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ISABELLA BANK Corp
Form 10-Q
November 09, 2018
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2018

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

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

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

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

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

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

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

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

Large accelerated filer Accelerated filer

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

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

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The number of common shares outstanding of the registrant's Common Stock (no par value) was 7,848,174 as of November 7, 2018.

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ISABELLA BANK CORPORATION
QUARTERLY REPORT ON FORM 10-Q
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Forward Looking Statements

This report contains certain forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Rule 175 promulgated thereunder, and Section 21E of the Securities Exchange Act of 1934, as amended and Rule 3b-6 promulgated thereunder. We intend such forward looking statements to be covered by the safe harbor provisions for forward looking statements contained in the Private Securities Litigation Reform Act of 1995, and are included in this statement for purposes of these safe harbor provisions. Forward looking statements, which are based on certain assumptions and describe future plans, strategies and expectations, are generally identifiable by use of the words “believe,” “expect,” “intend,” “anticipate,” “estimate,” “project,” or similar expressions. Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse effect on the operations and future prospects include, but are not limited to, changes in: interest rates, general economic conditions, federal or state tax laws, monetary and fiscal policy, the quality or composition of the loan or investment portfolios, demand for loan products, fluctuation in the value of collateral securing our loan portfolio, deposit flows, competition, cyber-security risk, demand for financial services in our market area, and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating forward looking statements and undue reliance should not be placed on such statements. Further information concerning our business, including additional factors that could materially affect our financial results, is included in our filings with the SEC.

Glossary of Acronyms and Abbreviations

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

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

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FDI Act: Federal Deposit Insurance Act

FDIC: Federal Deposit Insurance Corporation

FFIEC: Federal Financial Institutions Examinations Council

FRB: Federal Reserve Bank

FHLB: Federal Home Loan Bank

Freddie Mac: Federal Home Loan Mortgage Corporation

FTE: Fully taxable equivalent

PCAOB: Public Company Accounting
Oversight Board

Rabbi Trust: A trust established to fund
the Directors Plan

SEC: U.S. Securities and Exchange
Commission

SOX: Sarbanes-Oxley Act of 2002

Tax Act: Tax Cuts and Jobs Act, enacted
December 22, 2017

TDR: Troubled debt restructuring

XBRL: eXtensible Business Reporting
Language

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements.

INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(Dollars in thousands)

	September 30 2018	December 31 2017
ASSETS		
Cash and cash equivalents		
Cash and demand deposits due from banks	\$ 21,864	\$ 25,267
Interest bearing balances due from banks	26,688	5,581
Total cash and cash equivalents	48,552	30,848
AFS securities, at fair value	501,139	548,730
Equity securities, at fair value	—	3,577
Mortgage loans AFS	2,811	1,560
Loans		
Commercial	668,915	634,759
Agricultural	129,232	128,269
Residential real estate	276,904	272,368
Consumer	64,879	56,123
Gross loans	1,139,930	1,091,519
Less allowance for loan and lease losses	8,100	7,700
Net loans	1,131,830	1,083,819
Premises and equipment	28,186	28,450
Corporate owned life insurance policies	27,547	27,026
Accrued interest receivable	7,669	7,063
Equity securities without readily determinable fair values	24,948	23,454
Goodwill and other intangible assets	48,473	48,547
Other assets	12,508	10,056
TOTAL ASSETS	\$ 1,833,663	\$ 1,813,130
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest bearing	\$ 229,269	\$ 237,511
NOW accounts	235,529	231,666
Certificates of deposit under \$250 and other savings	739,859	728,090
Certificates of deposit over \$250	72,149	67,991
Total deposits	1,276,806	1,265,258
Borrowed funds	359,776	344,878
Accrued interest payable and other liabilities	8,545	8,089
Total liabilities	1,645,127	1,618,225
Shareholders' equity		
Common stock — no par value 15,000,000 shares authorized; issued and outstanding 7,830,940 shares (including 15,158 shares held in the Rabbi Trust) in 2018 and 7,857,293 shares (including 31,769 shares held in the Rabbi Trust) in 2017	139,480	140,277
Shares to be issued for deferred compensation obligations	5,339	5,502
Retained earnings	55,870	51,728
Accumulated other comprehensive income (loss)	(12,153) (2,602
Total shareholders' equity	188,536	194,905
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 1,833,663	\$ 1,813,130

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

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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(Dollars in thousands except per share amounts)

	Three Months Ended September 30		Nine Months Ended September 30	
	2018	2017	2018	2017
Interest income				
Loans, including fees	\$12,833	\$11,297	\$36,205	\$32,102
AFS securities				
Taxable	2,031	2,037	6,263	6,338
Nontaxable	1,301	1,406	4,014	4,234
Federal funds sold and other	254	236	771	661
Total interest income	16,419	14,976	47,253	43,335
Interest expense				
Deposits	2,436	1,715	6,712	4,870
Borrowings	1,795	1,485	4,661	4,189
Total interest expense	4,231	3,200	11,373	9,059
Net interest income	12,188	11,776	35,880	34,276
Provision for loan losses	(76) 49	636	85
Net interest income after provision for loan losses	12,264	11,727	35,244	34,191
Noninterest income				
Service charges and fees	1,557	1,435	4,533	4,370
Net gain on sale of mortgage loans	171	153	339	507
Earnings on corporate owned life insurance policies	170	174	521	537
Net gains on sale of AFS securities	—	—	—	142
Other	965	936	2,693	2,546
Total noninterest income	2,863	2,698	8,086	8,102
Noninterest expenses				
Compensation and benefits	5,845	5,293	17,018	15,667
Furniture and equipment	1,500	1,377	4,550	4,073
Occupancy	870	809	2,501	2,461
Other	2,857	2,660	7,883	7,396
Total noninterest expenses	11,072	10,139	31,952	29,597
Income before federal income tax expense	4,055	4,286	11,378	12,696
Federal income tax expense	359	750	887	2,180
NET INCOME	\$3,696	\$3,536	\$10,491	\$10,516
Earnings per common share				
Basic	\$0.47	\$0.45	\$1.33	\$1.34
Diluted	\$0.46	\$0.44	\$1.30	\$1.31
Cash dividends per common share	\$0.26	\$0.26	\$0.78	\$0.76

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

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(Dollars in thousands)

	Three Months Ended September 30		Nine Months Ended September 30	
	2018	2017	2018	2017
Net income	\$3,696	\$3,536	\$10,491	\$10,516
Unrealized gains (losses) on AFS securities				
Unrealized gains (losses) on AFS securities arising during the period	(2,513)	(96)	(12,548)	4,151)
Reclassification adjustment for net (gains) losses included in net income	—	—	—	(142)
Tax effect (1)	522	54	2,648	(1,158)
Unrealized gains (losses) on AFS securities, net of tax	(1,991)	(42)	(9,900)	2,851)
Unrealized gains (losses) on derivative instruments arising during the period	7	11	160	(33)
Tax effect (1)	(2)	(4)	(34)	11)
Unrealized gains (losses) on derivative instruments, net of tax	5	7	126	(22)
Other comprehensive income (loss), net of tax	(1,986)	(35)	(9,774)	2,829)
Comprehensive income	\$1,710	\$3,501	\$717	\$13,345

(1) See "Note 11 – Accumulated Other Comprehensive Income" for tax effect reconciliation.

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

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(UNAUDITED)

(Dollars in thousands except per share amounts)

	Common Stock		Common Shares to be Issued for Deferred Compensation Obligations	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Totals
	Common Shares Outstanding	Amount				
Balance, January 1, 2017	7,821,069	\$ 139,525	\$ 5,038	\$ 46,114	\$ (2,778)	\$ 187,899
Comprehensive income (loss)	—	—	—	10,516	2,829	13,345
Issuance of common stock	178,712	4,999	—	—	—	4,999
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	176	(176)	—	—	—
Share-based payment awards under equity compensation plan	—	—	502	—	—	502
Common stock purchased for deferred compensation obligations	—	(327)	—	—	—	(327)
Common stock repurchased pursuant to publicly announced repurchase plan	(143,117)	(4,005)	—	—	—	(4,005)
Cash dividends paid (\$0.76 per common share)	—	—	—	(5,950)	—	(5,950)
Balance, September 30, 2017	7,856,664	\$ 140,368	\$ 5,364	\$ 50,680	\$ 51	\$ 196,463
Balance, January 1, 2018	7,857,293	\$ 140,277	\$ 5,502	\$ 51,728	\$ (2,602)	\$ 194,905
Comprehensive income (loss)	—	—	—	10,491	(9,774)	717
Adoption of ASU 2016-01	—	—	—	(223)	223	—
Issuance of common stock	189,074	5,093	—	—	—	5,093
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	612	(612)	—	—	—
Share-based payment awards under equity compensation plan	—	—	449	—	—	449
Common stock purchased for deferred compensation obligations	—	(290)	—	—	—	(290)
Common stock repurchased pursuant to publicly announced repurchase plan	(215,427)	(6,212)	—	—	—	(6,212)
Cash dividends paid (\$0.78 per common share)	—	—	—	(6,126)	—	(6,126)
Balance, September 30, 2018	7,830,940	\$ 139,480	\$ 5,339	\$ 55,870	\$ (12,153)	\$ 188,536

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

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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Dollars in thousands)

	Nine Months Ended September 30	
	2018	2017
OPERATING ACTIVITIES		
Net income	\$10,491	\$10,516
Reconciliation of net income to net cash provided by operating activities:		
Provision for loan losses	636	85
Impairment of foreclosed assets	—	2
Depreciation	2,198	2,163
Amortization of OMSR	165	257
Amortization of acquisition intangibles	74	91
Net amortization of AFS securities	1,432	1,614
Net unrealized (gains) losses on equity securities, at fair value	41	—
Net (gains) losses on sale of AFS securities	—	(142)
Net (gains) losses on sale of equity securities, at fair value	(1)	—
Net gain on sale of mortgage loans	(339)	(507)
Increase in cash value of corporate owned life insurance policies	(521)	(537)
Share-based payment awards under equity compensation plan	449	502
Origination of loans held-for-sale	(20,072)	(28,436)
Proceeds from loan sales	19,160	29,522
Net changes in operating assets and liabilities which provided (used) cash:		
Accrued interest receivable	(606)	(808)
Other assets	(1,323)	(1,491)
Accrued interest payable and other liabilities	456	897
Net cash provided by (used in) operating activities	12,240	13,728
INVESTING ACTIVITIES		
Activity in AFS securities		
Sales	—	12,827
Maturities, calls, and principal payments	64,629	78,352
Purchases	(31,018)	(83,471)
Sale of equity securities, at fair value	3,537	—
Net loan principal (originations) collections	(48,862)	(66,928)
Proceeds from sales of foreclosed assets	201	203
Purchases of premises and equipment	(1,934)	(1,610)
Net cash provided by (used in) investing activities	(13,447)	(60,627)

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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)

(Dollars in thousands)

	Nine Months Ended September 30	
	2018	2017
FINANCING ACTIVITIES		
Net increase (decrease) in deposits	\$ 11,548	\$ 21,022
Net increase (decrease) in borrowed funds	14,898	29,333
Cash dividends paid on common stock	(6,126)	(5,950)
Proceeds from issuance of common stock	5,093	4,999
Common stock repurchased	(6,212)	(4,005)
Common stock purchased for deferred compensation obligations	(290)	(327)
Net cash provided by (used in) financing activities	18,911	45,072
Increase (decrease) in cash and cash equivalents	17,704	(1,827)
Cash and cash equivalents at beginning of period	30,848	22,894
Cash and cash equivalents at end of period	\$48,552	\$ 21,067
SUPPLEMENTAL CASH FLOWS INFORMATION:		
Interest paid	\$ 11,249	\$ 9,000
Income taxes paid	\$—	\$ 2,470
SUPPLEMENTAL NONCASH INFORMATION:		
Transfers of loans to foreclosed assets	\$ 215	\$ 214

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

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands except per share amounts)

Note 1 – Basis of Presentation

As used in these notes, as well as in Management's Discussion and Analysis of Financial Condition and Results of Operations, references to "Isabella," the "Corporation," "we," "our," "us," and similar terms refer to the consolidated entity consisting of Isabella Bank Corporation and its subsidiaries. Isabella Bank Corporation refers solely to the parent holding company, and Isabella Bank or the "Bank" refers to Isabella Bank Corporation's subsidiary, Isabella Bank. The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with GAAP for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In our opinion, all adjustments considered necessary for a fair presentation have been included. Operating results for the three and nine month periods ended September 30, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018. For further information, refer to our Annual Report on Form 10-K for the year ended December 31, 2017.

Our accounting policies are materially the same as those discussed in Note 1 to the Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2017.

Reclassifications: Certain amounts reported in the interim 2017 consolidated financial statements have been reclassified to conform with the 2018 presentation.

Note 2 – Accounting Standards Updates

Recently Adopted Accounting Standards Updates

ASU No. 2014-09: "Revenue from Contracts with Customers"

In May 2014, ASU No. 2014-09 was issued and created new Topic 606 to provide a common revenue standard to achieve consistency and clarification to the revenue recognition principles. The guidance outlines steps to achieve the core principle that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. These steps consist of: (1) identify the contract with a customer, (2) identify the performance obligations in the contract, (3) determine the transaction price, (4) allocate the transaction price to the performance obligations in the contract, and (5) recognize revenue when (or as) the entity satisfies a performance obligation. The new authoritative guidance, as amended, was effective on January 1, 2018. We reviewed our contracts related to trust and investment services and those related to other noninterest income to determine if changes in income recognition were required as a result of this guidance. Implementation of this guidance did not have a significant impact on our operating results for the three and nine month periods ended September 30, 2018.

ASU No. 2016-01: "Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Liabilities" and ASU No. 2018-03: "Technical Corrections and Improvements to Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities"

In January 2016, ASU No. 2016-01 was issued and sets forth the following: 1) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income; 2) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment and requiring measurement of the investment at fair value when an impairment exists; 3) for public entities, eliminates the requirement to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; 4) for public entities, requires the use of exit price notion when measuring the fair value of financial instruments for disclosure purposes; 5) requires an entity to present separately in other comprehensive income, the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; 6) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; and 7) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.

The new authoritative guidance was effective for interim and annual periods beginning after December 15, 2017. As a result of this guidance, the change in the fair value of equity investments has been recorded in net income beginning on January 1, 2018.

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Equity securities are now recorded separately from AFS securities and are recorded at a fair value which approximates an exit price notion. Adoption of this guidance had an insignificant impact on our operations and its future impact will depend on the fair value of these investments at the future measurement dates. The disclosures related to equity investment securities reflect a fully retrospective presentation for comparative purposes.

For discussion of the fair value measurement of financial instruments, refer to “Note 12 – Fair Value”.

In February 2018, ASU No. 2018-03 was issued and sets forth correction or improvement amendments for specific issues that may arise within the scope of ASU 2016-01. These amendments have been adopted and did not have a significant impact on our operating results or financial statement disclosures.

ASU No. 2017-08: “Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities”

In March 2017, ASU No. 2017-08 amended the amortization period for certain purchased callable debt securities held at a premium. Under current GAAP, entities generally amortize the premium as an adjustment of yield over the contractual life of the instrument. The amendments in this update shorten the amortization period and require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity.

The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2018 with early adoption permitted. The guidance has been adopted and did not have a significant impact on our operating results or financial statement disclosures.

ASU No. 2017-09: “Compensation - Stock Compensation (Topic 718): Scope of Modification Accounting”

In May 2017, ASU No. 2017-09 was issued and provided guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting under Topic 718. The current disclosure requirements in Topic 718 apply regardless of whether an entity is required to apply modification accounting under the amendments in this update. An entity should account for the effects of a modification unless all of the following are met:

1. The fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the modified award is the same as the fair value (or calculated value or intrinsic value, if such an alternative measurement method is used) of the original award immediately before the original award is modified. If the modification does not affect any of the inputs to the valuation technique that the entity uses to value the award, the entity is not required to estimate the value immediately before and after the modification.
2. The vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the original award is modified.
3. The classification of the modified award as an equity instrument or a liability instrument is the same as the classification of the original award immediately before the original award is modified.

The new authoritative guidance was effective on January 1, 2018 and did not have a significant impact on our operating results or financial statement disclosures.

Pending Accounting Standards Updates

ASU No. 2016-02: “Leases (Topic 842)”

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

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

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lease payments, in the statement of financial position; 2) recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a generally straight-line basis; and 3) classify all cash payments within operating activities in the statement of cash flows.

The accounting applied by a lessor is largely unchanged from that applied under previous GAAP. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2018. We have and will continue to review our lease agreements to determine the appropriate treatment under this guidance. We do not expect these changes to have a significant impact on our operating results or financial statement disclosures.

In July 2018, ASU No. 2018-10 was issued and provided codification improvements for various leasing issues. Also during July 2018, ASU No. 2018-11 was issued for targeted improvements related to the transition of the new guidance. Both updates are effective with the implementation of ASU 2016-02 and are not expected to impact our operating results or financial statement disclosures.

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

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

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

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

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

We have invested a considerable amount of effort toward this guidance and will continue to invest considerable effort until its effective date. A committee was formed and has developed a road map to implementation, and the committee is accountable for timely and accurate adoption of the guidance. A company that has been focused on the ALLL for more than 10 years and serves hundreds of financial institutions has been engaged to provide us with education, advisory, and software solutions exclusively related to the ACL. We expect to run parallel processes during 2019, which will help to ensure we are ready to calculate, review, and report the ACL by the required implementation date. ASU No. 2018-13: “Fair Value Measurement (Topic 820): Disclosure Framework-Changes to the Disclosure Requirements for Fair Value Measurement”

In August 2018, ASU No. 2018-13 was issued and provided updated framework related to fair value disclosures. For entities required to make disclosures about recurring or nonrecurring fair value measurements, the update provides

disclosure modifications which include the removal, modification and addition of specific disclosure requirements.

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The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2019 and will impact our financial statement disclosures.

ASU No. 2018-14: “Compensation - Retirement Benefits - Defined Pension Plans - General (Subtopic 715-20): Disclosure Framework - Changes to the Disclosure Requirements for Defined Benefit Plans”

In August 2018, ASU No. 2018-14 was issued and provided updated framework related to defined benefit plans. For employers that sponsor defined benefit pension or other postretirement plans, the update provides disclosure modifications which include the removal of six specific requirements, the addition of two specific requirements and clarification to existing requirements.

Disclosure additions include 1) the weighted-average interest crediting rates for cash balance plans and other plans with promised interest crediting rates; 2) an explanation of the reasons for significant gains and losses related to changes in the benefit obligation for the period. Clarification items relate to 1) the projected benefit obligation (PBO) and fair value of plan assets for plans with PBOs in excess of plan assets; and 2) the accumulated benefit obligation (ABO) and fair value of plan assets for plans with ABOs in excess of plan assets.

The new authoritative guidance is effective for fiscal years ending after December 15, 2020, with early adoption permitted, and will likely impact our financial statement disclosures.

ASU No. 2018-15: “Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract”

In August 2018, ASU No. 2018-15 was issued and provided guidance on the accounting for implementation, setup, and

other upfront costs (collectively referred to as implementation costs) for entities that are a customer in a hosting arrangement that is a service contract. The guidance also provides clarification on requirements to capitalize implementation costs and the required accounting for expenses related to capitalization of implementation costs.

The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2019, with early adoption permitted. The impact on our operating results and financial statement disclosures as a result of this update will depend upon our current and future arrangements and whether or not they meet the requirement to be capitalized.

Note 3 – AFS Securities

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

	September 30, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	\$184	\$ —	\$ 4	\$180
States and political subdivisions	193,195	1,328	566	193,957
Auction rate money market preferred	3,200	—	92	3,108
Mortgage-backed securities	196,194	21	8,079	188,136
Collateralized mortgage obligations	120,096	17	4,355	115,758
Total	\$512,869	\$ 1,366	\$ 13,096	\$501,139
	December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	\$217	\$ —	\$ 1	\$216
States and political subdivisions	204,131	4,486	143	208,474
Auction rate money market preferred	3,200	—	151	3,049
Mortgage-backed securities	210,757	390	2,350	208,797
Collateralized mortgage obligations	129,607	160	1,573	128,194
Total	\$547,912	\$ 5,036	\$ 4,218	\$548,730

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The amortized cost and fair value of AFS securities by contractual maturity at September 30, 2018 are as follows:

	Maturing		After Five Years But Within Ten Years	After Ten Years	Securities with Variable Monthly Payments or Noncontractual Maturities	Total
	Due in One Year or Less	After One Year But Within Five Years				
Government sponsored enterprises	\$—	\$ 184	\$—	\$ —	\$ —	\$184
States and political subdivisions	22,802	80,091	61,348	28,954	—	193,195
Auction rate money market preferred	—	—	—	—	3,200	3,200
Mortgage-backed securities	—	—	—	—	196,194	196,194
Collateralized mortgage obligations	—	—	—	—	120,096	120,096
Total amortized cost	\$22,802	\$ 80,275	\$61,348	\$ 28,954	\$ 319,490	\$512,869
Fair value	\$22,850	\$ 80,589	\$61,855	\$ 28,843	\$ 307,002	\$501,139

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

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

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

	Three Months Ended September 30 2018	Nine Months Ended September 30 2017
Proceeds from sales of AFS securities	\$ —	\$ —
Gross realized gains (losses)	\$ —	\$ —
Applicable income tax expense (benefit)	\$ —	\$ —

The following information pertains to AFS securities with gross unrealized losses at September 30, 2018 and December 31, 2017, aggregated by investment category and length of time that individual securities have been in a continuous loss position.

	September 30, 2018				Total Unrealized Losses
	Less Than Twelve Months		Twelve Months or More		
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	
Government sponsored enterprises	\$4	\$ 180	\$ —	\$ —	\$ 4
States and political subdivisions	566	41,972	—	—	566
Auction rate money market preferred	—	—	92	3,108	92
Mortgage-backed securities	2,780	89,602	5,299	96,985	8,079
Collateralized mortgage obligations	2,198	72,074	2,157	39,948	4,355
Total	\$5,548	\$203,828	\$ 7,548	\$ 140,041	\$ 13,096
Number of securities in an unrealized loss position:		164		37	201

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	December 31, 2017				
	Less Than Twelve Months		Months or More		Total Unrealized Losses
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	
Government sponsored enterprises	\$1	\$216	\$ —	\$ —	\$ 1
States and political subdivisions	142	16,139	1	188	143
Auction rate money market preferred	—	—	151	3,049	151
Mortgage-backed securities	454	72,007	1,896	76,065	2,350
Collateralized mortgage obligations	701	76,435	872	25,308	1,573
Total	\$1,298	\$164,797	\$ 2,920	\$ 104,610	\$ 4,218
Number of securities in an unrealized loss position:		81		24	105

Unrealized losses on our AFS securities portfolio are the result of recent increases in intermediate-term and long-term benchmark interest rates and not credit issues.

As of September 30, 2018 and December 31, 2017, we conducted an analysis to determine whether any AFS securities currently in an unrealized loss position should be other-than-temporarily impaired. Such analyses considered, among other factors, the following criteria:

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

• Is the investment credit rating below investment grade?

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

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

• Has the duration of the investment been extended?

During the fourth quarter of 2016, we identified one municipal bond as other-than-temporarily impaired. While management estimated the OTTI to be realized, we also engaged the services of an independent investment valuation firm to estimate the amount of impairment as of December 31, 2016. The valuation calculated the estimated market value utilizing two different approaches:

1) Market - Appraisal and Comparable Investments

2) Income - Discounted Cash Flow Method

The two methods were then weighted, with a higher weighting applied to the Market approach, to determine the estimated impairment. As a result of this analysis, we reduced the carrying value to \$230 which required us to recognize an OTTI of \$770 in earnings for the year ended December 31, 2016. Based on internal analysis of this bond as of September 30, 2018, there was no additional OTTI recognized as of September 30, 2018 and the carrying value of this bond remained at \$230.

Based on our analysis which included the criteria outlined above, the fact that we have asserted that we do not have the intent to sell AFS securities in an unrealized loss position, and considering it is unlikely that we will have to sell any AFS securities in an unrealized loss position before recovery of their cost basis, we do not believe that the values of any other AFS securities are other-than-temporarily impaired as of September 30, 2018 or December 31, 2017, with the exception of the one municipal bond discussed above.

Note 4 – Loans and ALLL

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

Loans that we have the intent and ability to hold in our portfolio are reported at their outstanding principal balance adjusted for any charge-offs, the ALLL, and any deferred fees or costs. Interest income is accrued over the term of the loan based on the principal amount outstanding. Loan origination fees and certain direct loan origination costs are

capitalized and recognized as a component of interest income over the term of the loan using the level yield method.

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The accrual of interest on commercial, agricultural, and residential real estate loans is discontinued at the time the loan is 90 days or more past due unless the credit is well-secured and in the process of collection. Upon transferring loans to nonaccrual status, we perform an evaluation to determine the net realizable value of the underlying collateral. This evaluation is used to help determine if any charge-offs are necessary. Consumer loans are typically charged-off no later than 180 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual status or charged-off at an earlier date if collection of principal or interest is considered doubtful.

For loans that are placed on nonaccrual status or charged-off, all interest accrued in the current calendar year, but not collected, is reversed against interest income while interest accrued in prior calendar years, but not collected, is charged against the ALLL. Loans may be returned to accrual status after six months of continuous performance and achievement of current payment status.

Commercial and agricultural loans include loans for commercial real estate, commercial operating loans, advances to mortgage brokers, farmland and agricultural production, and loans to states and political subdivisions. Repayment of these loans is dependent upon the successful operation and management of a business. We minimize our risk by limiting the amount of direct credit exposure to any one borrower to \$15,000. Borrowers with direct credit needs of more than \$15,000 are serviced through the use of loan participations with other commercial banks. Commercial and agricultural real estate loans commonly require loan-to-value limits of 80% or less. Depending upon the type of loan, past credit history, and current operating results, we may require the borrower to pledge accounts receivable, inventory, property, or equipment. Personal guarantees are generally required from the owners of closely held corporations, partnerships, and sole proprietorships. In addition, we may require annual financial statements, prepare cash flow analyses, and review credit reports.

We entered into a mortgage purchase program in 2016 with a financial institution where we participate in advances to mortgage brokers ("advances"). The mortgage brokers originate residential mortgage loans with the intent to sell them on the secondary market. We participate in the advance to the mortgage broker, which is secured by the underlying mortgage loan, until it is ultimately sold on the secondary market. As such, the average life of each participated advance is approximately 20-30 days. Funds from the sale of the loan are used to pay off our participation in the advance to the mortgage broker. We classify these advances as commercial loans and include the outstanding balance in commercial loans on our consolidated balance sheet. Under the participation agreement, we committed to a maximum outstanding aggregate amount of \$30,000. The difference between our outstanding balances and the maximum outstanding aggregate amount is classified as "Unfunded commitments under lines of credit" in the "Contractual Obligations and Loan Commitments" section of the Management's Discussion and Analysis of Financial Condition and Results of Operations of this report.

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

Our lending policies generally limit the maximum loan-to-value ratio on residential real estate loans to 100% of the lower of the appraised value of the property or the purchase price. Private mortgage insurance is typically required on loans with loan-to-value ratios in excess of 80% unless the loan qualifies for government guarantees.

Underwriting criteria for originated residential real estate loans generally include:

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

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

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

• Ensuring all debt servicing does not exceed 40% of income.

• Verification of acceptable credit reports.

• Verification of employment, income, and financial information.

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

Directors' Loan Committee, or the Board of Directors.

Consumer loans include secured and unsecured personal loans. Loans are amortized for a period of up to 15 years based on the age and value of the underlying collateral. The underwriting emphasis is on a borrower's perceived intent and ability to pay rather than collateral value. No consumer loans are sold to the secondary market.

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

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

The primary factors behind the determination of the level of the ALLL are specific allocations for impaired loans, historical loss percentages, as well as unallocated components. Specific allocations for impaired loans are primarily determined based on the difference between the loan's outstanding balance and the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral, less cost to sell. Historical loss allocations are calculated at the loan class and segment levels based on a migration analysis of the loan portfolio, with the exception of advances to mortgage brokers, over the preceding five years. With no historical losses on advances to mortgage brokers, there is no allocation in the commercial segment displayed in the following tables. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

	Allowance for Loan Losses					
	Three Months Ended September 30, 2018					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
July 1, 2018	\$2,197	\$ 982	\$ 2,167	\$ 882	\$ 1,972	\$8,200
Charge-offs	(7)	—	(61)	(111)	—	(179)
Recoveries	80	—	37	38	—	155
Provision for loan losses	(249)	(200)	239	93	41	(76)
September 30, 2018	\$2,021	\$ 782	\$ 2,382	\$ 902	\$ 2,013	\$8,100

	Allowance for Loan Losses					
	Nine Months Ended September 30, 2018					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2018	\$1,706	\$ 611	\$ 2,563	\$ 900	\$ 1,920	\$7,700
Charge-offs	(501)	—	(100)	(247)	—	(848)
Recoveries	284	—	162	166	—	612
Provision for loan losses	532	171	(243)	83	93	636
September 30, 2018	\$2,021	\$ 782	\$ 2,382	\$ 902	\$ 2,013	\$8,100

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Allowance for Loan Losses and Recorded Investment in Loans
September 30, 2018

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	\$481	\$ 193	\$ 1,400	\$ —	\$ —	\$2,074
Collectively evaluated for impairment	1,540	589	982	902	2,013	6,026
Total	\$2,021	\$ 782	\$ 2,382	\$ 902	\$ 2,013	\$8,100
Loans						
Individually evaluated for impairment	\$8,858	\$ 15,057	\$ 7,429	\$ 10		\$31,354
Collectively evaluated for impairment	660,057	114,175	269,475	64,869		1,108,576
Total	\$668,915	\$ 129,232	\$ 276,904	\$ 64,879		\$1,139,930

Allowance for Loan Losses
Three Months Ended September 30, 2017

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
July 1, 2017	\$1,978	\$ 475	\$ 2,598	\$ 583	\$ 1,966	\$7,600
Charge-offs	(8)	—	(77)	(72)	—	(157)
Recoveries	134	—	41	33	—	208
Provision for loan losses	65	(40)	(71)	89	6	49
September 30, 2017	\$2,169	\$ 435	\$ 2,491	\$ 633	\$ 1,972	\$7,700

Allowance for Loan Losses
Nine Months Ended September 30, 2017

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2017	\$1,814	\$ 884	\$ 2,664	\$ 624	\$ 1,414	\$7,400
Charge-offs	(60)	—	(120)	(190)	—	(370)
Recoveries	322	—	140	123	—	585
Provision for loan losses	93	(449)	(193)	76	558	85
September 30, 2017	\$2,169	\$ 435	\$ 2,491	\$ 633	\$ 1,972	\$7,700

Allowance for Loan Losses and Recorded Investment in Loans
December 31, 2017

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	\$650	\$ —	\$ 1,480	\$ —	\$ —	\$2,130
Collectively evaluated for impairment	1,056	611	1,083	900	1,920	5,570
Total	\$1,706	\$ 611	\$ 2,563	\$ 900	\$ 1,920	\$7,700
Loans						
Individually evaluated for impairment	\$8,099	\$ 10,598	\$ 7,939	\$ 17		\$26,653
Collectively evaluated for impairment	626,660	117,671	264,429	56,106		1,064,866
Total	\$634,759	\$ 128,269	\$ 272,368	\$ 56,123		\$1,091,519

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

September 30, 2018

Rating	Commercial			Total	Agricultural			Total
	Real Estate	Other	Advances to Mortgage Brokers		Real Estate	Other	Total	
1 - Excellent	\$22	\$42	\$ —	\$64	\$52	\$34	\$86	\$150
2 - High quality	4,518	17,255	—	21,773	2,947	630	3,577	25,350
3 - High satisfactory	125,083	39,794	15,631	180,508	19,137	7,631	26,768	207,276
4 - Low satisfactory	356,325	87,136	—	443,461	45,854	19,487	65,341	508,802
5 - Special mention	11,739	1,795	—	13,534	10,445	5,783	16,228	29,762
6 - Substandard	6,302	2,133	—	8,435	6,418	5,516	11,934	20,369
7 - Vulnerable	897	243	—	1,140	2,881	2,417	5,298	6,438
8 - Doubtful	—	—	—	—	—	—	—	—
9 - Loss	—	—	—	—	—	—	—	—
Total	\$504,886	\$148,398	\$15,631	\$668,915	\$87,734	\$41,498	\$129,232	\$798,147

December 31, 2017

Rating	Commercial			Total	Agricultural			Total
	Real Estate	Other	Advances to Mortgage Brokers		Real Estate	Other	Total	
1 - Excellent	\$24	\$316	\$ —	\$340	\$—	\$34	\$34	\$374
2 - High quality	8,402	12,262	—	20,664	2,909	1,024	3,933	24,597
3 - High satisfactory	131,826	46,668	12,081	190,575	21,072	8,867	29,939	220,514
4 - Low satisfactory	326,166	75,591	—	401,757	47,835	18,467	66,302	468,059
5 - Special mention	8,986	3,889	—	12,875	10,493	8,546	19,039	31,914
6 - Substandard	5,521	2,298	—	7,819	4,325	2,747	7,072	14,891
7 - Vulnerable	729	—	—	729	1,531	419	1,950	2,679
8 - Doubtful	—	—	—	—	—	—	—	—
9 - Loss	—	—	—	—	—	—	—	—
Total	\$481,654	\$141,024	\$12,081	\$634,759	\$88,165	\$40,104	\$128,269	\$763,028

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

1. EXCELLENT – Substantially Risk Free

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

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

Experienced management, with management succession in place.

Secured by cash.

2. HIGH QUALITY – Limited Risk

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

Favorable liquidity and leverage ratios.
Ability to meet all obligations when due.

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Management with successful track record.

Steady and satisfactory earnings history.

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

Access to alternative financing.

Well defined primary and secondary source of repayment.

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

3. HIGH SATISFACTORY – Reasonable Risk

Credit with satisfactory financial condition and further characterized by:

Working capital adequate to support operations.

Cash flow sufficient to pay debts as scheduled.

Management experience and depth appear favorable.

Loan performing according to terms.

If loan is secured, collateral is acceptable and loan is fully protected.

4. LOW SATISFACTORY – Acceptable Risk

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

Would include most start-up businesses.

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

Management's abilities are apparent yet unproven.

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

- Loan structure generally in accordance with policy.

If secured, loan collateral coverage is marginal.

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

5. SPECIAL MENTION – Criticized

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

Downward trend in sales, profit levels, and margins.

Impaired working capital position.

Cash flow is strained in order to meet debt repayment.

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

- Shrinking equity cushion.

Diminishing primary source of repayment and questionable secondary source.

Management abilities are questionable.

Weak industry conditions.

Litigation pending against the borrower.

Loan may need to be restructured to improve collateral position or reduce payments.

Collateral or guaranty offers limited protection.

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

6. SUBSTANDARD – Classified

Credit is inadequately protected by the current net worth and paying capacity of the borrower or of the collateral pledged. There is a distinct possibility we will implement collection procedures if the loan deficiencies are not corrected. Any commercial loan placed on nonaccrual status will be rated "7" or worse. In addition, the following characteristics may apply:

Sustained losses have severely eroded the equity and cash flow.

Deteriorating liquidity.

Serious management problems or internal fraud.

Original repayment terms liberalized.

Likelihood of bankruptcy.

Inability to access other funding sources.

Reliance on secondary source of repayment.

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Ⓛitigation filed against borrower.

Ⓜinterest non-accrual may be warranted.

Ⓒollateral provides little or no value.

Ⓡequires excessive attention of the loan officer.

Ⓟorrower is uncooperative with loan officer.

7. VULNERABLE – Classified

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

Ⓜnsufficient cash flow to service debt.

Ⓜinimal or no payments being received.

Ⓛimited options available to avoid the collection process.

Ⓧransition status, expect action will take place to collect loan without immediate progress being made.

8. DOUBTFUL – Workout

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

Ⓝormal operations are severely diminished or have ceased.

Ⓢeriously impaired cash flow.

Ⓞriginal repayment terms materially altered.

Ⓢecondary source of repayment is inadequate.

Ⓢurvivability as a “going concern” is impossible.

Ⓒollection process has begun.

Ⓟankruptcy petition has been filed.

Ⓜudgments have been filed.

Ⓟortion of the loan balance has been charged-off.

9. LOSS – Charge-off

Credit is considered uncollectible and of such little value that their continuance as bankable assets is not warranted.

This classification is for charged-off loans but does not mean that the asset has absolutely no recovery or salvage value. These loans are further characterized by:

Ⓛiquidation or reorganization under Bankruptcy, with poor prospects of collection.

- Fraudulently overstated assets and/or earnings.

Ⓒollateral has marginal or no value.

Ⓝebtor cannot be located.

Ⓞver 120 days delinquent.

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

	September 30, 2018				Total Past Due and Nonaccrual	Current	Total
	Accruing Interest and Past Due:						
	30-59 Days	60-89 Days	90 Days or More	Nonaccrual			
Commercial							
Commercial real estate	\$426	\$—	\$ —	\$ 897	\$ 1,323	\$503,563	\$504,886
Commercial other	703	815	—	243	1,761	146,637	148,398
Advances to mortgage brokers	—	—	—	—	—	15,631	15,631
Total commercial	1,129	815	—	1,140	3,084	665,831	668,915
Agricultural							
Agricultural real estate	70	23	—	2,881	2,974	84,760	87,734
Agricultural other	50	160	62	2,417	2,689	38,809	41,498
Total agricultural	120	183	62	5,298	5,663	123,569	129,232
Residential real estate							
Senior liens	1,261	458	212	698	2,629	233,325	235,954
Junior liens	9	—	—	—	9	6,157	6,166
Home equity lines of credit	465	34	—	—	499	34,285	34,784
Total residential real estate	1,735	492	212	698	3,137	273,767	276,904
Consumer							
Secured	66	—	—	—	66	60,956	61,022
Unsecured	2	—	—	—	2	3,855	3,857
Total consumer	68	—	—	—	68	64,811	64,879
Total	\$3,052	\$1,490	\$ 274	\$ 7,136	\$ 11,952	\$1,127,978	\$1,139,930

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	December 31, 2017				Total Past Due and Nonaccrual	Current	Total
	Accruing Interest and Past Due:						
	30-59 Days	60-89 Days	90 Days or More	Nonaccrual			
Commercial							
Commercial real estate	\$295	\$325	\$54	\$729	\$1,403	\$480,251	\$481,654
Commercial other	1,069	28	18	—	1,115	139,909	141,024
Advances to mortgage brokers	—	—	—	—	—	12,081	12,081
Total commercial	1,364	353	72	729	2,518	632,241	634,759
Agricultural							
Agricultural real estate	84	190	—	1,531	1,805	86,360	88,165
Agricultural other	39	—	104	419	562	39,542	40,104
Total agricultural	123	190	104	1,950	2,367	125,902	128,269
Residential real estate							
Senior liens	3,718	234	132	325	4,409	225,007	229,416
Junior liens	69	10	—	23	102	6,812	6,914
Home equity lines of credit	293	—	77	—	370	35,668	36,038
Total residential real estate	4,080	244	209	348	4,881	267,487	272,368
Consumer							
Secured	37	10	10	—	57	52,005	52,062
Unsecured	13	—	—	—	13	4,048	4,061
Total consumer	50	10	10	—	70	56,053	56,123
Total	\$5,617	\$797	\$395	\$3,027	\$9,836	\$1,081,683	\$1,091,519

Impaired Loans

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

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

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

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

	September 30, 2018			December 31, 2017		
	Recorded Balance	Unpaid Principal Balance	Valuation Allowance	Recorded Balance	Unpaid Principal Balance	Valuation Allowance
Impaired loans with a valuation allowance						
Commercial real estate	\$4,324	\$4,612	\$ 474	\$4,089	\$4,378	\$ 626
Commercial other	729	729	7	995	995	24
Agricultural real estate	950	950	148	—	—	—
Agricultural other	647	647	45	—	—	—
Residential real estate senior liens	7,361	7,903	1,398	7,816	8,459	1,473
Residential real estate junior liens	13	13	2	44	44	7
Total impaired loans with a valuation allowance	14,024	14,854	2,074	12,944	13,876	2,130
Impaired loans without a valuation allowance						
Commercial real estate	2,451	2,525		1,791	1,865	
Commercial other	1,354	1,398		1,224	1,224	
Agricultural real estate	7,249	7,257		7,913	7,913	
Agricultural other	6,211	6,211		2,685	2,685	
Home equity lines of credit	55	355		79	379	
Consumer secured	10	10		17	17	
Total impaired loans without a valuation allowance	17,330	17,756		13,709	14,083	
Impaired loans						
Commercial	8,858	9,264	481	8,099	8,462	650
Agricultural	15,057	15,065	193	10,598	10,598	—
Residential real estate	7,429	8,271	1,400	7,939	8,882	1,480
Consumer	10	10	—	17	17	—
Total impaired loans	\$31,354	\$32,610	\$ 2,074	\$26,653	\$27,959	\$ 2,130

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

	Three Months Ended September 30			
	2018		2017	
	Average Interest Recorded Income Balance Recognized		Average Interest Recorded Income Balance Recognized	
Impaired loans with a valuation allowance				
Commercial real estate	\$4,195	\$ 14	\$4,636	\$ 68
Commercial other	778	16	1,669	28
Agricultural real estate	673	40	—	—
Agricultural other	324	45	—	—
Residential real estate senior liens	7,512	17	8,333	79
Residential real estate junior liens	18	—	73	1
Home equity lines of credit	—	—	35	—
Total impaired loans with a valuation allowance	13,500	132	14,746	176
Impaired loans without a valuation allowance				
Commercial real estate	3,076	8	1,546	31
Commercial other	1,396	2	93	2
Agricultural real estate	7,193	137	7,830	98
Agricultural other	5,786	68	3,221	39
Home equity lines of credit	59	—	86	5
Consumer secured	11	—	19	—
Total impaired loans without a valuation allowance	17,521	215	12,795	175
Impaired loans				
Commercial	9,445	40	7,944	129
Agricultural	13,976	290	11,051	137
Residential real estate	7,589	17	8,527	85
Consumer	11	—	19	—
Total impaired loans	\$31,021	\$ 347	\$27,541	\$ 351

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	Nine Months Ended September 30			
	2018		2017	
	Average Interest RecordedIncome Balance	Recognized	Average Interest RecordedIncome Balance	Recognized
Impaired loans with a valuation allowance				
Commercial real estate	\$4,739	\$ 118	\$4,765	\$ 225
Commercial other	1,263	55	1,363	75
Agricultural real estate	584	46	—	—
Agricultural other	108	45	22	—
Residential real estate senior liens	7,694	107	8,379	245
Residential real estate junior liens	29	—	75	2
Home equity lines of credit	—	—	23	—
Total impaired loans with a valuation allowance	14,417	371	14,627	547
Impaired loans without a valuation allowance				
Commercial real estate	2,763	55	1,483	83
Commercial other	1,297	21	109	6
Agricultural real estate	7,600	414	5,936	218
Agricultural other	4,105	219	2,353	85
Home equity lines of credit	68	5	115	15
Consumer secured	13	—	22	—
Total impaired loans without a valuation allowance	15,846	714	10,018	407
Impaired loans				
Commercial	10,062	249	7,720	389
Agricultural	12,397	724	8,311	303
Residential real estate	7,791	112	8,592	262
Consumer	13	—	22	—
Total impaired loans	\$30,263	\$ 1,085	\$24,645	\$ 954

We had committed to advance \$299 and \$472 in connection with impaired loans, which includes TDRs, as of September 30, 2018 and December 31, 2017, respectively.

Troubled Debt Restructurings

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

Typical concessions granted include, but are not limited to:

- Agreeing to interest rates below prevailing market rates for debt with similar risk characteristics.
- Extending the amortization period beyond typical lending guidelines for loans with similar risk characteristics.
- Agreeing to an interest only payment structure and delaying principal payments.
- Forgiving principal.
- Forgiving accrued interest.

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

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

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

	Three Months Ended September 30		2017	
	2018	2017	2018	2017
	Number of Recorded Loans	Post-Modification Investment	Number of Recorded Loans	Post-Modification Investment
Commercial other	—	\$ —	3	\$ 1,385
Agricultural other	7	1,327	—	—
Residential real estate				
Senior liens	1	99	2	179
Junior liens	—	—	—	—
Total residential real estate	1	99	2	179
Consumer unsecured	—	—	—	—
Total	8	\$ 1,426	5	\$ 1,564

	Nine Months Ended September 30		2017	
	2018	2017	2018	2017
	Number of Recorded Loans	Post-Modification Investment	Number of Recorded Loans	Post-Modification Investment
Commercial other	4	\$ 1,360	6	\$ 1,698
Agricultural other	22	5,718	7	5,445
Residential real estate				
Senior liens	8	593	5	434
Junior liens	—	—	1	8
Total residential real estate	8	593	6	442
Consumer unsecured	—	—	—	—
Total	34	\$ 7,671	19	\$ 7,585

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

	Three Months Ended September 30		2017	
	2018	2017	2018	2017
	Number of Recorded Loans	Below Market Interest Rate and Extension of Amortization Period	Number of Recorded Loans	Below Market Interest Rate and Extension of Amortization Period
Commercial other	—	\$ —	—	3
Agricultural other	5	476	—	—
Residential real estate				
Senior liens	1	99	—	2
Junior liens	—	—	—	—
Total residential real estate	1	99	—	2
Consumer unsecured	—	—	—	—
Total	6	\$ 575	—	5

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	Nine Months Ended September 30 2018		2017	
	Below Market Interest Rate	Below Market Interest Rate and Extension of Amortization Period	Below Market Interest Rate	Below Market Interest Rate and Extension of Amortization Period
	Number of Recorded Loans Investment	Number of Recorded Loans Investment	Number of Recorded Loans Investment	Number of Recorded Loans Investment
Commercial other	1 \$ 174	3 \$ 1,186	— \$ —	6 \$ 1,698
Agricultural other	12 2,345	10 3,373	4 1,349	3 4,096
Residential real estate				
Senior liens	2 155	6 438	—	5 434
Junior liens	— —	— —	1 8	— —
Total residential real estate	2 155	6 438	1 8	5 434
Consumer unsecured	— —	— —	—	— —
Total	15 \$ 2,674	19 \$ 4,997	5 \$ 1,357	14 \$ 6,228

We did not restructure any loans by forgiving principal or accrued interest in the three and nine month periods ended September 30, 2018 or 2017.

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

We had no loans that defaulted in the three and nine month periods ended September 30, 2018 and 2017 which were modified within 12 months prior to the default date.

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

	September 30, 2018	December 31, 2017
TDRs	\$ 28,010	\$ 26,197

Note 5 – Equity Securities Without Readily Determinable Fair Values

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

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

	September 30 2018	December 31 2017
FHLB Stock	\$ 15,050	\$ 13,700
Corporate Settlement Solutions, LLC	7,565	7,421
FRB Stock	1,999	1,999
Other	334	334
Total	\$ 24,948	\$ 23,454

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Note 6 – Borrowed Funds

Borrowed funds consist of the following obligations as of:

	September 30, 2018		December 31, 2017	
	Amount	Rate	Amount	Rate
FHLB advances	\$320,000	2.17%	\$290,000	1.94%
Securities sold under agreements to repurchase without stated maturity dates	39,776	0.10%	54,878	0.12%
Total	\$359,776	1.94%	\$344,878	1.65%

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

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

	September 30, 2018		December 31, 2017	
	Amount	Rate	Amount	Rate
Fixed rate due 2018	\$20,000	1.86%	\$70,000	1.96%
Fixed rate due 2019	100,000	1.94%	85,000	1.87%
Fixed rate due 2020	55,000	2.18%	35,000	1.80%
Fixed rate due 2021	50,000	1.91%	50,000	1.91%
Variable rate due 2021 ⁽¹⁾	10,000	2.62%	10,000	1.72%
Fixed rate due 2022	20,000	1.97%	20,000	1.97%
Fixed rate due 2023	35,000	3.17%	10,000	3.90%
Fixed rate due 2024	20,000	2.96%	—	—%
Fixed rate due 2026	10,000	1.17%	10,000	1.17%
Total	\$320,000	2.17%	\$290,000	1.94%

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

Securities sold under agreements to repurchase are classified as secured borrowings and are reflected at the amount of cash received in connection with the transaction. The securities underlying the agreements have a carrying value and a fair value of \$39,795 and \$54,898 at September 30, 2018 and December 31, 2017, respectively. Such securities remain under our control. We may be required to provide additional collateral based on the fair value of underlying securities. Securities sold under repurchase agreements without stated maturity dates, federal funds purchased, and FRB Discount Window advances generally mature within one to four days from the transaction date. The following tables provide a summary of securities sold under repurchase agreements without stated maturity dates and federal funds purchased. We had no FRB Discount Window advances during the three and nine month periods ended September 30, 2018.

	Three Months Ended September 30							
	2018				2017			
	Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period		Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period	
Securities sold under agreements to repurchase without stated maturity dates	\$40,346	\$34,886	0.09%		\$58,464	\$53,846	0.13%	
Federal funds purchased	—	1,375	1.90%		3,815	1,474	1.20%	
FRB Discount Window	—	—	—%		—	82	1.60%	

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	Nine Months Ended September 30							
	2018				2017			
	Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period		Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period	
Securities sold under agreements to repurchase without stated maturity dates	\$40,346	\$34,608	0.14 %		\$58,464	\$55,051	0.13 %	
Federal funds purchased	16,200	5,000	2.52 %		5,965	3,280	1.13 %	
FRB Discount Window	—	—	— %		—	57	1.54 %	

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

	September 30 2018	December 31 2017
Pledged to secure borrowed funds	\$ 432,217	\$ 410,988
Pledged to secure repurchase agreements	39,795	54,898
Pledged for public deposits and for other purposes necessary or required by law	33,978	27,976
Total	\$ 505,990	\$ 493,862

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

	September 30 2018	December 31 2017
States and political subdivisions	\$ 7,045	\$ 7,332
Mortgage-backed securities	7,450	13,199
Collateralized mortgage obligations	25,300	34,367
Total	\$ 39,795	\$ 54,898

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

As of September 30, 2018, we had the ability to borrow up to an additional \$128,606, based on assets pledged as collateral. We had no investment securities that were restricted to be pledged for specific purposes.

Derivative Instruments

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

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

The following tables provide information on derivatives related to variable rate borrowings as of:

	September 30, 2018						
	Pay Rate	Receive Rate	Remaining Life (Years)	Notional Amount	Balance Sheet Location	Fair Value	
Derivatives designated as hedging instruments							
Cash Flow Hedges:							
Interest rate swaps	1.56 %	3-Month LIBOR	2.6	\$ 10,000	Other Assets	\$ 451	

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	December 31, 2017		Remaining Life (Years)	Notional Amount	Balance Sheet Location	Fair Value
	Pay Rate	Receive Rate				
Derivatives designated as hedging instruments						
Cash Flow Hedges:						
Interest rate swaps	1.56%	3-Month LIBOR	3.3	\$ 10,000	Other Assets	\$ 291

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

Note 7 – Revenue

Our revenue is comprised primarily of interest income, service charges and fees, gains on the sale of loans and AFS securities, earnings on corporate owned life insurance policies, and other noninterest income. Other noninterest income is typically service and performance driven in nature and comprised primarily of trust and brokerage advisory fees. We recognize revenue, excluding interest income, in accordance with ASC 606, Revenue From Contracts with Customers. Revenue is recognized when our performance obligation has been satisfied according to our contractual obligation.

We record receivables when revenue is unpaid and collectability is reasonably assured. Accounts receivable balances primarily represent amounts due from customers for which revenue has been recognized. Accounts receivable balances are recorded in the consolidated balance sheets in accrued interest receivable and other assets. For the three and nine month periods ended September 30, 2018 and 2017, we satisfied our performance obligations pursuant to contracts with customers. As a result, we have not recorded any contract assets or liabilities. We estimate no returns or allowances for the three and nine month periods ended September 30, 2018 and 2017.

Our contracts with customers define our performance obligations with clearly established pricing which did not require us to allocate or disaggregate revenue by performance obligation. A summary of revenue recognized for each major category of contracts with customers, subject to ASC 606, is as follows for the:

	Three Months Ended September 30		Nine Months Ended September 30	
	2018	2017	2018	2017
Debit card income	\$600	\$579	\$1,809	\$1,703
Trust service fees	562	560	1,628	1,471
Brokerage advisory fees	186	164	516	490
Service charges and fees related to deposit accounts	83	88	250	259
Total	\$1,431	\$1,391	\$4,203	\$3,923

A large portion of our revenue consists of interest income which is not subject to the requirements set forth in ASC 606. This recently adopted guidance required us to review our other noninterest revenue sources within the scope of the guidance to ensure appropriate recognition of revenue from contracts with customers. This review process did not identify significant changes related to revenue recognition. As such, we did not record or disclose transactions related to the adoption of this guidance.

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Note 8 – Other Noninterest Expenses

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

	Three Months		Nine Months	
	Ended		Ended	
	September 30	September 30	September 30	September 30
	2018	2017	2018	2017
Audit and related fees	\$353	\$322	\$813	\$757
Consulting fees	189	259	798	672
ATM and debit card fees	246	253	712	873
Loan underwriting fees	339	237	653	546
Director fees	212	212	643	634
Marketing costs	285	172	544	361
FDIC insurance premiums	185	172	505	480
Donations and community relations	141	190	502	488
Education and travel	130	143	346	332
Printing and supplies	131	110	336	320
Postage and freight	108	85	330	304
All other	538	505	1,701	1,629
Total other	\$2,857	\$2,660	\$7,883	\$7,396

Note 9 – Federal Income Taxes

The reconciliation of the provision for federal income taxes and the amount computed at the federal statutory tax rate of income before federal income tax expense, which has significantly changed as a result of the Tax Act, is as follows for the:

	Three Months		Nine Months	
	Ended		Ended	
	September 30	September 30	September 30	September 30
	2018	2017	2018	2017
Income taxes at statutory rate (21% in 2018 and 34% in 2017)	\$851	\$1,458	\$2,389	\$4,317
Effect of nontaxable income				
Interest income on tax exempt municipal securities	(259)	(452)	(797)	(1,361)
Earnings on corporate owned life insurance policies	(35)	(60)	(109)	(183)
Effect of tax credits	(200)	(186)	(601)	(566)
Other	(6)	(18)	(25)	(54)
Total effect of nontaxable income	(500)	(716)	(1,532)	(2,164)
Effect of nondeductible expenses	8	8	30	27
Federal income tax expense	\$359	\$750	\$887	\$2,180

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Note 10 – Computation of Earnings Per Common Share

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

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2018	2017	2018	2017
Average number of common shares outstanding for basic calculation	7,851,448	8,317,848	7,876,941	7,839,172
Average potential effect of common shares in the Directors Plan (1)	200,597	192,572	199,488	191,548
Average number of common shares outstanding used to calculate diluted earnings per common share	8,052,045	8,510,420	8,076,429	8,030,720
Net income	\$3,696	\$3,536	\$10,491	\$10,516
Earnings per common share				
Basic	\$0.47	\$0.45	\$1.33	\$1.34
Diluted	\$0.46	\$0.44	\$1.30	\$1.31

(1) Exclusive of shares held in the Rabbi Trust

Note 11 – Accumulated Other Comprehensive Income

The following tables summarize the changes in AOCI by component for the:

	Three Months Ended September 30				2017			
	2018				2017			
	Unrealized Holding Gains (Losses) on AFS Securities	Unrealized Gains (Losses) on Derivative Instruments	Defined Benefit Pension Plan	Total	Unrealized Holding Gains (Losses) on AFS Securities	Unrealized Gains (Losses) on Derivative Instruments	Defined Benefit Pension Plan	Total
Balance, July 1	\$(7,295)	\$ 351	\$(3,223)	\$(10,167)	\$2,923	\$ 135	\$(2,972)	\$86
OCI before reclassifications	(2,513)	7	—	(2,506)	(96)	11	—	(85)
Amounts reclassified from AOCI	—	—	—	—	—	—	—	—
Subtotal	(2,513)	7	—	(2,506)	(96)	11	—	(85)
Tax effect	522	(2)	—	520	54	—	—	54