."

The Corporation had no Level 3 assets or liabilities measured at fair value on a recurring basis as of September 30, 2016, or December 31, 2015.

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In instances where inputs used to measure fair value fall into different levels in the above fair value hierarchy, fair value measurements in their entirety are categorized based on the lowest level input that is significant to the valuation. The Corporation's assessment of the significance of particular inputs to these fair value measurements requires judgment and considers factors specific to each asset or liability.

The Corporation also has assets that under certain conditions are subject to measurement at fair value on a non-recurring basis. These assets include certain impaired loans and other real estate owned. The Corporation has estimated the fair values of these assets using Level 3 inputs, specifically discounted cash flow projections.

Assets Measured at Fair Value on a Nonrecurring Basis at September 30, 2016

(dollars in thousands)	Balance at September 30, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total (Gains) Losses for Three Months Ended September 30, 2016	Total (Gains) Losses for Nine Months Ended September 30, 2016
Assets						
Impaired loans	$ 11,328	$ —	$ —	$ 11,328	$ 80	$ 583
Other real estate owned	3,269	—	—	3,269	60	62
					$ 140	645

Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2015

(dollars in thousands)	Balance at December 31, 2015	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses for Twelve months ended December 31, 2015
Assets					
Impaired loans	$ 10,724	$ —	$ —	$ 10,724	$ 1,852
Other real estate held for sale	2,324	—	—	2,324	332

$ 2,184

Impaired loans categorized as Level 3 assets consist of non-homogeneous loans that are considered impaired. The Corporation estimates the fair value of the loans based on the present value of expected future cash flows using management's best estimate of key assumptions. These assumptions include future payment ability, timing of payment streams, and estimated realizable values of available collateral (typically based on outside appraisals).

13.SHAREHOLDERS' EQUITY

The Corporation currently has a share repurchase program. The program is conducted under authorizations from time to time by the Board of Directors. The Corporation repurchased 14,000 shares thus far in 2016, 102,455 shares in 2015, 13,700 shares in 2014 and 55,594 shares in 2013. The share repurchases were conducted under Board authorizations made and publically announced of $600,000 on February 27, 2013, $600,000 on December 17, 2013 and an additional $750,000 on April 28, 2015. None of these authorizations has an expiration date. As of September 30, 2016, $.026 million of the total authorization was available for future purchases.

14.COMMITMENTS, CONTINGENCIES AND CREDIT RISK

Financial Instruments With Off-Balance-Sheet Risk

The Corporation is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated balance sheets.

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The Corporation's exposure to credit loss, in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit, is represented by the contractual amount of those instruments. The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. These commitments are as follows (dollars in thousands):

	September 30, 2016	December 31, 2015
Commitments to extend credit:		
Variable rate	$ 69,478	$ 53,628
Fixed rate	36,602	26,846
Standby letters of credit - Variable rate	8,042	6,390
Credit card commitments - Fixed rate	5,458	3,747
	$ 119,580	$ 90,611

Commitments to extend credit 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. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Corporation evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Corporation upon extension of credit, is based on management's credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The commitments are structured to allow for 100% collateralization on all standby letters of credit.

Credit card commitments are commitments on credit cards issued by the Corporation's subsidiary and serviced by other companies. These commitments are unsecured.

Legal Proceedings and Contingencies

In the normal course of business, the Corporation is involved in various legal proceedings. For expanded discussion on the Corporation's legal proceedings, see Part II, Item 1, "Legal Proceedings" in this report.

Concentration of Credit Risk

The Bank grants commercial, residential, agricultural, and consumer loans throughout Michigan. The Bank's most prominent concentration in the loan portfolio relates to commercial real estate loans to operators of nonresidential buildings. This concentration at September 30, 2016 represents $110.252 million, or 21.48%, compared to $102.897 million, or 23.11%, of the commercial loan portfolio on September 30, 2015. The remainder of the commercial loan portfolio is diversified in such categories as hospitality and tourism, real estate agents and managers, new car dealers, gaming, petroleum, forestry, agriculture and construction. Due to the diversity of the Bank's locations, the ability of debtors of residential and consumer loans to honor their obligations is not tied to any particular economic sector.

15. BUSINESS COMBINATIONS

The First National Bank of Eagle River

The Corporation completed its acquisition of The First National Bank of Eagle River ("Eagle") in April 2016. Eagle had three branch offices and approximately $125 million in assets as of April 29, 2016. The results of operations due to the merger have been included in the Corporation's results since the acquisition date. The merger was effected by a cash payment of $12.500 million.

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The table below highlights the allocation of the purchase price (dollars in thousands, except per share data):

Purchase Price:		
Eagle shares outstanding	85,776	
Price per share/Cash price	$ 145.73	
Total purchase price		$ 12,500
Reimbursement of termination fees		(1,763)
Cash consideration		$ 10,737
Net assets acquired:		
Cash and cash equivalents	$ 10,600	
Securities available for sale	24,046	
Valuation mark	(750)	
FRB & FHLB Stock	575	
Total Loans	84,138	
Allowance for loan losses	(611)	
Valuation mark - ASC 310-30, nonperforming	(1,563)	
- ASC 310-20, performing	(1,700)	
Allowance for loan loss reversal	611	
Premises and equipment	1,931	
Other real estate owned	1,795	
Valuation mark	(891)	
Deposit based intangible	993	
Mortgage servicing rights	120	
Deferred tax benefit - book for valuation marks	948	
Bank owned life insurance	4,132	
Other assets	323	
Total assets	124,697	
Non-interest bearing deposits	22,349	
Interest bearing deposits	82,165	
Total deposits	104,514	
FHLB Borrowings	11,000	
Other liabilities	285	
Total liabilities	115,799	
Net assets acquired		8,898
Goodwill		$ 1,839

The results of operations for the nine months ended September 30, 2016 include the operating results of the acquired assets and assumed liablities for the 153 days subsequent to the acquisition date. Eagle's results of operations prior to the acquisition date are not included in the Corporation's consolidated statement of comprehensive income.

In addition to the data processing termination fees of $1.763 million, the Corporation incurred other Eagle transaction related expenses of $.890 million, for a total of $2.653 million, or $1.751 million on an after tax basis during the nine months ended September 30, 2016. These expenses included professional services such as legal, accounting, employee severance payments and contractual arrangements for consulting services.

Niagara Bancorporation

The Corporation completed its acquisition of Niagara Bancorporation, Inc. ("Niagara") in August 2016. Niagara had four branch offices and approximately $67 million in assets as of August 31, 2016. The results of operations due to the

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merger have been included in the Corporation's results since the acquisition date. The merger was effected by a cash payment of $7.325 million.

The table below highlights the allocation of the purchase price (dollars in thousands, except per share data):

Purchase Price:		
Eagle shares outstanding	4,354	
Price per share/Cash price	$ 1,682.36	
Total purchase price		$ 7,325
Net assets acquired:		
Cash and cash equivalents	$ 9,778	
Securities available for sale	21,491	
FRB & FHLB Stock	287	
Total Loans	32,660	
Allowance for loan losses	(358)	
Valuation mark - ASC 310-30, nonperforming	(353)	
- ASC 310-20, performing	(600)	
Allowance for loan loss reversal	358	
Premises and equipment	926	
Other real estate owned	450	
Valuation mark	(149)	
Deposit based intangible	300	
Mortgage servicing rights	87	
Deferred tax benefit - book for valuation marks	273	
Deferred tax benefit	124	
Bank owned life insurance	1,109	
Other assets	302	
Total assets	66,685	
Non-interest bearing deposits	5,396	
Interest bearing deposits	53,788	
Total deposits	59,184	
Other liabilities	226	
Total liabilities	59,410	
Net assets acquired		7,275
Goodwill		$ 50

The results of operations for the nine months ended September 30, 2016 include the operating results of the acquired assets and assumed liablities for the 30 days subsequent to the acquisition date. Niagara's results of operations prior to the acquisition date are not included in the Corporation's consolidated statement of comprehensive income.

The Corporation incurred Niagara transaction related expenses of $.275 million, $.182 million on an after tax basis during the nine months ended September 30, 2016. These expenses included professional services such as data processing, legal, accounting, employee severance payments, and contractual arrangements for consulting services.

The following table provides the unaudited pro forma information for the results of operations for the nine months ended September 30, 2016, and the year ended December 31, 2015 as if both the Eagle acquisition and Niagara acquistion had occurred on January 1 of each year. These adjustments reflect the impact of certain purchase accounting fair value measurements, primarily on the loan and deposit portfolios of Eagle. In addition, the merger related costs noted above are excluded from the nine months ended September 30, 2016 results of operations, for comparative proforma purposes. Further operating cost savings are expected along with additional business synergies as a result of the merger which are not presented in the pro forma amounts. These unaudited pro forma results are presented for illustrative purposes only

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and are not intended to represent or be indicative of the actual results of operations of the combined banking organization that would have been achieved had the merger occurred at the beginning of the period presented, nor are the intended to represent or be indicative of future results of the Corporation.

Proforma Mackinac Financial Combined with Eagle River and Niagara

	Nine months ended September 30, 2016	Year Ended December 31, 2015
Net interest income	$ 26,833	$ 35,492
Noninterest income	3,744	5,533
Noninterest expense	25,431	30,691
Net income	3,396	7,117
Net income per diluted share	$ .54	1.13

Fair Value

In most instances, determining the fair value of the acquired assets and assumed liabilities required the Corporation to estimate the cash flows expected to result from those assets and liabilities and to discount those cash flows at appropriate rates of interest. The most significant of those determinations is related to the valuation of acquired loans. For such loans, the excess cash flows expected at merger over the estimated fair value is recognized as interest income over the remaining lives of the loans. The difference between contractually required payments at merger and the cash flows expected to be collected at merger reflects the impact of estimated credit losses and other factors, such as prepayments. In accordance with the applicable accounting guidance for business combinations, there was no carry-over of either Eagle's or Niagara's previously established allowance for loan losses.

The acquired loans were divided into loans with evidence of credit quality deterioration, which are accounted for under ASC 310-30 ("acquired impaired") and loans that do not meet the criteria, which are accounted for under ASC 310-20 ("acquired non-impaired"). In addition, the loans are further categorized into different pools based primarily on the type and purpose of the loan.

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Forward Looking Statements/Risk Factors

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. The Corporation intends 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 is including this statement for purposes of these safe harbor provisions. Forward-looking statements which are based on certain assumptions and describe future plans, strategies, or expectations of the Corporation, are generally identifiable by use of the words “believe”, “expect”, “intend”, “anticipate”, “estimate”, “project”, or similar expressions. The Corporation’s ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors that could cause actual results to differ from the results in forward-looking statements include, but are not limited to:

RISK FACTORS

Risks Related to our Lending and Credit Activities

· Our business may be adversely affected by conditions in the financial markets and economic conditions generally, as our borrowers’ ability to repay loans and the value of the collateral securing our loans decline.

· Weakness in the markets for residential or commercial real estate, including the secondary residential mortgage loan markets, could reduce our net income and profitability.

· As a community banking organization, the Corporation’s success depends upon local and regional economic conditions and has different lending risks than larger banks.

We manage our credit exposure through careful monitoring of loan applicants and loan concentrations in particular industries and through loan approval and review procedures. We have established an evaluation process designed to determine the adequacy of our allowance for loan losses. While this evaluation process uses historical and other objective information, the classification of loans and the establishment of loan losses is estimated based on experience, judgment and expectations regarding borrowers and economic conditions, as well as regulator judgments. We can make no assurance that our loan loss reserves will be sufficient to absorb future loan losses or prevent a material adverse effect on our business, profitability or financial condition.

· Our allowance for loan losses may be insufficient.

Continuing deterioration in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans, and other factors, both within and outside of our control, may require an increase in our allowance for loan losses.

Risks Related to Our Operations

· We are subject to interest rate risk.

Our earnings and cash flows are largely dependent upon our net interest income, which is the difference between interest income on interest-earning assets such as loans and securities and interest expense paid on interest-bearing liabilities such as deposits and borrowed funds. There are many factors which influence interest rates that are beyond our control, including but not limited to general economic conditions and governmental policy, in particular, the policies of the FRB.

· Changes in our accounting policies or in accounting standards could materially affect how we report our financial results and condition.

· We may not realize the expected benefits of our recently completed acquisitions of The First National Bank of Eagle River and Niagara Bancorporation, Inc.

· Our controls and procedures may fail or be circumvented.

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· Impairment of deferred income tax assets could require charges to earnings, which could result in an adverse impact on our results of operations.

In assessing the realizability of deferred income tax assets, management considers whether it is more likely than not that some allowance requires management to evaluate all available evidence, both negative and positive. Positive evidence necessary to overcome the negative evidence includes whether future taxable income in sufficient amounts and character within the carry back and carry forward periods is available under the tax law, including the use of tax planning strategies. When negative evidence (e.g. cumulative losses in recent years, history of operating loss or tax credit carry forwards expiring unused) exists, more positive evidence than negative evidence will be necessary. At September 30, 2016, net deferred tax assets were approximately $9.287 million. If a valuation allowance becomes necessary with respect to such balance, it could have a material adverse effect on our business, results of operations and financial condition.

· Our information systems may experience an interruption of breach in security.

Risks Related to Legal and Regulatory Compliance

· We operate in a highly regulated environment, which could increase our cost structure or have other negative impacts on our operations.

· The full impact of the recently implemented Dodd-Frank Act is currently unknown and subject to significant uncertainty.

Strategic Risks

· Maintaining or increasing our market share may depend on lowering prices and market acceptance of new products and services.

· Future growth or operating results may require us to raise additional capital but that capital may not be available.

Reputation Risks

· Unauthorized disclosure of sensitive or confidential client or customer information, whether through a breach of our computer system or otherwise, could severely harm our business.

Liquidity Risks

- We could experience an unexpected inability to obtain needed liquidity.

The ability of a financial institution to meet its current financial obligations is a function of its balance sheet structure, its ability to liquidate assets and its access to alternative sources of funds. We seek to ensure our funding needs are met by maintaining an appropriate level of liquidity through asset/liability management.

Risks Related to an Investment in Our Common Stock

- Limited trading activity for shares of our common stock may contribute to price volatility.
- Our securities are not an insured deposit.
- You may not receive dividends on your investment in common stock.

Our ability to pay dividends is dependent upon our receipt of dividends from the Bank, which is subject to regulatory restrictions. Such restrictions, which govern state-chartered banks, generally limit the payment of dividends on bank stock to the bank's undivided profits after all payments of all necessary expenses, provided that the bank's surplus equals or exceeds its capital.

These risks and uncertainties should be considered in evaluating forward-looking statements. Further information concerning the Corporation and its business, including additional factors that could materially affect the Corporation's financial results, is included in the Corporation's filings with the Securities and Exchange Commission. All forward-looking statements contained in this report are based upon information presently available and the Corporation assumes no obligation to update any forward-looking statements.

MACKINAC FINANCIAL CORPORATION

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion will cover results of operations, asset quality, financial position, liquidity, interest rate sensitivity, and capital resources for the periods indicated. The information included in this discussion is intended to assist readers in their analysis of, and should be read in conjunction with, the consolidated financial statements, the related notes, and other supplemental information presented elsewhere in this report. It should be noted that there are non-GAAP disclosures presented within this discussion to further assist readers in their analysis of the financial condition of the Corporation. These disclosures are specifically noted where present. This discussion should also be read in conjunction with the consolidated financial statements and footnotes contained in the Corporation's Annual Report and Form 10-K for the year-ended December 31, 2015. Throughout this discussion and elsewhere in this report, the term "Bank" refers to mBank, the principal banking subsidiary of the Corporation.

FINANCIAL OVERVIEW

The Corporation recorded third quarter 2016 net income of $1.778 million, or $.29 per share, compared to net income available to common shareholders of $1.018 million, or $.16 per share for the third quarter of 2015. In connection with the acquisitions of Niagara and Eagle, the Corporation had total GAAP pre-tax transaction related expenses for the third quarter of $.359 million that reduced net income by $.237 million or $.04 per share, on an after tax basis. The adjusted net income (a non-GAAP measure) for the third quarter of 2016 (exclusive of all transaction related expenses) is $2.015 million, or $.32 per share.

Operating results for the first nine months of 2016, including transaction related expenses from both Niagara and Eagle River, totaled $2.785 million, or $.45 per share, compared to $4.003 million, or $.64 per share, for the same period in 2015. Year-to-date transaction related expenses, largely associated with the early termination of the Eagle River data processing system, totaled $2.928 million with an after-tax impact of $1.932 million on earnings equating to $.31 per share. Adjusted net income (a non-GAAP measure) for the first nine months of 2016 for the Corporation is $4.718 million, or $.76 per share.

Weighted average shares for the nine month period in 2016 totaled 6,226,900, compared to 6,247,416 shares in the same period of 2015. Weighted average shares for the third quarter of 2016 were 6,238,756, compared to 6,238,963 for the same period in 2015.

The net interest margin for the third quarter of 2016 was $8.696 million, or 4.18%, compared to $7.235 million, or 4.18% in the third quarter of 2015. The nine month net interest margin in 2016 was $23.980 million, or 4.21%, compared to $21.755 million, or 4.29%, in 2015.

Total assets of the Corporation at September 30, 2016 were $959.121 million, up by $219.852 million, or 29.74%, from the $739.269 million in total assets reported at year-end 2015.

FINANCIAL CONDITION

Cash and Cash Equivalents

Cash and cash equivalents increased $23.607 million during the first nine months of 2016. See further discussion of the change in cash and cash equivalents in the Liquidity section.

Investment Securities

Securities available for sale increased $35.158 million from December 31, 2015 to September 30, 2016, with the balance on September 30, 2016 totaling $88.886 million. Investment securities are utilized in an effort to manage interest rate risk and liquidity. As of September 30, 2016, investment securities with an estimated fair value of $25.048 million were pledged against borrowings at the FHLB and certain customer relationships.

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Loans

Through the first nine months of 2016, loan balances increased by $138.410 million from December 31, 2015 balances of $618.394 million. During the first nine months of 2016, the Bank had total loan production of $206.8 million, which included $56.9 million of secondary market loan production. This loan production, however, was offset by loan principal runoff, paydowns and amortization.

Management continues to actively manage the loan portfolio, seeking to identify and resolve problem assets at an early stage. Management believes a properly positioned loan portfolio provides the most attractive earning asset yield available to the Corporation and, with a diligent loan approval process and exception reporting, management can effectively manage the risk in the loan portfolio. Management intends to continue loan growth within its markets for mortgage, consumer, and commercial loan products while concentrating on loan quality, industry concentration issues, and competitive pricing.

Following is a summary of the loan portfolio at September 31, 2016 and December 31, 2015 (dollars in thousands):

	September 30, 2016	Percent of Total	December 31, 2015	Percent of Total
Commercial real estate	$ 362,858	47.95%	$ 312,805	50.59%
Commercial, financial, and agricultural	136,065	17.98	122,140	19.75
One to four family residential real estate	211,072	27.89	140,502	22.72
Construction:				
Consumer	11,768	1.55	11,770	1.90
Commercial	14,343	1.90	15,330	2.48
Consumer	20,698	2.73	15,847	2.56
Total loans	$ 756,804	100.00%	$ 618,394	100.00%

Following is a table showing the significant industry types in the commercial loan portfolio as of September 30, 2016 and December 31, 2015 (dollars in thousands):

	September 30, 2016			December 31, 2015		
	Outstanding Balance	Percent of Loans	Percent of Capital	Outstanding Balance	Percent of Loans	Percent of Capital

Real estate - operators of nonresidential buildings	110,252	22.15%	144.68%	102,620	22.79%	133.97%
Hospitality and tourism	53,182	9.59	62.65	41,300	9.17	53.92
Lessors of residential buildings	23,939	5.30	34.59	25,930	5.76	33.85
Gasoline stations and convenience stores	20,286	4.09	26.70	21,647	4.81	28.26
Commercial construction	14,343	3.69	24.10	15,330	3.40	20.01
Real estate agents and managers	9,962	3.31	21.61	11,225	2.49	14.65
Other	281,302	51.87	338.88	232,223	51.58	303.16
Total Commercial Loans	$ 513,266	100.00%		$ 450,275	100.00%	

Management recognizes the additional risk presented by the concentration in certain segments of the portfolio. Management does not believe that its current portfolio composition has increased exposure related to any specific industry concentration as of September 30, 2016. The current concentration of real estate related loans represents a broad customer base composed of a high percentage of owner occupied developments.

Our residential real estate portfolio predominantly includes one to four family adjustable rate mortgages that have repricing terms generally from one to three years, construction loans to individuals and bridge financing loans for qualifying customers. As of September 30, 2016, our residential loan portfolio totaled $222.840 million, or 29.45% of our total outstanding loans.

Due to the seasonal nature of many of the Corporation's commercial loan customers, loan payment terms provide flexibility by structuring payments to coincide with the customer's business cycle. The lending staff evaluates the collectability of the past due loans based on documented collateral values and payment history. The Corporation discontinues the accrual of interest on loans when, in the opinion of management, there is an indication that the borrower may be unable to meet the payments as they become due. Upon such discontinuance, all unpaid accrued interest is

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reversed. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Credit Quality

Management analyzes the allowance for loan losses in detail on a monthly basis to determine whether the losses inherent in the portfolio are properly reserved for. Net charge-offs for the nine months ended September 30, 2016 amounted to $.492 million, compared to net charge-offs of $.216 million, for the same period in 2015. The current reserve balance is representative of the relevant risk inherent within the Corporation's loan portfolio. Additions or reductions to the reserve in future periods will be dependent upon a combination of future loan growth, nonperforming loan balances and charge-off activity.

The table below shows period end balances of nonperforming assets (dollars in thousands):

	September 30, 2016	December 31, 2015
Nonperforming Assets:		
Nonaccrual loans	$ 4,498	$ 2,353
Loans past due 90 days or more	32	32
Restructured loans	139	154
Total nonperforming loans	4,669	2,539
Other real estate owned	3,269	2,324
Total nonperforming assets	$ 7,938	$ 4,863
Nonperforming loans as a % of loans	0.62%	0.41%
Nonperforming assets as a % of assets	0.83%	0.66%
Reserve for Loan Losses:		
At period end	$ 4,862	$ 5,004
As a % of average loans	.71%	.83%
As a % of nonperforming loans	104.13%	197.09%
As a % of nonaccrual loans	108.09%	212.66%
Texas Ratio	10.55%	6.34%

Nonperforming assets at $7.938 million have increased in 2016 by $3.075 million from the $4.863 million at 2015 year end, largely a result of the nonperforming assets garnered in the Eagle and Niagara acquisitions.

The following ratios provide additional information relative to the Corporation's credit quality (dollars in thousands):

	At Period End	
	September 30, 2016	December 31, 2015
Total loans, at period end	$ 756,804	618,394
Average loans for the period	$ 680,027	$ 602,904

	For the Period Ended	
	Nine Months Ended September 30, 2016	Twelve Months Ended December 31, 2015
Net charge-offs (recoveries) during the period	$ 492	1,340
Net charge-offs to average loans, annualized	.10%	.22%

Management continues to address market issues impacting its loan customer base. In conjunction with the Corporation's senior lending staff and bank regulatory examinations, management reviews the Corporation's loans, related collateral evaluations, and the overall lending process. The Corporation also utilizes an outside loan consultant to perform a review of the loan portfolio. The opinion of this consultant upon completion of the 2015 independent review provided findings similar to management with respect to credit quality. In 2016, the Corporation continues to utilize a consultant for loan review.

As of September 30, 2016, the allowance for loan losses represented .65% of total loans. At September 30, 2016, the allowance included specific reserves in the amount of $.954 million, as compared to specific reserves of $.727 million at December 31, 2015. In management's opinion, the allowance for loan losses is adequate to cover probable losses related to specifically identified loans, as well as probable losses inherent in the balance of the loan portfolio.

As part of the process of resolving problem credits, the Corporation may acquire ownership of collateral which secured such credits. The Corporation carries this collateral in other real estate on the balance sheet.

The following table represents the activity in other real estate for the periods indicated (dollars in thousands):

	Nine Months Ended September 30, 2016	Year Ended December 31, 2015
Balance at beginning of period	$ 2,324	$ 3,010
Other real estate acquired, net of purchase accounting adjustments	1,242	—
Other real estate transferred from loans due to foreclosure	1,091	1,376
Other real estate sold, net of purchase accounting adjustments	(1,128)	(1,702)
Transferred out of other real estate for bank use	(197)	—
Writedowns on other real estate held for sale, including purchase accounting adjustment	(53)	(295)
Loss on sale of other real estate held for sale	(10)	(65)
Balance at end of period	$ 3,269	$ 2,324

During the first nine months of 2016, the Corporation received real estate in lieu of loan payments of $1.091 million. Other real estate is initially valued at the lower of cost or the fair value less selling costs. After the initial receipt, management periodically re-evaluates the recorded balances and any additional reductions in the fair value result in a write-down of other real estate.

Deposits

The Corporation had an increase in deposits in the first nine months of 2016. Total deposits increased by $196.857 million, or 32.25%, in the first nine months of 2016. The increase in deposits for the first nine months of 2016 is composed of an increase in core deposits of $180.342 million and an increase in noncore deposits of $16.515 million. These increases included the acquisition of Eagle deposits amounting to $104.514 million and Niagara deposits amounting to $59.184 million. In recent years, the Corporation has strategically emphasized the growth of core deposits with the introduction of several new deposit products and competitive deposit pricing. Management also utilizes brokered deposits as a funding source, which provides flexibility in managing interest rate risk for fixed rate longer term loan fundings.

Management continues to monitor existing deposit products in order to stay competitive as to both terms and pricing. It is the intent of management to be aggressive in its markets to grow core deposits with an emphasis placed on transactional deposits.

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The following table represents detail of deposits at the end of the periods indicated (dollars in thousands):

	September 30, 2016	% of Total	December 31, 2015	% of Total
Noninterest bearing	$ 163,278	20.23%	$ 122,775	20.12%
NOW, money market, checking	287,097	35.57	202,784	33.23
Savings	60,322	7.47	30,882	5.06
Certificates of Deposit <$250,000	150,170	18.60	124,084	20.33
Total core deposits	660,867	81.87	480,525	78.73
Certificates of Deposit >$250,000	9,015	1.12	8,532	1.40
Brokered CDs	137,298	17.01	121,266	19.87
Total non-core deposits	146,313	18.13	129,798	21.27
Total deposits	$ 807,180	100.00%	$ 610,323	100.00%

Borrowings

The Corporation also utilizes FHLB borrowings as a source of funding. At September 30, 2016, this source of funding totaled $46 million and the Corporation secured this funding by pledging loans and investments. The $46 million of FHLB borrowings has a weighted average maturity of 1.75 years and a weighted average rate of 2.01% at September 30, 2016. The Corporation also has a USDA Rural Development loan held by its wholly owned subsidiary, First Rural Relending, that has an outstanding balance of $.630 million, with a fixed interest rate of 1% that matures in August 2024.

In addition to the above, the Corporation currently has one banking borrowing relationship. The relationship consists of a nonrevolving line of credit and a term note. The line of credit had no balance at September 30, 2016 and bears interest at 90-day LIBOR plus 2.75%, with a floor rate of 4.00% and has an initial term that expires on April 30, 2018. The term note had a September 30, 2016 balance of $21.100 million, bears the same interest and matures on April 30, 2019 and requires quarterly principal payments of $550,000 beginning March 31, 2017.

Shareholders' Equity

Total shareholders' equity increased $1.683 million from December 31, 2015 to September 30, 2016. Contributing to the increase in shareholders' equity was net income available to common shareholders of $2.785 million, a reduction for cash dividends on common stock of $1.891 million, increases due to stock compensation of $.450 million, an increase in the market value of securities of $.489 million and a decrease due to the repurchase of common stock of $.150 million.

RESULTS OF OPERATIONS

Summary

The Corporation reported net income available to common shareholders of $2.785 million, or $.45 per share, in the first nine months of 2016, compared to $4.003 million, or $.64 per share, for the first nine months of 2015.

Net Interest Income

Net interest income is the Corporation’s primary source of core earnings. Net interest income represents the difference between the average yield earned on interest earning assets and the average rate paid on interest bearing obligations. The net interest income is impacted by economic and competitive factors that influence rates, loan demand, and the availability of funding.

Net interest margin on a fully taxable equivalent basis amounted to $24.049 million, 4.23% of average earning assets, in the first nine months of 2016, compared to $21.827 million, and 4.31% of average earning assets, in the first half of 2015.

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The following table presents the amount of interest income from average interest-earning assets and the yields earned on those assets, as well as the interest expense on average interest-bearing obligations and the rates paid on those obligations. All average balances are daily average balances.

	Three Months Ended							2016-2015
	Average Balances September 30,		Increase/	Average Rates September 30,		Interest September 30,		Income/ Expense
(dollars in thousands)	2016	2015	(Decrease)	2016	2015	2016	2015	Variance
Loans (1,2,3)	$ 734,702	$ 614,315	$ 120,387	5.13%	5.18%	$ 9,470	$ 8,027	$ 1,443
Taxable securities	59,881	49,578	10,303	2.57	2.26	387	282	105
Nontaxable securities (2)	16,927	9,888	7,039	2.02	1.97	86	49	37
Federal funds sold	12,358	5,219	7,139	0.23	0	7	1	6
Other interest-earning assets	11,043	7,423	3,620	3.03	2.46	84	46	38
Total earning assets	834,911	686,423	148,488	4.78	4.86	10,034	8,405	1,629
Reserve for loan losses	(4,855)	(5,565)	710					
Cash and due from banks	52,367	31,319	21,048					
Fixed Assets	15,185	12,703	2,482					
Other Real Estate	3,480	2,342	1,138					
Other assets	29,265	23,931	5,334					
Total assets	$ 930,353	$ 751,153	$ 179,200					
NOW and money market deposits	$ 215,372	$ 158,155	$ 57,217	.33	.32	$ 180	$ 127	$ 53
Interest checking	59,443	52,706	6,737	.15	.18	23	24	(1)
Savings deposits	53,338	30,688	22,650	.09	.10	12	8	4
Certificates of deposit	144,466	161,746	(17,280)	.84	1.03	306	420	(114)
Brokered deposits	149,839	107,951	41,888	.93	.97	349	264	85
Borrowings	69,308	50,458	18,850	2.03	2.41	354	307	47
Total interest-bearing liabilities	691,766	561,704	130,062	.70	.81	1,224	1,150	74
Demand deposits	157,808	113,282	44,526					
Other liabilities	2,752	(195)	2,947					
Shareholders' equity	78,027	76,362	1,665					
Total liabilities and shareholders' equity	$ 930,353	$ 751,153	$ 179,200					
Rate spread				4.08%	4.05%			
Net interest margin/revenue				4.20%	4.19%	$ 8,810	$ 7,255	$ 1,555

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	Nine Months Ended									
	Average Balances September 30,		Increase/	Average Rates September 30,		Interest September 30,		2016-2015 Income/ Expense	Volume	Rate
housands)	2016	2015	(Decrease)	2016	2015	2016	2015	Variance	Variance	Varianc
3)	$ 680,137	$ 607,284	$ 72,853	5.13%	5.28%	$ 26,128	$ 23,999	$ 2,129	$ 2,879	$ (691)
urities	54,014	50,468	3,546	2.36	2.24	954	845	109	59	46
securities	12,863	10,224	2,639	1.80	2.58	173	197	(24)	51	(60)
ds sold	4,576	1761	2,815	.26	0	9	1	8	2	2
st-earning	8,598	8,019	579	3.15	2.45	203	147	56	11	42
g assets	760,188	677,756	82,432	4.83	4.97	27,467	25,189	2,278	3,002	(661)
loan	(5,015)	(5419)	404							
e from	36,529	25,675	10,854							
s	13,935	12,684	1,251							
Estate	3,371	2,505	866							
	25,370	27,392	(2,022)							
	$ 834,378	$ 740,593	$ 93,785							
noney										
sits	$ 189,765	$ 158,082	$ 31,683	.33	.30	$ 462	$ 357	$ 105	$ 72	$ 28
cking	52,063	52,208	(145)	.16	.19	62	73	(11)	—	(11)
osits	43,467	29,637	13,830	.10	.10	32	22	10	10	—
of deposit	135,162	160,674	(25,512)	.90	1.05	914	1,260	(346)	(200)	(174)
posits	130,280	101,395	28,885	.96	1.00	940	755	185	215	(24)
	65,505	53,223	12,282	2.06	2.25	1,008	895	113	207	(77)
st-bearing	616,242	555,219	61,023	.74	.81	3,418	3,362	56	304	(258)
posits	137,395	104,815	32,580							
ties	2,477	5,123	(2,646)							
s' equity	78,264	75,436	2,828							
ties and s' equity	$ 834,378	$ 740,593	$ 93,785							
				4.09%	4.16%					
nue				4.23%	4.31%	$ 24,049	$ 21,827	$ 2,222	$ 2,698	$ (403)

(1) For purposes of these computations, nonaccruing loans are included in the daily average loan amounts outstanding.

(2) The amount of interest income on loans and nontaxable securities has been adjusted to a tax equivalent basis, using a 34% tax rate.

(3) Interest income on loans includes fees.

In this relatively low interest environment, the Corporation has also repriced a significant portion of its loan portfolio. Management has been diligent when repricing maturing or new loans in establishing interest rate floors in order to maintain our improved interest rate spread. The Corporation is anticipating some margin pressure in future periods as we continue to see extremely competitive pricing on new and renewable loans.

Provision for Loan Losses

The Corporation records a provision for loan losses when it believes it is necessary to adjust the allowance for loan losses to maintain an adequate level after considering factors such as loan charge-offs and recoveries, changes in identified levels of risk in the loan portfolio, changes in the mix of loans in the portfolio, loan growth, and other economic factors. During the first nine months of 2016, the Corporation recorded a loan loss provision of $.350 million, compared to $.855 million in the first nine months of 2015. There were net charge-offs of $.492 million in the first nine months of 2016, compared to net charge-offs of $.216 million for the same period in 2015.

Other Income

Other income was $3.012 million in the first nine months of 2016, compared to $2.747 million in the same period in 2015. The increases year over year were largely a result of increased SBA/USDA loan sale gains and increased secondary market mortgage income. With respect to mortgage servicing income, the Corporation has slowed the retention of mortgage servicing on those loans sold to the secondary market, which has contributed to the decrease year over year in this category.

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Management continues to evaluate deposit products and services for ways to better serve its customer base and also enhance service fee income through a broad array of products that price services based on income contribution and cost attributes.

The following table details other income for the three and nine months ended September 30, 2016 and 2015 (dollars in thousands):

	Three Months Ended September 30,				Nine Months Ended September 30,			
			Increase/(Decrease)				Increase/(Decrease)	
	2016	2015	Dollars	Percent	2016	2015	Dollars	Percent
Deposit service fees	$ 259	$ 196	$ 63	32.14%	$ 723	$ 624	$ 99	15.87%
Income from loans sold in the secondary market	512	301	211	70.10	1,118	750	368	49.07
SBA/USDA loan sale gains	551	40	511	1,277.50	717	440	277	62.95
Mortgage servicing (amortization) income	(12)	9	(21)	(233.33)	(74)	239	(313)	(130.96)
Net realized security gains	40	133	(93)	(69.92)	149	402	(253)	(62.94)
Other noninterest income	139	94	45	47.87	379	292	87	29.79
Total other income	$ 1,489	$ 773	$ 716	92.63%	$ 3,012	$ 2,747	$ 265	9.65%

Other Expense

For the first nine months of 2016, the Corporation recorded other expenses of $22.376 million, compared to $17.570 million in 2015, an increase of $4.806 million. The 2016 increase from the first nine months of 2015 was due to transaction related expenses of $2.928 million incurred with the acquisitions of Eagle and Niagara, as well as customary employee compensation and retention related costs to ensure our personnel infrastructure keeps pace with our growing asset base and subsequent regulatory platform monitoring needs.

The following table details other expense for the three and nine months ended September 30, 2016 and 2015 (dollars in thousands):

	Three Months Ended September 30,		Increase/(Decrease)		Nine Months Ended September 30,		Increase/(Decrease)	
	2016	2015	Dollars	Percentage	2016	2015	Dollars	Percentage
Salaries and employee benefits	$ 3,687	$ 3,139	$ 548	17.46%	$ 10,592	$ 9,102	$ 1,490	16.37%
Occupancy	680	602	78	12.96	1,960	1,804	156	8.65
Furniture and equipment	440	370	70	18.92	1,248	1,159	89	7.68
Data processing	440	327	113	34.56	1,118	1,041	77	7.40
Advertising	157	153	4	2.61	494	399	95	23.81
Professional service fees	309	348	(39)	(11.21)	807	928	(121)	(13.04)
Loan and deposit	152	136	16	11.76	434	399	35	8.77
Writedowns and losses on other real estate held for sale	60	104	(44)	(42.31)	62	141	(79)	(56.03)
FDIC insurance premiums	131	135	(4)	(2.96)	356	383	(27)	(7.05)
Telephone	140	108	32	29.63	374	346	28	8.09
Transaction related expenses	359	—	359	N/A	2,928	—	2,928	N/A
Other	730	692	38	5.49	2,003	1,868	135	7.23
Total other expense	$ 7,285	$ 6,114	$ 1,171	19.15%	$ 22,376	$ 17,570	$ 4,806	27.35%

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Federal Income Taxes

The Corporation recognized a federal income tax expense for the nine months ended September 30, 2016 of $1.481 million, compared to $2.074 million a year earlier.

The Corporation has reported deferred tax assets of $9.287 million at September 30, 2016. A valuation allowance is provided against deferred tax assets when it is more likely than not that some or all of the deferred tax asset will not be realized. The Corporation, as of September 30, 2016 had a net operating loss and tax credit carryforwards for tax purposes of approximately $11.200 million and $2.300 million, respectively. The Corporation evaluated the future benefits from these carryforwards as of September 30, 2016 and determined it was “more likely than not” that they would be utilized prior to expiration. The net operating loss carryforwards expire twenty years from the date they originated. These carryforwards, if not utilized, will begin to expire in the year 2023. A portion of the NOL and all of the credit carryforwards are subject to the limitations for utilization as set forth in Section 382 of the Internal Revenue Code. The annual limitation is $1.404 million for the NOL and the equivalent value of tax credits, which is approximately $.476 million. These limitations for use were established in conjunction with the recapitalization of the Corporation in December 2004. The Corporation will continue to evaluate the future benefits from these carryforwards in order to determine if any adjustment to the deferred tax asset is warranted.

LIQUIDITY

Liquidity is defined as the ability to generate cash at a reasonable cost to fulfill lending commitments and support asset growth, while satisfying the withdrawal demands of customers and make payments on existing borrowing commitments. The Bank’s principal sources of liquidity are core deposits and loan and investment payments and prepayments. Providing a secondary source of liquidity is the available for sale investment portfolio. As a final source of liquidity, the Bank can exercise existing credit arrangements.

Current balance sheet liquidity consists of $48.615 million in cash and cash equivalents and $63.838 million of unpledged investment securities. Although current liquidity is deemed adequate, management has the ability to increase on hand liquidity by acquiring brokered CDs in order to fund any anticipated loan growth.

During the first nine months of 2016, the Corporation increased cash and cash equivalents by $23.607 million. The management of bank liquidity for funding of loans and deposit maturities and withdrawals includes monitoring projected loan fundings and scheduled prepayments and deposit maturities within a 30 day period, a 30- to 90- day period and from 90 days until the end of the year. This funding forecast model is completed weekly.

The Corporation's primary source of liquidity on a stand-alone basis is dividends from the Bank. The Corporation also has a line of credit with a correspondent bank with current availability of $5.000 million. The Corporation's current plan for dividends from the Bank are dependent upon the profitability of the Bank, growth of assets at the Bank and the level of capital needed to stay "adequately capitalized."

Liquidity is managed by the Corporation through its Asset and Liability Committee ("ALCO"). The ALCO Committee meets regularly to discuss asset and liability management in order to address liquidity and funding needs to provide a process to seek the best alternatives for investments of assets, funding costs, and risk management. The liquidity position of the Bank is managed daily, thus enabling the Bank to adapt its position according to market fluctuations. Core deposits are important in maintaining a strong liquidity position as they represent a stable and relatively low cost source of funds. The Bank's liquidity is best illustrated by the mix in the Bank's core and noncore funding dependence ratio, which explains the degree of reliance on noncore liabilities to fund long-term assets.

Core deposits are herein defined as demand deposits, NOW (negotiable order withdrawals), money markets, savings and certificates of deposit under $250,000. Noncore funding consists of certificates of deposit greater than $250,000, brokered deposits, and FHLB and Farmers' Home Administration borrowings. At September 30, 2016, the Bank's core deposits in relation to total funding were 75.54% compared to 73.24% at September 30, 2015. These ratios indicate that at September 30, 2016, that the Bank had slightly decreased its reliance on noncore deposits and borrowings to fund the Bank's long-term assets, namely loans and investments. The Bank believes that by maintaining adequate volumes of short-term investments and implementing competitive pricing strategies on deposits, it can ensure adequate liquidity to support future growth. The Bank also has correspondent lines of credit available to meet unanticipated short-term liquidity needs. As of September 30, 2016, the Bank had $43.000 million of unsecured lines available and additional

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funding sources available if secured. The bank believes that its liquidity position remains strong to meet both present and future financial obligations and commitments, events or uncertainties that have resulted or are reasonably likely to result in material changes with respect to the Bank's liquidity.

From a long-term perspective, the Corporation's strategy is to increase core deposits in the Corporation's local markets. Management continually evaluates deposit products offered in order to remain competitive in its goal of increasing core deposits. The Corporation also has the ability to augment local deposit growth efforts with wholesale CD funding.

CAPITAL AND REGULATORY

The Corporation is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Corporation's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation must meet specific capital guidelines that involve quantitative measures of the Corporation's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Corporation's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Corporation to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets. Management has determined that, as of September 30, 2016, the Corporation is adequately capitalized.

Effective January 1, 2015, the Corporation became subject to new capital requirements due to the Basel III regulation, including:

- A new minimum ratio of Common Equity Tier I Capital to risk-weighted assets of 4.5%;
- An increase in the minimum required amount of Additional Tier 1 Capital to 6% of risk-weighted assets;
- A continuation of the current minimum required amount of Total Capital (Tier 1 plus Tier 2) of 8% of risk-weighted assets; and
- A minimum leverage ratio of Tier I Capital to total assets equal to 4% in all circumstances.

In order to be "well-capitalized" under the current guidelines, a depository institution must maintain a Common Equity Tier 1 Capital ratio of 6.5% or more; an Additional Tier 1 Capital ratio of 8% or more; a Total Capital ratio of 10% or more; and a leverage ratio of 5% or more.

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The Corporation’s and the Bank’s actual capital and ratios compared to generally applicable regulatory requirements as of September 30, 2016 are as follows (dollars in thousands):

	Actual Amount	Ratio	Adequacy Purposes Amount	Ratio	Well-Capitalized Amount	Ratio
Total capital to risk weighted assets:						
Consolidated	$ 72,376	9.3% >	$ 62,457>	8.0% >	$ 78,071>	10.0%
mBank	$ 96,179	11.6%>	$ 62,187>	8.0% >	$ 77,734>	10.0%
Tier 1 capital to risk weighted assets:						
Consolidated	$ 67,514	8.7% >	$ 46,842>	6.0% >	$ 62,457>	8.0%
mBank	$ 85,408	11.0%>	$ 46,640>	6.0% >	$ 62,187>	8.0%
Common equity Tier 1 capital to risk weighted assets						
Consolidated	$ 67,514	8.7% >	$ 35,132>	4.5% >	$ 50,746>	6.5%
mBank	$ 85,408	11.0%>	$ 34,980>	4.5% >	$ 50,527>	6.5%
Tier 1 capital to average assets:						
Consolidated	$ 67,514	7.4% >	$ 36,749>	4.0% >	$ 45,937>	5.0%
mBank	$ 85,408	9.3% >	$ 36,809>	4.0% >	$ 46,011>	5.0%

Regulatory capital is not the same as shareholders’ equity reported in the accompanying condensed consolidated financial statements. Certain assets cannot be considered assets for regulatory purposes, such as acquisition intangibles and noncurrent deferred tax benefits.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INTEREST RATE RISK

In general, the Corporation attempts to manage interest rate risk by investing in a variety of assets which afford it an opportunity to reprice assets and increase interest income at a rate equal to or greater than the interest expense associated with repricing liabilities.

Interest rate risk is the exposure of the Corporation to adverse movements in interest rates. The Corporation derives its income primarily from the excess of interest collected on its interest-earning assets over the interest paid on its interest-bearing obligations. The rates of interest the Corporation earns on its assets and owes on its obligations generally are established contractually for a period of time. Since market interest rates change over time, the Corporation is exposed to lower profitability if it cannot adapt to interest rate changes. Accepting interest rate risk can be an important source of profitability and shareholder value; however, excess levels of interest rate risk could pose a significant threat to the Corporation’s earnings and capital base. Accordingly, effective risk management that maintains interest rate risk at prudent levels is essential to the Corporation’s safety and soundness.

Loans are the most significant earning asset. Management offers commercial and real estate loans priced at interest rates which fluctuate with various indices such as the prime rate or rates paid on various government issued securities. In addition, the Corporation prices the majority of fixed rate loans so it has an opportunity to reprice the loan within 12 to 36 months.

As of September 30, 2016, the Corporation had established interest rate floors on approximately $150.301 million of its variable rate commercial loans. These interest rate floors will result in a “lag” on the repricing of these variable rate loans when and if interest rates increase in future periods. Approximately $130.263 million of the “floor rate” loan balances will reprice with a 100 basis point increase on the prime rate, with another $19.968 million repricing in the next 100 basis point prime rate increase.

The Corporation also has $88.886 million of securities providing for scheduled monthly principal and interest payments as well as unanticipated prepayments of principal as of September 30, 2016. These cash flows are then reinvested into other earning assets at current market rates. The Corporation also has federal funds sold to correspondent banks as well as other interest-bearing deposits with correspondent banks. These funds are generally repriced on a daily basis.

As of September 30, 2016, the Corporation has $510.697 million of transactional accounts, of which $163.278 million consists of noninterest bearing demand deposit balances. Transaction account balances have increased significantly in the last year due in part to the acquisitions of Eagle and Niagara, as well as the Corporation's focus on these low costs accounts by developing new attractive products and increased sales efforts to municipalities, schools and businesses. These transactional account balances provide additional repricing flexibility in changing interest rate environments since they have no scheduled maturities and interest rates can be reset at any time.

Other deposit products have a variety of terms ranging from deposits whose interest rates can change on a weekly basis to certificates of deposit with repricing terms of up to five years. Longer term deposits generally include penalty provisions for early withdrawal.

Beyond general efforts to shorten the loan pricing periods and extend deposit maturities, management can manage interest rate risk by managing the maturity periods of securities purchased, selling securities available for sale, and borrowing funds with targeted maturity periods, among other strategies. Also, the rate of interest rate changes can impact the actions taken since the rate environment affects borrowers and depositors differently.

Exposure to interest rate risk is reviewed on a regular basis. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect of interest rate changes on net interest income and to structure the composition of the balance sheet to minimize interest rate risk and at the same time maximize income. Management realizes certain risks are inherent and that the goal is to identify and minimize the risks. Tools used by management include maturity and repricing analysis and interest rate sensitivity analysis. The Bank has monthly asset/liability meetings with an outside consultant to review its current position and strategize about future opportunities on risks relative to pricing and positioning of assets and liabilities.

The difference between repricing assets and liabilities for a specific period is referred to as the gap. An excess of repricable assets over liabilities is referred to as a positive gap. An excess of repricable liabilities over assets is referred to as a negative gap. The cumulative gap is the summation of the gap for all periods to the end of the period for which the cumulative gap is being measured.

Assets and liabilities scheduled to reprice are reported in the following time frames. Those instruments with a variable interest rate tied to an index and considered immediately repricable are reported in the 1- to 90-day time frame. The estimates of principal amortization and prepayments are assigned to the following time frames.

The following is the Corporation's repricing opportunities at September 30, 2016 (dollars in thousands):

	1-90 Days	91-365 Days	>1-5 Years	Over 5 Years	Total
Interest-earning assets:					
Loans	$ 273,535	182,968	298,188	2,113	$ 756,804
Securities	8,603	4,408	53,756	22,119	88,886
Other (1)	5,597	5,046	8,298	447	19,388
Total interest-earning assets	287,735	192,422	360,242	24,679	865,078
Interest-bearing obligations:					
NOW, money market, savings and interest checking	347,419	—	—	—	347,419
Time deposits	31,925	61,525	63,198	2,537	159,185
Brokered CDs	29,592	85,591	22,115	—	137,298
Borrowings	6,000	1,724	59,450	556	67,730
Total interest-bearing obligations	414,936	148,840	144,763	3,093	711,632
Gap	$ (127,201)	$ 43,582	$ 215,479	$ 21,586	$ 153,446
Cumulative gap	$ (127,201)	$ (83,619)	$ 131,860	$ 153,446	

(1) Includes Federal Home Loan Bank Stock.

The above analysis indicates that at September 30, 2016, the Corporation had a cumulative liability sensitivity gap position of $83.619 million within the one-year time frame. The Corporation's cumulative liability sensitive gap suggests that if market interest rates were to increase in the next twelve months, the Corporation has the potential to earn less net interest income. This is because more liabilities would reprice at higher rates than assets. Conversely, if market interest rates decrease in the next twelve months, the above gap position suggests the Corporation's net interest income would increase. A limitation of the traditional gap analysis is that it does not consider the timing or magnitude of non-contractual repricing or expected prepayments. In addition, the gap analysis treats savings, NOW, and money market accounts as repricing within 90 days, while experience suggests that these categories of deposits are actually comparatively resistant to rate sensitivity.

At December 31, 2015, the Corporation had a cumulative liability sensitivity gap position of $37.492 million within the one-year time frame.

The borrowings in the gap analysis include $46.000 million of FHLB advances that have a weighted average maturity of 1.75 years and a weighted average rate of 2.01%.

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The Corporation's primary market risk exposure is interest rate risk and, to a lesser extent, liquidity risk and foreign exchange risk. The Corporation has no market risk sensitive instruments held for trading purposes. The Corporation has limited agricultural-related loan assets and therefore has minimal significant exposure to changes in commodity prices. Any impact that changes in foreign exchange rates and commodity prices would have on interest rates are assumed to be insignificant.

Evaluating the exposure to changes in interest rates includes assessing both the adequacy of the process used to control interest rate risk and the quantitative level of exposure. The Corporation's interest rate risk management process seeks to ensure that appropriate policies, procedures, management information systems, and internal controls are in place to maintain interest rate risk at prudent levels with consistency and continuity. In evaluating the quantitative level of interest rate risk, the Corporation assesses the existing and potential future effects of changes in interest rates on its financial condition, including capital adequacy, earnings, liquidity, and asset quality.

In addition to changes in interest rates, the level of future net interest income is also dependent on a number of variables, including: the growth, composition and levels of loans, deposits, and other earning assets and interest-bearing obligations, and economic and competitive conditions; potential changes in lending, investing, and deposit strategies; customer preferences; and other factors.

FOREIGN EXCHANGE RISK

In addition to managing interest rate risk, management also actively manages risk associated with foreign exchange. The Corporation provides foreign exchange services, makes loans to, and accepts deposits from, Canadian customers primarily at its banking offices in Sault Ste. Marie, Michigan. To protect against foreign exchange risk, the Corporation monitors the volume of Canadian deposits it takes in and then invests these Canadian funds in Canadian commercial loans and securities. Management believes the exposure to short-term foreign exchange risk is minimal and at an acceptable level for the Corporation.

OFF-BALANCE-SHEET RISK

Derivative financial instruments include futures, forwards, interest rate swaps, option contracts and other financial instruments with similar characteristics. The Corporation currently does not enter into futures, forwards, swaps, or options. However, the Corporation is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit and involve to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the condensed consolidated balance sheets. Commitments to extend credit 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 and may require collateral from the borrower if deemed necessary by the

Corporation. Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party up to a stipulated amount and with specified terms and conditions.

Commitments to extend credit and standby letters of credit are not recorded as an asset or liability by the Corporation until the instrument is exercised.

IMPACT OF INFLATION AND CHANGING PRICES

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and results of operations in historical dollars without considering the change in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of the Corporation's operations. Nearly all the assets and liabilities of the Corporation are financial, unlike industrial or commercial companies. As a result, the Corporation's performance is directly impacted by changes in interest rates, which are indirectly influenced by inflationary expectations. The Corporation's ability to match the interest sensitivity of its financial assets to the interest sensitivity of its financial liabilities tends to minimize the effect of changes in interest rates on the Corporation's performance. Changes in interest rates do not necessarily move to the same extent as changes in the price of goods and services.

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ITEM 4 CONTROLS AND PROCEDURES

As of September 30, 2016, we carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15 of the Securities Exchange Act of 1934. Our management, which includes our principal executive officer and our principal financial officer, does not expect that our disclosure controls and procedures will prevent all errors and all fraud.

A control system, no matter how well conceived and operated, can provide only reasonable, but not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints; additionally, the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Corporation have been detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is also based, in part, upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate due to changes in conditions; also the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Our principal executive officer and principal accounting officer have concluded, based on our evaluation of our disclosure controls and procedures, that our disclosure controls and procedures, as defined, under Rule 13a-15 of the Securities Exchange Act of 1934 are effective as of September 30, 2016.

Changes in Internal Control Over Financial Reporting

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

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Corporation and its subsidiaries are subject to routine litigation incidental to the business of banking.

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

The Corporation currently has a share repurchase program. The program is conducted under authorizations from time to time by the Board of Directors. The shares reported in the table below are covered by Board authorizations made and publically announced for $600,000 on February 27, 2013, an additional $600,000 on December 17, 2013 and an additional $750,000 on April 28, 2015. None of these authorizations has an expiration date.

Issuer purchase of Equity Securities

Period of purchases	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of a publically announced plan or program	Maximum dollars yet to be used for stock purchases
July 1, 2016 to July 31, 2016	—	$ —	—	$ 25,335
August 1, 2016 to August 31, 2016	—	$ —	—	25,335
September 1, 2016 to September 30, 2016	—	$ —	—	25,335
Total Third Quarter 2016	—	$ —	—	

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

Exhibit 10.1	Amended and Restated Emloyment Agreement, dated as of August 1, 2016, by and between Mackinac Financial Corporation and Jesse Deering, filed with the SEC on August 1, 2016 as Exhibit 10.1 to the Corporation's Current Report on Form 8-K filed and incorporated herein by reference.
Exhibit 31.1	Rule 13a-14(a) Certification of Chief Executive Officer.
Exhibit 31.2	Rule 13a-14(a) Certification of Chief Financial Officer.
Exhibit 32.1	Section 1350 Certification of Chief Executive Officer.
Exhibit 32.2	Section 1350 Certification of Chief Financial Officer.
101.INS	XBRL Instance Document.
101.SCH	XBRL Taxonomy Extension Schema Document.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB	XBRL Taxonomy Extension Labels Linkbase Document.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.

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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.

MACKINAC FINANCIAL CORPORATION
(Registrant)

Date:	November 14, 2016	By:	/s/ Paul D. Tobias PAUL D. TOBIAS, CHAIRMAN AND CHIEF EXECUTIVE OFFICER (principal executive officer)
		By:	/s/ Jesse A. Deering JESSE A. DEERING EVP/CHIEF FINANCIAL OFFICER (principal financial and accounting officer)