Quad/Graphics, Inc.
Form SC 13G/A
February 14, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

SCHEDULE 13G

Under the Securities Exchange Act of 1934
(Amendment No. 2)*

QUAD/GRAPHICS, INC.
(Name of Issuer)

Class A Common Stock, par value $0.025 per share
(Title of Class of Securities)

747301109
(CUSIP Number)

December 31, 2013
(Date of Event which Requires Filing
of this Statement)

Check the appropriate box to designate the rule pursuant to which this Schedule is filed:

[X] Rule 13d-1(b)
[ ] Rule 13d-1(c)
[ ] Rule 13d-1(d)

*The remainder of this cover page shall be filled out for a reporting person's initial filing on this form with respect to the subject class of securities, and for any subsequent amendment containing information which would alter the disclosures provided in a prior cover page.

The information required on the remainder of this cover page shall not be deemed to be "filed" for the purpose of Section 18 of the Securities Exchange Act of 1934 ("Act") or otherwise subject to the liabilities of that section of the Act but shall be subject to all other provisions of the Act (however, see the Notes).

Continued on following pages
Page 1 of 16 Pages

CUSIP NO. 747301109

1. Names of Reporting Persons

ANGELO, GORDON & CO., L.P.

2. Check the Appropriate Box If a Member of a Group (See Instructions)

a. [ ]
b. [X]

3. SEC Use Only

4. Citizenship or Place of Organization

DELAWARE

Number of Shares Beneficially Owned By Each Reporting Person With	5.	Sole Voting Power 2,101,522
	6.	Shared Voting Power 0
	7.	Sole Dispositive Power 2,101,522
	8.	Shared Dispositive Power 0

9. Aggregate Amount Beneficially Owned by Each Reporting Person

2,101,522

10. Check Box If the Aggregate Amount in Row (9) Excludes Certain Shares (See Instructions)

[ ]

11. Percent of Class Represented By Amount in Row (9)

6.21%

12. Type of Reporting Person (See Instructions)

IA; PN

CUSIP NO. 747301109 Page 3 of 16 Pages

1. Names of Reporting Persons

JOHN M. ANGELO

2. Check the Appropriate Box If a Member of a Group (See Instructions)

a. [ ]
b. [X]

3. SEC Use Only

4. Citizenship or Place of Organization

UNITED STATES

Number of Shares Beneficially Owned By Each Reporting Person With		
	5.	Sole Voting Power 0
	6.	Shared Voting Power 2,101,522
	7.	Sole Dispositive Power 0
	8.	Shared Dispositive Power 2,101,522

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10. Check Box If the Aggregate Amount in Row (9) Excludes Certain Shares (See Instructions)

[ ]

11. Percent of Class Represented By Amount in Row (9)

6.21%

12. Type of Reporting Person (See Instructions)

IN; HC

CUSIP NO. 747301109

1. Names of Reporting Persons

MICHAEL L. GORDON

2. Check the Appropriate Box If a Member of a Group (See Instructions)

a. [ ]
b. [X]

3. SEC Use Only

4. Citizenship or Place of Organization

UNITED STATES

Number of Shares Beneficially Owned By Each Reporting Person With	5.	Sole Voting Power 0
	6.	Shared Voting Power 2,101,522
	7.	Sole Dispositive Power 0
	8.	Shared Dispositive Power 2,101,522

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10. Check Box If the Aggregate Amount in Row (9) Excludes Certain Shares (See Instructions)

[ ]

11. Percent of Class Represented By Amount in Row (9)

6.21%

12. Type of Reporting Person (See Instructions)

IN; HC

Item 1(a). Name of Issuer:

Quad/Graphics, Inc. (the "Issuer").

Item 1(b). Address of the Issuer's Principal Executive Offices:

N63 W23075 Highway 74
Sussex, Wisconsin 53089-2827

Item 2(a). Name of Person Filing

The Statement is filed on behalf of each of the following persons (collectively, the “Reporting Persons”):

i) Angelo, Gordon & Co., L.P. (“Angelo, Gordon”);

ii) John M. Angelo (“Mr. Angelo”); and

iii) Michael L. Gordon (“Mr. Gordon”).

This statement relates to Shares held for the account of certain private investment funds for which Angelo, Gordon acts as investment adviser. Mr. Angelo is a managing member of JAMG LLC, which is the general partner of AG Partners, L.P., which is the sole general partner of Angelo, Gordon. Mr. Angelo serves as the chief executive officer of Angelo, Gordon. Mr. Gordon is the other managing member of JAMG LLC and is the chief operating officer of Angelo, Gordon.

Item 2(b). Address of Principal Business Office or, if None, Residence:

The address of the principal business office of each of the Reporting Persons is 245 Park Avenue, 26th Floor, New York, New York 10167.

Item 2(c). Citizenship:

i) Angelo, Gordon is a Delaware limited partnership;

ii) Mr. Angelo is a United States citizen; and

iii) Mr. Gordon is a United States citizen.

Item 2(d). Title of Class of Securities:

Class A Common Stock, par value $0.025 per share (the “Shares”).

Item 2(e). CUSIP Number:

747301109

Item 3. If this statement is filed pursuant to Rule 13d-1(b), or 13d-2(b) or (c), check whether the person filing is a:

i) Angelo, Gordon is an investment adviser registered under Section 203 of the Investment Advisers Act of 1940.

ii) Mr. Angelo is a control person of Angelo, Gordon.

iii) Mr. Gordon is a control person of Angelo, Gordon.

Item 4. Ownership:

Item 4(a). Amount Beneficially Owned:

As of the date hereof, each of the Reporting Persons may be deemed to be the beneficial owner of 2,101,522 Shares.

Item 4(b). Percent of Class:

As of the date hereof, each of the Reporting Persons may be deemed to be the beneficial owner of approximately 6.21% of the total number of Shares outstanding (based upon information provided by the Issuer in its most recent quarterly report on Form 10-Q, there were 33,840,759 Shares outstanding as of October 31, 2013).

Item 4(c). Number of shares as to which such person has:

Angelo, Gordon		
(i)	Sole power to vote or direct the vote	2,101,522
(ii)	Shared power to vote or to direct the vote	0
(iii)	Sole power to dispose or to direct the disposition of	2,101,522
(iv)	Shared power to dispose or to direct the disposition of	0

Mr. Angelo		
(i)	Sole power to vote or direct the vote	0
(ii)	Shared power to vote or to direct the vote	2,101,522
(iii)	Sole power to dispose or to direct the disposition of	0
(iv)	Shared power to dispose or to direct the disposition of	2,101,522

Mr. Gordon		
(i)	Sole power to vote or direct the vote	0
(ii)	Shared power to vote or to direct the vote	2,101,522
(iii)	Sole power to dispose or to direct the disposition of	0
(iv)	Shared power to dispose or to direct the disposition of	2,101,522

Item 5. Ownership of Five Percent or Less of a Class:

This Item 5 is not applicable.

Item 6. Ownership of More than Five Percent on Behalf of Another Person:

This Item 6 is not applicable.

Item 7. Identification and Classification of the Subsidiary Which Acquired the Security Being Reported on by the Parent Holding Company:

i) Angelo, Gordon is the relevant entity for which Mr. Angelo and Mr. Gordon may each be considered a control person.

ii) Angelo, Gordon is an investment adviser registered under the Investment Advisers Act of 1940.

Item 8. Identification and Classification of Members of the Group:

This Item 8 is not applicable.

Item 9. Notice of Dissolution of Group:

This Item 9 is not applicable.

Item 10. Certification:

By signing below each of the Reporting Persons certifies that, to the best of such person's knowledge and belief, the securities referred to above were acquired and are held in the ordinary course of business and were not acquired and are not held for the purpose of or with the effect of changing or influencing the control of the issuer of the securities and were not acquired and are not held in connection with or as a participant in any transaction having that purpose or effect.

SIGNATURES

After reasonable inquiry and to the best of my knowledge and belief, the undersigned certifies that the information set forth in this statement is true, complete and correct.

Date: February 14, 2014 ANGELO, GORDON & CO., L.P.

By: AG Partners, L.P
Its General Partner

By: JAMG LLC
Its General Partner

By: MICHAEL L. GORDON
Its Managing Member

By: /s/ Kirk Wickman
Kirk Wickman
Attorney-in-Fact

Date: February 14, 2014 JOHN M. ANGELO

By: /s/ Kirk Wickman
Kirk Wickman
Attorney-in-Fact

Date: February 14, 2014 MICHAEL L. GORDON

By: /s/ Kirk Wickman
Kirk Wickman
Attorney-in-Fact

EXHIBIT INDEX

		Page No.
A.	Joint Filing Agreement, dated as of February 14, 2014, by and among Angelo, Gordon & Co., L.P., John M. Angelo and Michael L. Gordon	10
B.	Power of Attorney granted by John M. Angelo in favor of Kirk Wickman, Joseph Wekselblatt, and D. Forest Wolfe, dated July 5, 2011	11
C.	Power of Attorney granted by Michael L. Gordon in favor of Kirk Wickman, Joseph Wekselblatt, and D. Forest Wolfe, dated July 5, 2011	14

EXHIBIT A

JOINT FILING AGREEMENT

The undersigned hereby agree that the statement on Schedule 13G with respect to the Class A Common Stock of Quad/Graphics, Inc. dated as of February 14, 2014, is, and any amendments thereto (including amendments on Schedule 13D) signed by each of the undersigned shall be, filed on behalf of each of us pursuant to and in accordance with the provisions of Rule 13d-1(k) under the Securities Exchange Act of 1934.

Date: February 14, 2014

ANGELO, GORDON & CO., L.P.

By: AG Partners, L.P
Its General Partner

By: JAMG LLC
Its General Partner

By: MICHAEL L. GORDON
Its Managing Member

By: /s/ Kirk Wickman
Kirk Wickman
Attorney-in-Fact

Date: February 14, 2014

JOHN M. ANGELO

By: /s/ Kirk Wickman
Kirk Wickman
Attorney-in-Fact

Date: February 14, 2014

MICHAEL L. GORDON

By: /s/ Kirk Wickman
Kirk Wickman
Attorney-in-Fact

EXHIBIT B

POWER OF ATTORNEY

I, JOHN M. ANGELO, do hereby appoint KIRK WICKMAN, JOSEPH WEKSELBLATT, and D. FOREST WOLFE as my true and lawful attorneys-in-fact (each an "Attorney-in-Fact" and, collectively, the "Attorneys-in-Fact"), each, individually or jointly, with full power of substitution and resubstitution, to have full power and authority to act in my name, place and stead and on my behalf to:

1) execute and deliver for and on behalf of me, in my personal capacity or my capacity as one or more of an officer, director, managing member, or significant stockholder of Angelo, Gordon & Co., L.P., AG Partners, L.P., JAMG LLC or any of their subsidiaries (collectively, the "Company"), documents, certificates, instruments, statements, agreements, reports, schedules, or other filings to be filed with or delivered to any foreign or domestic governmental or regulatory body or required or requested by any other person or entity pursuant to any legal or regulatory requirement relating to the acquisition, ownership, management or disposition of securities, futures contracts or other investments, and any other documents relating or ancillary thereto, including without limitation all documents relating to filings with the Commodity Futures Trading Commission and National Futures Association, the United States Securities and Exchange Commission (the "SEC") pursuant to the Securities Act of 1933, as amended (the "Securities Act") or the Securities Exchange Act of 1934, as amended (the "Exchange Act") and the rules and regulations promulgated thereunder, including all documents relating to the beneficial ownership of securities required to be filed with the SEC pursuant to Section 13(d) or Section 16(a) of the Exchange Act and any information statements on Form 13F required to be filed with the SEC pursuant to Section 13(f) of the Exchange Act;

2) do and perform any and all acts for and on behalf of me that such Attorney-in-Fact (in his or her sole discretion) determines may be necessary or desirable to complete and execute any such reports, schedules or other filings and timely file same with the SEC; and

3) take any other action of any type whatsoever in connection with the foregoing which, in the sole opinion of such Attorney-in-Fact, may be of benefit to, in the best interest of, or legally required by me, it being understood that the documents executed by such Attorney-in-Fact on behalf of me pursuant to this Power of Attorney shall be in such form and shall contain such terms and conditions as such Attorney-in-Fact may approve in his or her sole discretion.

I hereby ratify and confirm all that the Attorneys-in-Fact shall lawfully do and that they have done or cause to be done by virtue of this Power of Attorney and the rights and powers herein granted. I acknowledge that the Attorneys-in-Fact, in serving in such capacity at my request, are not assuming, nor is the Company assuming, (i) any of my responsibilities to comply with the requirements of the Exchange Act or the Securities Act or any liability for my failure to comply with such requirements, or (ii) any obligation or liability I incur for profit disgorgement under Section 16(b) of the Exchange Act. I further acknowledge that this Power of Attorney does not relieve me from responsibility for compliance with my obligations under the Exchange Act or the Securities Act.

This Power of Attorney shall not revoke any powers of attorney granted by me, nor shall this Power of Attorney be revoked by future powers of attorney I grant. This Power of Attorney shall remain

in full force and effect until I am no longer subject to Sections 13 and 16 of the Exchange Act, unless earlier revoked by me in a signed writing delivered to the Attorneys-in-Fact.

I acknowledge receipt of the following language provided in Section 5-1513 of the General Obligations Law of the State of New York (the “Cautionary Language”), provided, however, (1) for the avoidance of doubt, I understand and agree, and affirm that it is my intent, that if any provision contained in the Cautionary Language shall be inconsistent with any of the foregoing provisions of this Power of Attorney, the foregoing provisions shall prevail to the fullest extent permitted by law, and (2) nothing in this Power of Attorney shall be construed as an admission or acknowledgement by me that this Power of Attorney is subject to the requirements of Section 5-1501B of the General Obligations Law of the State of New York:

CAUTION TO THE PRINCIPAL: Your Power of Attorney is an important document. As the “principal,” you give the person whom you choose (your “agent”) authority to act on your behalf. You do not lose your authority to act even though you have given your agent similar authority.

When your agent exercises this authority, he or she must act according to any instructions you have provided or, where there are no specific instructions, in your best interest. “Important Information for the Agent” at the end of this document describes your agent’s responsibilities.

Your agent can act on your behalf only after signing the Power of Attorney before a notary public.

You can request information from your agent at any time. If you are revoking a prior Power of Attorney by executing this Power of Attorney, you should provide written notice of the revocation to your prior agent(s) and to the financial institutions where your accounts are located.

You can revoke or terminate your Power of Attorney at any time for any reason as long as you are of sound mind. If you are no longer of sound mind, a court can remove an agent for acting improperly.

Your agent cannot make health care decisions for you. You may execute a “Health Care Proxy” to do this."

The law governing Powers of Attorney is contained in the New York General Obligations Law, Article 5, Title 15. This law is available at a law library, or online through the New York State Senate or Assembly websites, www.senate.state.ny.us or www.assembly.state.ny.us.

If there is anything about this document that you do not understand, you should ask a lawyer of your own choosing to explain it to you.

IMPORTANT INFORMATION FOR THE AGENT: When you accept the authority granted under this Power of Attorney, a special legal relationship is created between you and the principal. This relationship imposes on you legal responsibilities that continue until you resign or the Power of Attorney is terminated or revoked. You must:

(1) act according to any instructions from the principal, or, where there are no instructions, in the principal’s best interest;

(2) avoid conflicts that would impair your ability to act in the principal’s best interest;

(3) keep the principal's property separate and distinct from any assets you own or control, unless otherwise permitted by law;

(4) keep a record or all receipts, payments, and transactions conducted for the principal; and

(5) disclose your identity as an agent whenever you act for the principal by writing or printing the principal's name and signing your own name as "agent" in either of the following manner: (Principal's Name) by (Your Signature) as Agent, or (your signature) as Agent for (Principal's Name).

You may not use the principal's assets to benefit yourself or give major gifts to yourself or anyone else unless the principal has specifically granted you that authority in this Power of Attorney or in a Statutory Major Gifts Rider attached to this Power of Attorney. If you have that authority, you must act according to any instructions of the principal or, where there are no such instructions, in the principal's best interest. You may resign by giving written notice to the principal and to any co-agent, successor agent, monitor if one has been named in this document, or the principal's guardian if one has been appointed. If there is anything about this document or your responsibilities that you do not understand, you should seek legal advice.

Liability of agent: The meaning of the authority given to you is defined in New York's General Obligations Law, Article 5, Title 15. If it is found that you have violated the law or acted outside the authority granted to you in the Power of Attorney, you may be liable under the law for your violation.

IN WITNESS WHEREOF, I have executed this Power of Attorney on July 5, 2011.

Signature: /s/ John M. Angelo
Name: John M. Angelo

ACKNOWLEDGEMENT OF APPOINTMENTS BY ATTORNEYS-IN-FACT:
The undersigned executed this Power of Attorney on July 5, 2011.

By: s/ Kirk Wickman
Name: Kirk Wickman
Title: Attorney-in-Fact

ACKNOWLEDGEMENT OF APPOINTMENTS BY ATTORNEYS-IN-FACT (con't):
The undersigned executed this Power of Attorney on July 5, 2011.

By: s/ Joseph Wekselblatt
Name:Joseph Wekselblatt
Title: Attorney-in-Fact

ACKNOWLEDGEMENT OF APPOINTMENTS BY ATTORNEYS-IN-FACT (con't):
The undersigned executed this Power of Attorney on July 5, 2011.

By: /s/ D. Forest Wolfe
Name:D. Forest Wolfe
Title: Attorney-in-Fact

EXHIBIT C

POWER OF ATTORNEY

I, MICHAEL L. GORDON, do hereby appoint KIRK WICKMAN, JOSEPH WEKSELBLATT, and D. FOREST WOLFE as my true and lawful attorneys-in-fact (each an "Attorney-in-Fact" and, collectively, the "Attorneys-in-Fact"), each, individually or jointly, with full power of substitution and resubstitution, to have full power and authority to act in my name, place and stead and on my behalf to:

1) execute and deliver for and on behalf of me, in my personal capacity or my capacity as one or more of an officer, director, managing member, or significant stockholder of Angelo, Gordon & Co., L.P., AG Partners, L.P., JAMG LLC or any of their subsidiaries (collectively, the "Company"), documents, certificates, instruments, statements, agreements, reports, schedules, or other filings to be filed with or delivered to any foreign or domestic governmental or regulatory body or required or requested by any other person or entity pursuant to any legal or regulatory requirement relating to the acquisition, ownership, management or disposition of securities, futures contracts or other investments, and any other documents relating or ancillary thereto, including without limitation all documents relating to filings with the Commodity Futures Trading Commission and National Futures Association, the United States Securities and Exchange Commission (the "SEC") pursuant to the Securities Act of 1933, as amended (the "Securities Act") or the Securities Exchange Act of 1934, as amended (the "Exchange Act") and the rules and regulations promulgated thereunder, including all documents relating to the beneficial ownership of securities required to be filed with the SEC pursuant to Section 13(d) or Section 16(a) of the Exchange Act and any information statements on Form 13F required to be filed with the SEC pursuant to Section 13(f) of the Exchange Act;

2) do and perform any and all acts for and on behalf of me that such Attorney-in-Fact (in his or her sole discretion) determines may be necessary or desirable to complete and execute any such reports, schedules or other filings and timely file same with the SEC; and

3) take any other action of any type whatsoever in connection with the foregoing which, in the sole opinion of such Attorney-in-Fact, may be of benefit to, in the best interest of, or legally required by me, it being understood that the documents executed by such Attorney-in-Fact on behalf of me pursuant to this Power of Attorney shall be in such form and shall contain such terms and conditions as such Attorney-in-Fact may approve in his or her sole discretion.

I hereby ratify and confirm all that the Attorneys-in-Fact shall lawfully do and that they have done or cause to be done by virtue of this Power of Attorney and the rights and powers herein granted. I acknowledge that the Attorneys-in-Fact, in serving in such capacity at my request, are not assuming, nor is the Company assuming, (i) any of my responsibilities to comply with the requirements of the Exchange Act or the Securities Act or any liability for my failure to comply with such requirements, or (ii) any obligation or liability I incur for profit disgorgement under Section 16(b) of the Exchange Act. I further acknowledge that this Power of Attorney does not relieve me from responsibility for compliance with my obligations under the Exchange Act or the Securities Act.

This Power of Attorney shall not revoke any powers of attorney granted by me, nor shall this Power of Attorney be revoked by future powers of attorney I grant. This Power of Attorney shall remain

in full force and effect until I am no longer subject to Sections 13 and 16 of the Exchange Act, unless earlier revoked by me in a signed writing delivered to the Attorneys-in-Fact.

I acknowledge receipt of the following language provided in Section 5-1513 of the General Obligations Law of the State of New York (the "Cautionary Language"), provided, however, (1) for the avoidance of doubt, I understand and agree, and affirm that it is my intent, that if any provision contained in the Cautionary Language shall be inconsistent with any of the foregoing provisions of this Power of Attorney, the foregoing provisions shall prevail to the fullest extent permitted by law, and (2) nothing in this Power of Attorney shall be construed as an admission or acknowledgement by me that this Power of Attorney is subject to the requirements of Section 5-1501B of the General Obligations Law of the State of New York:

CAUTION TO THE PRINCIPAL: Your Power of Attorney is an important document. As the "principal," you give the person whom you choose (your "agent") authority to act on your behalf. You do not lose your authority to act even though you have given your agent similar authority.

When your agent exercises this authority, he or she must act according to any instructions you have provided or, where there are no specific instructions, in your best interest. "Important Information for the Agent" at the end of this document describes your agent's responsibilities.

Your agent can act on your behalf only after signing the Power of Attorney before a notary public.

You can request information from your agent at any time. If you are revoking a prior Power of Attorney by executing this Power of Attorney, you should provide written notice of the revocation to your prior agent(s) and to the financial institutions where your accounts are located.

You can revoke or terminate your Power of Attorney at any time for any reason as long as you are of sound mind. If you are no longer of sound mind, a court can remove an agent for acting improperly.

Your agent cannot make health care decisions for you. You may execute a "Health Care Proxy" to do this."

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If there is anything about this document that you do not understand, you should ask a lawyer of your own choosing to explain it to you.

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(1) act according to any instructions from the principal, or, where there are no instructions, in the principal's best interest;

(2) avoid conflicts that would impair your ability to act in the principal's best interest;

(3) keep the principal's property separate and distinct from any assets you own or control, unless otherwise permitted by law;

(4) keep a record or all receipts, payments, and transactions conducted for the principal; and

(5) disclose your identity as an agent whenever you act for the principal by writing or printing the principal's name and signing your own name as "agent" in either of the following manner: (Principal's Name) by (Your Signature) as Agent, or (your signature) as Agent for (Principal's Name).

You may not use the principal's assets to benefit yourself or give major gifts to yourself or anyone else unless the principal has specifically granted you that authority in this Power of Attorney or in a Statutory Major Gifts Rider attached to this Power of Attorney. If you have that authority, you must act according to any instructions of the principal or, where there are no such instructions, in the principal's best interest. You may resign by giving written notice to the principal and to any co-agent, successor agent, monitor if one has been named in this document, or the principal's guardian if one has been appointed. If there is anything about this document or your responsibilities that you do not understand, you should seek legal advice.

Liability of agent: The meaning of the authority given to you is defined in New York's General Obligations Law, Article 5, Title 15. If it is found that you have violated the law or acted outside the authority granted to you in the Power of Attorney, you may be liable under the law for your violation.

IN WITNESS WHEREOF, I have executed this Power of Attorney on July 5, 2011.

Signature: /s/ Michael L. Gordon
Name: Michael L. Gordon

ACKNOWLEDGEMENT OF APPOINTMENTS BY ATTORNEYS-IN-FACT:
The undersigned executed this Power of Attorney on July 5, 2011.

By: /s/ Kirk Wickman
Name:Kirk Wickman
Title: Attorney-in-Fact

ACKNOWLEDGEMENT OF APPOINTMENTS BY ATTORNEYS-IN-FACT (con't):
The undersigned executed this Power of Attorney on July 5, 2011.

By: /s/ Joseph Wekselblatt
Name:Joseph Wekselblatt
Title: Attorney-in-Fact

ACKNOWLEDGEMENT OF APPOINTMENTS BY ATTORNEYS-IN-FACT (con't):
The undersigned executed this Power of Attorney on July 5, 2011.

By: /s/ D. Forest Wolfe
Name:D. Forest Wolfe
Title: Attorney-in-Fact

nt style="font-family:inherit;font-size:10pt;">—

—

—

Total
$
722,763

$
171,714

$
436,308

$
41,840

Cumulative repricing gap
$
(409,368
)

$

(413,667
)

$
(97,388
)

$
268,174

Cumulative repricing gap as a % of assets
(22.58
)%

(22.82
)%

(5.37
)%

14.79
%

The following table shows the maturity of commercial and agricultural loans outstanding at December 31, 2017. Also provided are the amounts due after one year, classified according to the sensitivity to changes in interest rates.

	1 Year or Less	1 to 5 Years	Over 5 Years	Total
Commercial and agricultural	$104,928	$404,948	$253,152	$763,028
Interest sensitivity				
Loans maturing after one year that have:				
Fixed interest rates		$340,713	$241,880	
Variable interest rates		64,235	11,272	
Total		$404,948	$253,152	

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Table of Contents

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

The information presented in the section captioned “Market Risk” in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations is incorporated herein by reference.

Item 8. Financial Statements and Supplementary Data.

The following consolidated financial statements accompanied by the report of our independent registered public accounting firm are set forth beginning on page 38 of this report:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets

Consolidated Statements of Changes in Shareholders’ Equity

Consolidated Statements of Income

Consolidated Statements of Comprehensive Income (Loss)

Consolidated Statements of Cash Flows

Notes to Consolidated Financial Statements

Supplementary data regarding quarterly results of operations is included in Item 6. Selected Financial Data.

Table of Contents

Report of Independent Registered Public Accounting Firm
Shareholders and Board of Directors
Isabella Bank Corporation
Mount Pleasant, Michigan
Opinion on the Financial Statements and Internal Control over Financial Reporting
We have audited the accompanying consolidated balance sheets of Isabella Bank Corporation as of December 31, 2017 and 2016, and the related consolidated statements of changes in shareholders' equity, income, comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2017, and the related notes (collectively referred to as the financial statements). We also have audited Isabella Bank Corporation's internal control over financial reporting as of December 31, 2017, based on criteria established in the Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (the COSO criteria).
In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Isabella Bank Corporation as of December 31, 2017 and 2016, and the consolidated results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2017, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion Isabella Bank Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017, based on the COSO criteria.
Basis for Opinions
Isabella Bank Corporation's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express opinions on Isabella Bank Corporation's consolidated financial statements and on Isabella Bank Corporation's internal control over financial reporting based on our integrated audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to Isabella Bank Corporation in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.
We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.
Our audits of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material misstatement exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. We believe that our audits provide a reasonable basis for our opinions.
Definition and Limitations of Internal Control over Financial Reporting
A corporation's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements for external purposes in accordance with generally accepted accounting principles. A corporation's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the corporation; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of consolidated financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the corporation are being made only in accordance with authorizations of management and directors of the corporation;

and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the corporation’s assets that could have a material effect on the consolidated financial statements.

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Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/Rehmann Robson LLC

We have served as Isabella Bank Corporation's independent auditor since 1996.
Saginaw, Michigan
March 15, 2018

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CONSOLIDATED BALANCE SHEETS
(Dollars in thousands)

	December 31	
	2017	2016
ASSETS		
Cash and cash equivalents		
Cash and demand deposits due from banks	$25,267	$20,167
Interest bearing balances due from banks	5,581	2,727
Total cash and cash equivalents	30,848	22,894
AFS securities (amortized cost of $551,712 in 2017 and $557,648 in 2016)	552,307	558,096
Mortgage loans AFS	1,560	1,816
Loans		
Commercial	634,759	575,664
Agricultural	128,269	126,492
Residential real estate	272,368	266,050
Consumer	56,123	42,409
Gross loans	1,091,519	1,010,615
Less allowance for loan and lease losses	7,700	7,400
Net loans	1,083,819	1,003,215
Premises and equipment	28,450	29,314
Corporate owned life insurance policies	27,026	26,300
Accrued interest receivable	7,063	6,580
Equity securities without readily determinable fair values	23,454	21,694
Goodwill and other intangible assets	48,547	48,666
Other assets	10,056	13,576
TOTAL ASSETS	$1,813,130	$1,732,151
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest bearing	$237,511	$205,071
NOW accounts	231,666	209,325
Certificates of deposit under $250 and other savings	728,090	717,078
Certificates of deposit over $250	67,991	63,566
Total deposits	1,265,258	1,195,040
Borrowed funds	344,878	337,694
Accrued interest payable and other liabilities	8,089	11,518
Total liabilities	1,618,225	1,544,252
Shareholders' equity		
Common stock — no par value 15,000,000 shares authorized; issued and outstanding 7,857,293 shares (including 31,769 shares held in the Rabbi Trust) in 2017 and 7,821,069 shares (including 26,042 shares held in the Rabbi Trust) in 2016	140,277	139,525
Shares to be issued for deferred compensation obligations	5,502	5,038
Retained earnings	51,728	46,114
Accumulated other comprehensive income (loss)	(2,602)	(2,778)
Total shareholders' equity	194,905	187,899
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$1,813,130	$1,732,151

The accompanying notes are an integral part of these consolidated financial statements.

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CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(Dollars in thousands except per share amounts)

	Common Stock					
	Common Shares Outstanding	Amount	Common Shares to be Issued for Deferred Compensation Obligations	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Totals
Balance, January 1, 2015	7,776,274	$138,755	$ 4,242	$32,103	$ (506)	$174,594
Comprehensive income (loss)	—	—	—	15,130	727	15,857
Issuance of common stock	216,700	5,201	—	—	—	5,201
Common stock issued for deferred compensation obligations	—	—	—	—	—	—
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	200	(200)	—	—	—
Share-based payment awards under equity compensation plan	—	—	550	—	—	550
Common stock purchased for deferred compensation obligations	—	(368)	—	—	—	(368)
Common stock repurchased pursuant to publicly announced repurchase plan	(193,107)	(4,590)	—	—	—	(4,590)
Cash dividends paid ($0.94 per common share)	—	—	—	(7,273)	—	(7,273)
Balance, December 31, 2015	7,799,867	139,198	4,592	39,960	221	183,971
Comprehensive income (loss)	—	—	—	13,799	(2,999)	10,800
Issuance of common stock	179,903	5,023	—	—	—	5,023
Common stock issued for deferred compensation obligations	—	—	—	—	—	—
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	127	(127)	—	—	—
Share-based payment awards under equity compensation plan	—	—	573	—	—	573
Common stock purchased for deferred compensation obligations	—	(383)	—	—	—	(383)
Common stock repurchased pursuant to publicly announced repurchase plan	(158,701)	(4,440)	—	—	—	(4,440)
Cash dividends paid ($0.98 per common share)	—	—	—	(7,645)	—	(7,645)
Balance, December 31, 2016	7,821,069	139,525	5,038	46,114	(2,778)	187,899
Comprehensive income (loss)	—	—	—	13,237	543	13,780
Reclassification resulting from the enactment of the Tax Act	—	—	—	367	(367)	—
Issuance of common stock	220,510	6,177	—	—	—	6,177
Common stock issued for deferred compensation obligations	—	—	—	—	—	—
	—	176	(176)	—	—	—

Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations						
Share-based payment awards under equity compensation plan	—	—	640	—	—	640
Common stock purchased for deferred compensation obligations	—	(420)	—	—	—	(420)
Common stock repurchased pursuant to publicly announced repurchase plan	(184,286)	(5,181)	—	—	—	(5,181)
Cash dividends paid ($1.02 per common share)	—	—	—	(7,990)	—	(7,990)
Balance, December 31, 2017	7,857,293	$140,277	$ 5,502	$51,728	$ (2,602)	$194,905

The accompanying notes are an integral part of these consolidated financial statements.

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CONSOLIDATED STATEMENTS OF INCOME
(Dollars in thousands except per share amounts)

	Year Ended December 31		
	2017	2016	2015
Interest income			
Loans, including fees	$43,537	$38,537	$35,853
AFS securities			
Taxable	8,564	8,746	9,053
Nontaxable	5,570	5,715	5,996
Federal funds sold and other	742	668	600
Total interest income	58,413	53,666	51,502
Interest expense			
Deposits	6,809	5,836	5,850
Borrowings	5,685	5,029	4,313
Total interest expense	12,494	10,865	10,163
Net interest income	45,919	42,801	41,339
Provision for loan losses	253	(135)	(2,771)
Net interest income after provision for loan losses	45,666	42,936	44,110
Noninterest income			
Service charges and fees	6,013	5,230	5,437
Earnings on corporate owned life insurance policies	726	761	771
Net gain on sale of mortgage loans	647	651	573
Net gains on sale of AFS securities	142	245	163
Other	3,284	4,221	3,415
Total noninterest income	10,812	11,108	10,359
Noninterest expenses			
Compensation and benefits	21,525	19,170	18,431
Furniture and equipment	5,523	5,275	5,144
Occupancy	3,133	3,227	3,037
Other	10,044	10,225	9,439
Total noninterest expenses	40,225	37,897	36,051
Income before federal income tax expense	16,253	16,147	18,418
Federal income tax expense	3,016	2,348	3,288
NET INCOME	$13,237	$13,799	$15,130
Earnings per common share			
Basic	$1.69	$1.77	$1.95
Diluted	$1.65	$1.73	$1.90
Cash dividends per common share	$1.02	$0.98	$0.94

The accompanying notes are an integral part of these consolidated financial statements.

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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Dollars in thousands)

	Year Ended December 31		
	2017	2016	2015
Net income	$13,237	$13,799	$15,130
Unrealized gains (losses) on AFS securities			
Unrealized gains (losses) arising during the period	289	(5,865)	310
Reclassification adjustment for net realized (gains) losses included in net income	(142)	(245)	(163)
Reclassification adjustment for impairment loss included in net income	—	770	—
Comprehensive income (loss) before income tax (expense) benefit	147	(5,340)	147
Tax effect (1)	89	1,834	87
Unrealized gains (losses) on AFS securities, net of tax	236	(3,506)	234
Unrealized gains (losses) on derivative instruments			
Unrealized gains (losses) on derivative instruments arising during the period	43	248	—
Tax effect (1)	(15)	(84)	—
Unrealized gains (losses) on derivative instruments, net of tax	28	164	—
Change in unrecognized pension cost on defined benefit pension plan			
Change in unrecognized pension cost arising during the period	11	282	255
Reclassification adjustment for net periodic benefit cost included in net income	412	238	492
Net change in unrecognized pension cost	423	520	747
Tax effect (1)	(144)	(177)	(254)
Change in unrealized pension cost, net of tax	279	343	493
Other comprehensive income (loss), net of tax	543	(2,999)	727
Comprehensive income (loss)	$13,780	$10,800	$15,857

(1) See “Note 18 – Accumulated Other Comprehensive Income (Loss)” in the accompanying notes to consolidated financial statements for tax effect reconciliation.

The accompanying notes are an integral part of these consolidated financial statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in thousands)

	Year Ended December 31		
	2017	2016	2015
OPERATING ACTIVITIES			
Net income	$13,237	$13,799	$15,130
Reconciliation of net income to net cash provided by operating activities:			
Provision for loan losses	253	(135)	(2,771)
Impairment of foreclosed assets	2	10	99
Depreciation	2,902	2,821	2,677
Amortization of OMSR	340	394	340
Amortization of acquisition intangibles	119	162	169
Net amortization of AFS securities	2,144	2,747	2,074
AFS security impairment loss	—	770	—
Net (gains) losses on sale of AFS securities	(142)	(245)	(163)
Net gain on sale of mortgage loans	(647)	(651)	(573)
Increase in cash value of corporate owned life insurance policies	(726)	(761)	(771)
Gains from redemption of corporate owned life insurance policies	—	(469)	—
Share-based payment awards under equity compensation plan	640	573	550
Deferred income tax (benefit) expense	2,837	(282)	1,692
Origination of loans held-for-sale	(36,276)	(33,089)	(42,887)
Proceeds from loan sales	37,179	33,111	43,174
Net changes in operating assets and liabilities which provided (used) cash:			
Accrued interest receivable	(483)	(311)	(418)
Other assets	(961)	(954)	(5,322)
Accrued interest payable and other liabilities	(3,429)	1,672	(910)
Net cash provided by (used in) operating activities	16,989	19,162	12,090
INVESTING ACTIVITIES			
Activity in AFS securities			
Sales	12,827	35,664	1,319
Maturities, calls, and principal payments	97,617	137,278	90,036
Purchases	(106,510)	(79,514)	(185,721)
Net loan principal (originations) collections	(81,188)	(160,294)	(15,029)
Proceeds from sales of foreclosed assets	269	486	1,523
Purchases of premises and equipment	(2,038)	(3,804)	(5,127)
Purchases of corporate owned life insurance policies	—	—	(500)
Proceeds from redemption of corporate owned life insurance policies	—	1,353	—
Net cash provided by (used in) investing activities	(79,023)	(68,831)	(113,499)

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CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
(Dollars in thousands)

	Year Ended December 31		
	2017	2016	2015
FINANCING ACTIVITIES			
Net increase (decrease) in deposits	$70,218	$30,477	$90,079
Net increase (decrease) in borrowed funds	7,184	27,962	20,023
Cash dividends paid on common stock	(7,990)	(7,645)	(7,273)
Proceeds from issuance of common stock	6,177	5,023	5,201
Common stock repurchased	(5,181)	(4,440)	(4,590)
Common stock purchased for deferred compensation obligations	(420)	(383)	(368)
Net cash provided by (used in) financing activities	69,988	50,994	103,072
Increase (decrease) in cash and cash equivalents	7,954	1,325	1,663
Cash and cash equivalents at beginning of period	22,894	21,569	19,906
Cash and cash equivalents at end of period	$30,848	$22,894	$21,569
SUPPLEMENTAL CASH FLOWS INFORMATION:			
Interest paid	$12,388	$10,836	$10,176
Income taxes paid	3,120	1,415	3,493
SUPPLEMENTAL NONCASH INFORMATION:			
Transfers of loans to foreclosed assets	$331	$306	$1,158

The accompanying notes are an integral part of these consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands except per share amounts)
Note 1 – Nature of Operations and Summary of Significant Accounting Policies
BASIS OF PRESENTATION AND CONSOLIDATION: The consolidated financial statements include the accounts of Isabella Bank Corporation, a financial services holding company, and its wholly owned subsidiary, Isabella Bank. All intercompany balances and accounts have been eliminated in consolidation. References to "the Corporation," "Isabella," "we," "our," "us," and similar terms refer to the consolidated entity consisting of Isabella Bank Corporation and its subsidiary. 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.
For additional information, see "Note 19 – Related Party Transactions."
NATURE OF OPERATIONS: Isabella Bank Corporation is a financial services holding company offering a wide array of financial products and services in several mid-Michigan counties. Our banking subsidiary, Isabella Bank, offers banking services through 29 locations and a loan production office, 24 hour banking services locally and nationally through shared automatic teller machines, 24 hour online banking, mobile banking, and direct deposits to businesses, institutions, and individuals. Lending services offered include commercial loans, agricultural loans, residential real estate loans, and consumer loans. Deposit services include interest and noninterest bearing checking accounts, savings accounts, money market accounts, and certificates of deposit. Other related financial products include trust and investment services, safe deposit box rentals, and credit life insurance. Active competition, principally from other commercial banks, savings banks and credit unions, exists in all of our principal markets. Our results of operations can be significantly affected by changes in interest rates, changes in the local economic environment and changes in regulations.
USE OF ESTIMATES: In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, we make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the consolidated balance sheet and reported amounts of revenues and expenses during the reporting year. 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 ALLL, the fair value of AFS investment securities, the valuation of goodwill and other intangible assets, and determination of net deferred tax assets.
FAIR VALUE MEASUREMENTS: Fair value refers to the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants in the market in which the reporting entity transacts such sales or transfers based on the assumptions market participants would use when pricing an asset or liability. Assumptions are developed based on prioritizing information within a fair value hierarchy that gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data, such as the reporting entity's own data. We may choose to measure eligible items at fair value at specified election dates.
For assets and liabilities recorded at fair value, it is our policy to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements for those financial instruments for which there is an active market. In cases where the market for a financial asset or liability is not active, we include appropriate risk adjustments that market participants would make for nonperformance and liquidity risks when developing fair value measurements. Fair value measurements for assets and liabilities for which limited or no observable market data exists are accordingly based primarily upon estimates, are often calculated based on the economic and competitive environment, the characteristics of the asset or liability and other factors. Therefore, the results cannot be determined with precision and may not be realized in an actual sale or immediate settlement of the asset or liability. Additionally, there may be inherent weaknesses in any calculation technique, and changes in the underlying assumptions used, including discount rates and estimates of future cash flows, could significantly affect the results of current or future values.
We utilize fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Investment securities AFS and derivative instruments are recorded at fair value on a recurring basis. Additionally, from time-to-time, we may be required to record other assets and liabilities at fair value on a nonrecurring basis, such as mortgage loans AFS, impaired loans, foreclosed assets, OMSR, goodwill, and certain

other assets and liabilities. These nonrecurring fair value adjustments typically involve the application of lower of cost or market accounting or write-downs of individual assets.

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Fair Value Hierarchy

Under fair value measurement and disclosure authoritative guidance, we group assets and liabilities measured at fair value into three levels, based on the markets in which the assets and liabilities are traded, and the reliability of the assumptions used to determine fair value, based on the prioritization of inputs in the valuation techniques. These levels are:

Level 1:	Valuation is based upon quoted prices for identical instruments traded in active markets.
Level 2:	Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model based valuation techniques for which all significant assumptions are observable in the market.
Level 3:	Valuation is generated from model based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability.

The asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques maximize the use of observable inputs and minimize the use of unobservable inputs. Transfers between measurement levels are recognized at the end of reporting periods.

For further discussion of fair value considerations, refer to "Note 20 – Fair Value."

SIGNIFICANT GROUP CONCENTRATIONS OF CREDIT RISK: Most of our activities conducted are with customers located within the central Michigan area. A significant amount of our outstanding loans are secured by commercial and residential real estate. Other than these types of loans, there is no significant concentration to any other industry or any one customer.

CASH AND CASH EQUIVALENTS: For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash and balances due from banks, federal funds sold, and other deposit accounts. Generally, federal funds sold are for a one day period. We maintain deposit accounts in various financial institutions which generally exceed federally insured limits or are not insured. We do not believe we are exposed to any significant interest, credit or other financial risk as a result of these deposits.

AFS SECURITIES: Purchases of investment securities are generally classified as AFS. However, we may elect to classify securities as either held to maturity or trading. Securities classified as AFS are recorded at fair value, with unrealized gains and losses, net of the effect of deferred income taxes, excluded from earnings and reported in other comprehensive income. Included in AFS securities are auction rate money market preferreds and preferred stocks. These investments are considered equity securities for federal income tax purposes, and as such, no estimated federal income tax impact is expected or recorded. Auction rate money market preferred securities and preferred stocks are recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Realized gains and losses on the sale of AFS securities are determined using the specific identification method.

AFS securities are reviewed quarterly for possible OTTI. In determining whether an OTTI exists for debt securities, we assert that: (a) we do not have the intent to sell the security; and (b) it is more likely than not we will not have to sell the security before recovery of its cost basis. If these conditions are not met, we recognize an OTTI charge through earnings for the difference between the debt security's amortized cost basis and its fair value, and such amount is included in noninterest income. For debt securities that do not meet the above criteria, and we do not expect to recover the security's amortized cost basis, the security is considered other-than-temporarily impaired. For these debt securities, we separate the total impairment into the credit risk loss component and the amount of the loss related to market and other risk factors. In order to determine the amount of the credit loss for a debt security, we calculate the recovery value by performing a discounted cash flow analysis based on the current cash flows and future cash flows we expect to recover. The amount of the total OTTI related to the credit risk is recognized in earnings and is included in noninterest income. The amount of the total OTTI related to other risk factors is recognized as a component of other comprehensive income. For debt securities that have recognized an OTTI through earnings, if through subsequent evaluation there is a significant increase in the cash flow expected, the difference between the amortized cost basis

and the cash flows expected to be collected is accreted as interest income.
AFS equity securities are reviewed for OTTI at each reporting date. This evaluation considers a number of factors including, but not limited to, the length of time and extent to which the fair value has been less than cost, the financial condition and near term prospects of the issuer, and our ability and intent to hold the securities until fair value recovers. If it is determined that we do not have the ability and intent to hold the securities until recovery or that there are conditions that indicate that a security may not recover in value then the difference between the fair value and the cost of the security is recognized in earnings and is included in noninterest income.

LOANS: Loans that we have the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their outstanding principal balance adjusted for any charge-offs, the ALLL, and any deferred fees or costs on originated loans. Interest income on loans is accrued over the term of the loan based on the principal amount outstanding. Loan origination fees and certain direct loan origination costs are capitalized and recognized as a component of interest income over the term of the loan using the level yield method.

The accrual of interest on agricultural, commercial and mortgage 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. 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 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. The interest on these loans is accounted for on the cash-basis, until qualifying for return to accrual status. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured. For impaired loans not classified as nonaccrual, interest income continues to be accrued over the term of the loan based on the principal amount outstanding.

ALLOWANCE FOR LOAN AND LEASE LOSSES: 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 allowance when we believe the uncollectability of the loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

We evaluate the ALLL on a regular basis which is based upon our 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 ALLL consists of specific, general, and unallocated components. The specific component relates to loans that are deemed to be impaired. For such loans that are analyzed for specific allowance allocations, an allowance is established when the discounted cash flows, collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers non classified loans and is based on historical loss experience adjusted for current conditions. An unallocated component is maintained to cover uncertainties that we believe affect our estimate of probable losses based on qualitative factors. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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;
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 by either 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.

LOANS HELD FOR SALE: Mortgage loans held for sale on the secondary market are carried at the lower of cost or fair value as determined by aggregating outstanding commitments from investors or current investor yield requirements. Net unrealized losses, if any, would be recognized as a component of other noninterest expenses.

Mortgage loans held for sale are sold with the mortgage servicing rights retained by us. The carrying value of mortgage loans sold is reduced by the cost allocated to the associated mortgage servicing rights. Gains or losses on sales of mortgage loans are recognized based on the difference between the selling price and the carrying value of the related mortgage loans sold.

TRANSFERS OF FINANCIAL ASSETS: Transfers of financial assets, including mortgage loans and participation loans, are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is

determined to be surrendered when 1) the assets have been legally isolated from us, 2) the transferee obtains the right (free of conditions that constrain it from taking advantage of the right) to pledge or exchange the transferred assets, and 3) we do not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity. Other than servicing, we have no substantive continuing involvement related to these loans. SERVICING: Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of financial assets. We have no purchased servicing rights. For sales of mortgage loans, a portion of the cost of originating the

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loan is allocated to the servicing right based on relative fair value. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses.
Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights into tranches based on predominant risk characteristics, such as interest rate, loan type, and investor type. Impairment is recognized through a valuation allowance for an individual tranche, to the extent that fair value is less than the capitalized amount for the tranche. If we later determine that all or a portion of the impairment no longer exists for a particular tranche, a reduction of the valuation allowance may be recorded as an increase to income. Capitalized servicing rights are reported in other assets and are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. The unpaid principal balance of mortgages serviced for others was $266,789 and $272,882 with capitalized servicing rights of $2,409 and $2,306 at December 31, 2017 and 2016, respectively.
Servicing fee income is recorded for fees earned for servicing loans for others. The fees are based on a contractual percentage of the outstanding principal or a fixed amount per loan and are recorded as income when earned. We recorded servicing fee revenue of $671, $696, and $712 related to residential mortgage loans serviced for others during 2017, 2016, and 2015, respectively, which is included in other noninterest income.
FORECLOSED ASSETS: Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at the lower of our carrying amount or fair value less estimated selling costs at the date of transfer, establishing a new cost basis. Any write-downs based on the asset's fair value at the date of acquisition are charged to the ALLL. After foreclosure, property held for sale is carried at the lower of the new cost basis or fair value less costs to sell. Impairment losses on property to be held and used are measured at the amount by which the carrying amount of property exceeds its fair value. Costs relating to holding these assets are expensed as incurred. We periodically perform valuations and any subsequent write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of a property to the lower of our carrying amount or fair value less costs to sell. Foreclosed assets of $291 and $231 as of December 31, 2017 and 2016, respectively, are included in other assets.
PREMISES AND EQUIPMENT: Land is carried at cost. Buildings and equipment are carried at cost, less accumulated depreciation which is computed principally by the straight-line method based upon the estimated useful lives of the related assets, which range from 3 to 40 years. Major improvements are capitalized and appropriately amortized based upon the useful lives of the related assets or the expected terms of the leases, if shorter, using the straight-line method. Maintenance, repairs and minor alterations are charged to current operations as expenditures occur. We annually review these assets to determine whether carrying values have been impaired.
EQUITY SECURITIES WITHOUT READILY DETERMINABLE FAIR VALUES: Included in equity securities without readily determinable fair values are our holdings in FHLB stock and FRB stock as well as our ownership interest in Corporate Settlement Solutions, LLC. Our investment in Corporate Settlement Solutions, LLC, a title insurance company, was made in the 1st quarter of 2008. We are not the managing entity of Corporate Settlement Solutions, LLC, and account for our investment in that entity under the equity method of accounting.
Equity securities without readily determinable fair values consist of the following as of December 31:

	2017	2016
FHLB Stock	$13,700	$11,900
Corporate Settlement Solutions, LLC	7,421	7,461
FRB Stock	1,999	1,999
Other	334	334
Total	$23,454	$21,694

EQUITY COMPENSATION PLAN: At December 31, 2017, the Directors Plan had 226,909 shares eligible to be issued to participants, for which the Rabbi Trust held 31,769 shares. We had 213,470 shares to be issued in 2016, with 26,042 shares held in the Rabbi Trust. Compensation costs relating to share based payment transactions are recognized as the services are rendered, with the cost measured based on the fair value of the equity or liability

instruments issued (see “Note 17 – Benefit Plans”).

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CORPORATE OWNED LIFE INSURANCE: We have purchased life insurance policies on key members of management, partially for the purpose of funding certain post-retirement benefits. In the event of death of one of these individuals, we would receive a specified cash payment equal to the face value of the policy. Such policies are recorded at their cash surrender value, or the amount that can be realized on the balance sheet. Increases in cash surrender value in excess of single premiums paid are reported as other noninterest income.

As of December 31, 2017 and 2016, the present value of the post retirement benefits payable by us to the covered employees was estimated to be $2,891 and $2,174, respectively, and is included in accrued interest payable and other liabilities. The periodic policy maintenance costs were $31, $(8), and $71 for 2017, 2016, and 2015, respectively, and are included in other noninterest expenses.

ACQUISITION INTANGIBLES AND GOODWILL: We previously acquired branch facilities and related deposits in business combinations accounted for as a purchase. The acquisitions included amounts related to the valuation of customer deposit relationships (core deposit intangibles). Core deposit intangibles arising from acquisitions are included in goodwill and other intangible assets are being amortized over their estimated lives and evaluated for potential impairment on at least an annual basis. Goodwill, which represents the excess of the purchase price over identifiable assets, is not amortized but is evaluated for impairment on at least an annual basis. Acquisition intangibles and goodwill are typically qualitatively evaluated to determine if it is more likely than not that the carrying balance is impaired. If it is determined that the carrying balance is more likely than not to be impaired, we perform a cash flow valuation to determine the extent of the potential impairment. This valuation method requires a significant degree of our judgment. In the event the projected undiscounted net operating cash flows for these intangible assets are less than the carrying value, the asset is recorded at fair value as determined by the valuation model.

OFF BALANCE SHEET CREDIT RELATED FINANCIAL INSTRUMENTS: In the ordinary course of business, we have entered into commitments to extend credit, including commitments under credit card arrangements, home equity lines of credit, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded only when funded.

FEDERAL INCOME TAXES: Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax assets or liability is determined based on the tax effects of the temporary differences between the book and tax basis on the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws. Valuation allowances are established, where necessary, to reduce deferred tax assets to the amount expected to be realized. Income tax expense is the tax payable or refundable for the year plus or minus the change during the year in deferred tax assets and liabilities.

On December 22, 2017, the Tax Cuts and Jobs Act was enacted. The new law establishes a flat corporate federal statutory income tax rate of 21%. In accordance with ASC 740, Income Taxes, the effect of income tax law changes on deferred taxes should be recognized as a component of income tax expense related to continuing operations in the period in which the law is enacted. As such, federal income tax expense for the year ended December 31, 2017 reflects the effect of the tax rate change on net deferred tax assets and liabilities.

We analyze our filing positions in the jurisdictions where we are required to file income tax returns, as well as all open tax years in these jurisdictions. We also treat interest and penalties attributable to income taxes, to the extent they arise, as a component of our noninterest expenses.

DEFINED BENEFIT PENSION PLAN: We maintain a noncontributory defined benefit pension plan, which was curtailed effective March 1, 2007. The service cost component of the defined benefit pension plan is included in “compensation and benefits” on the consolidated statements of income and are funded consistent with the requirements of federal laws and regulations. All other costs related to the defined benefit pension plan are included in “other” noninterest expenses on the consolidated statements of income. The current benefit obligation is included in "accrued interest payable and other liabilities" on the consolidated balance sheets. Inherent in the determination of defined benefit pension costs are assumptions concerning future events that will affect the amount and timing of required benefit payments under the plan. These assumptions include demographic assumptions such as mortality, a discount rate used to determine the current benefit obligation and a long-term expected rate of return on plan assets. Net periodic benefit cost includes interest cost based on the assumed discount rate, an expected return on plan assets based on an actuarially derived market-related value of assets, and amortization of unrecognized net actuarial gains or losses.

Actuarial gains and losses result from experience different from that assumed and from changes in assumptions (excluding asset gains and losses not yet reflected in market-related value). Amortization of actuarial gains and losses is included as a component of net periodic defined benefit pension cost.

For additional information, see “Note 17 – Benefit Plans.”

MARKETING COSTS: Marketing costs are expensed as incurred (see “Note 11 – Other Noninterest Expenses”).

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RECLASSIFICATIONS: Certain amounts reported in the 2016 and 2015 consolidated financial statements have been reclassified to conform with the 2017 presentation.

Note 2 – Computation of Earnings Per Common Share

Basic earnings per common share represents income available to common shareholders divided by the weighted average number of common shares outstanding during the period. Diluted earnings per common share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued relate solely to outstanding shares in the Directors Plan, see "Note 17 – Benefit Plans."

Earnings per common share have been computed based on the following:

	2017	2016	2015
Average number of common shares outstanding for basic calculation	7,841,451	7,813,739	7,775,988
Average potential effect of common shares in the Directors Plan (1)	192,286	185,611	177,988
Average number of common shares outstanding used to calculate diluted earnings per common share	8,033,737	7,999,350	7,953,976
Net income	$ 13,237	$ 13,799	$ 15,130
Earnings per common share			
Basic	$ 1.69	$ 1.77	$ 1.95
Diluted	$ 1.65	$ 1.73	$ 1.90

(1) Exclusive of shares held in the Rabbi Trust

Note 3 – Accounting Standards Updates

Recently Adopted Accounting Standards Updates

ASU No. 2017-07: “Compensation - Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost”

In March 2017, ASU 2017-07 was issued and sets forth requirements related to the disclosure of costs related to defined benefit pension plans, other postretirement benefit plans, or other types of benefits accounted for under Topic 715. Specifically, the amendments require that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component. If a separate line item or items are used to present the other components of net benefit cost, that line item or items must be appropriately described. If a separate line item or items are not used, the line item or items used in the income statement to present the other components of net benefit cost must be disclosed.

The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2017 with early adoption permitted. We elected to early adopt the new authoritative guidance and have disclosed costs related to our plans in accordance with the new authoritative guidance. As a result, interest and fees related to our retirement plans are now disclosed separately from service costs which are included in total compensation and benefits. Interest and fees related to retirement plans in 2017, 2016 and 2015 were $515, $312, and $638, respectively, and are included in other noninterest expenses on the consolidated statements of income.

ASU No. 2018-02: “Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income”

In February 2018, ASU 2018-02 was issued which provided guidance related to "stranded" deferred tax amounts in accumulated other comprehensive income resulting from the tax effects of the recently enacted Tax Cuts and Jobs Act. For the stranded tax effects, this update allows for a reclassification from accumulated other comprehensive income to retained earnings to eliminate the stranded tax effects.

The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2018 with early adoption permitted. We elected to early adopt the new authoritative guidance to eliminate the stranded tax effects on each AOCI component. As a result of this guidance, we reclassified $367 from AOCI to retained earnings as of December 31, 2017. For additional information, see “Note 18 – Accumulated Other Comprehensive Income (Loss).”

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Pending Accounting Standards Updates

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

In May 2014, ASU No. 2014-09 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 which states 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(s) 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, is effective on January 1, 2018. The majority of our income, as well as that of the vast majority of financial institutions, is excluded from this guidance. 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 is not expected to have a significant impact on our operating results.

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

In January 2016, ASU No. 2016-01 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 is 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 will be required to be recorded in net income beginning on January 1, 2018. The impact on our operations or financial statement disclosures will depend on the fair value of these investments at their next measurement date.

In February 2018, ASU No. 2018-03: “Technical Corrections and Improvements to Financial Instruments - Overall (Subtopic 825-10: Recognition and Measurement of Financial Assets and Financial Liabilities” was issued. This update sets forth correction or improvement amendments for specific issues that may arise within the scope of ASU 2016-01. These amendments follow ASU 2016-01 in regards to effective dates and are not believed to have a significant impact on our initial assessment of ASU 2016-01 as it relates to the impact on our operations or financial statement disclosures.

ASU No. 2016-02: “Leases (Topic 842)”

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

For finance leases, a lessee is required to do the following: 1) recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position; 2) recognize interest on the lease liability separately from amortization of the right-of-use asset in the statement of comprehensive

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

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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.

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

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

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 is expected to have a significant impact on our operations and financial statement disclosures as well as that of the banking industry as a whole.

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 to develop a road map to implementation. This committee will monitor progress to ensure timely and accurate adoption of the guidance. We began work around the identification and collection of required borrower and loan level data. We recognize that quality data is key to properly identify loan segments and then apply the most appropriate methodology to each segment. We anticipate a significant amount of progress during 2018 to position ourselves to be able to run parallel models during 2019. This will allow us to solidify our methodology for implementation in 2020.

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

In May 2017, ASU No. 2017-09 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.

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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 is effective for interim and annual periods beginning after December 15, 2017 and is not expected to have a significant impact on our operating results or financial statement disclosures.

ASU No. 2017-12: “Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities”

In August 2017, ASU No. 2017-12 was issued to improve financial reporting of hedging activities to better portray the economic results of an entity’s risk management activities. The update provides changes to both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results.

The update addresses current GAAP designation limitations by permitting three hedge accounting options for risk components in hedging relationships involving nonfinancial risk and interest rate risk. The amendments in this update provide further revisions to the current limitations on designation in a fair value hedge of interest rate risk. Specifically, the update changes the guidance for designating fair value hedges of interest rate risk and for measuring the change in fair value of the hedged item in fair value hedges of interest rate risk by providing four permissible accounting treatments.

In addition to the amendments to the designation and measurement guidance for qualifying hedging relationships, the amendments in this update also align the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements. The update provides requirements for the recognition and presentation for qualifying hedges.

Lastly, the guidance within this update provides exclusions from the hedge effectiveness assessment and five other targeted improvements to current guidance also related to the assessment of hedge effectiveness. Excluding option premiums and forward points will still be permissible under the new guidance. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2018 and is not expected to have a significant impact on our operating results or financial statement disclosures.

Note 4 – AFS Securities

The amortized cost and fair value of AFS securities, with gross unrealized gains and losses, are as follows as of 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
Preferred stocks	3,800	—	223	3,577
Mortgage-backed securities	210,757	390	2,350	208,797
Collateralized mortgage obligations	129,607	160	1,573	128,194
Total	$551,712	$ 5,036	$ 4,441	$552,307

	2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	$10,258	$ 3	$ 2	$10,259
States and political subdivisions	208,977	4,262	320	212,919
Auction rate money market preferred	3,200	—	406	2,794
Preferred stocks	3,800	—	375	3,425
Mortgage-backed securities	229,593	581	2,918	227,256

Collateralized mortgage obligations	101,820	600	977	101,443
Total	$557,648	$ 5,446	$ 4,998	$558,096

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The amortized cost and fair value of AFS securities by contractual maturity at December 31, 2017 are as follows:

	Maturing					
	Due in One Year or Less	After One Year But Within Five Years	After Five Years But Within Ten Years	After Ten Years	Securities with Variable Monthly Payments or Noncontractual Maturities	Total
Government sponsored enterprises	$—	$ 217	$—	$ —	$ —	$217
States and political subdivisions	25,655	73,498	71,611	33,367	—	204,131
Auction rate money market preferred	—	—	—	—	3,200	3,200
Preferred stocks	—	—	—	—	3,800	3,800
Mortgage-backed securities	—	—	—	—	210,757	210,757
Collateralized mortgage obligations	—	—	—	—	129,607	129,607
Total amortized cost	$25,655	$ 73,715	$71,611	$ 33,367	$ 347,364	$551,712
Fair value	$25,709	$ 74,974	$73,649	$ 34,358	$ 343,617	$552,307

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

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

A summary of the sales activity of AFS securities was as follows during the years ended December 31:

	2017	2016	2015
Proceeds from sales of AFS securities	$12,827	$35,664	$1,319
Gross realized gains (losses)	$142	$245	$163
Applicable income tax expense (benefit)	$48	$83	$55

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

	2017				
	Less Than Twelve Months		Twelve Months or More		
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Total Unrealized Losses
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
Preferred stocks	—	—	223	3,577	223
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	$ 3,143	$ 108,187	$ 4,441
Number of securities in an unrealized loss position:		81		26	107

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	2016				
	Less Than Twelve Months		Twelve Months or More		
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Total Unrealized Losses
Government sponsored enterprises	$2	$9,936	$ —	$ —	$ 2
States and political subdivisions	311	21,800	9	355	320
Auction rate money market preferred	—	—	406	2,794	406
Preferred stocks	—	—	375	3,425	375
Mortgage-backed securities	2,918	175,212	—	—	2,918
Collateralized mortgage obligations	628	51,466	349	11,381	977
Total	$3,859	$258,414	$ 1,139	$ 17,955	$ 4,998
Number of securities in an unrealized loss position:		104		9	113

As of December 31, 2017 and 2016, we conducted an analysis to determine whether any 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 recognized an OTTI of $770 in earnings for the year ended December 31, 2016. Based on analysis of the bond, there was no additional OTTI recognized as of December 31, 2017. The following table provides a roll-forward of credit related impairment recorded in earnings for the years ended December 31:

	2017	2016	2015
Balance at beginning of year	$770	$—	$282
Additions to credit losses for which no previous OTTI was recognized	—	770	—
Reductions for credit losses realized on securities sold during the year	—	—	(282)
Balance at end of year	$770	$770	$—

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 December 31, 2017 and 2016, with the exception of the one municipal bond discussed above.

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Note 5 – Loans and ALLL

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

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

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

For loans that are placed on nonaccrual status or charged-off, all interest accrued in the current calendar year, but not collected, is reversed against interest income while interest accrued in prior calendar years, but not collected, is charged against the ALLL. Loans may be returned to accrual status after six months of continuous performance 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 states and political subdivisions. Repayment of these loans is dependent upon the successful operation and management of a business. We minimize our risk by limiting the amount of direct credit exposure to any one borrower to $15,000. Borrowers with direct credit needs of more than $15,000 are serviced through the use of loan participations with other commercial banks. Commercial and agricultural real estate loans commonly require loan-to-value limits of 80% or less. Depending upon the type of loan, past credit history, and current operating results, we may require the borrower to pledge accounts receivable, inventory, and property and equipment. Personal guarantees are generally required from the owners of closely held corporations, partnerships, and sole proprietorships. In addition, we require annual financial statements, prepare cash flow analyses, and review credit reports.

We entered into a mortgage purchase program 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 payoff our participation in the advance to the mortgage broker. We classify these advances as commercial loans and include the outstanding balance in commercial loans on our balance sheet. Under the participation agreement, we committed to a maximum outstanding aggregate amount of $30,000. The difference between our outstanding balances and the maximum outstanding aggregate amount 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, 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 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.

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- 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. All mortgage loan requests are reviewed by our mortgage loan committee or through a secondary market underwriting system; loans in excess of $500 require the approval of our Internal Loan Committee, the Executive Loan Committee, the Board of Directors' Loan Committee, or the Board of Directors.

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.

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

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

The primary factors behind the determination of the level of the ALLL are specific allocations for impaired loans, historical loss percentages, as well as unallocated components. Specific allocations for impaired loans are primarily determined based on the difference between the loan's outstanding balance 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 based on historical loss factors. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

	Allowance for Loan Losses Year Ended December 31, 2017					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2017	$1,814	$ 884	$ 2,664	$ 624	$ 1,414	$7,400
Charge-offs	(265)	—	(200)	(306)	—	(771)
Recoveries	453	—	206	159	—	818
Provision for loan losses	(296)	(273)	(107)	423	506	253
December 31, 2017	$1,706	$ 611	$ 2,563	$ 900	$ 1,920	$7,700

	Allowance for Loan Losses Year Ended December 31, 2016					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2016	$2,171	$ 329	$ 3,330	$ 522	$ 1,048	$7,400
Charge-offs	(57)	—	(574)	(285)	—	(916)
Recoveries	448	92	287	224	—	1,051
Provision for loan losses	(748)	463	(379)	163	366	(135)
December 31, 2016	$1,814	$ 884	$ 2,664	$ 624	$ 1,414	$7,400

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	Allowance for Loan Losses and Recorded Investment in Loans As of 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

	Allowance for Loan Losses and Recorded Investment in Loans As of December 31, 2016					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	$741	$ 1	$ 1,629	$ —	$ —	$2,371
Collectively evaluated for impairment	1,073	883	1,035	624	1,414	5,029
Total	$1,814	$ 884	$ 2,664	$ 624	$ 1,414	$7,400
Loans						
Individually evaluated for impairment	$7,859	$ 5,545	$ 8,638	$ 26		$22,068
Collectively evaluated for impairment	567,805	120,947	257,412	42,383		988,547
Total	$575,664	$ 126,492	$ 266,050	$ 42,409		$1,010,615

The following table displays the credit quality indicators for commercial and agricultural credit exposures based on internally assigned credit risk ratings as of December 31:

	2017							
	Commercial				Agricultural			
	Real Estate	Other	Advances to Mortgage Brokers	Total	Real Estate	Other	Total	Total
Rating								
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	5,377	2,747	8,124	15,943
7 - Vulnerable	729	—	—	729	479	419	898	1,627
8 - Doubtful	—	—	—	—	—	—	—	—
Total	$481,654	$141,024	$ 12,081	$634,759	$88,165	$40,104	$128,269	$763,028

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	2016							
	Commercial				Agricultural			
	Real Estate	Other	Advances to Mortgage Brokers	Total	Real Estate	Other	Total	Total
Rating								
1 - Excellent	$28	$438	$ —	$466	$—	$—	$—	$466
2 - High quality	11,821	12,091	19,688	43,600	3,566	1,426	4,992	48,592
3 - High satisfactory	103,529	41,982	—	145,511	21,657	11,388	33,045	178,556
4 - Low satisfactory	299,317	74,432	—	373,749	48,955	22,715	71,670	445,419
5 - Special mention	3,781	1,178	—	4,959	6,009	3,085	9,094	14,053
6 - Substandard	5,901	1,474	—	7,375	3,650	3,508	7,158	14,533
7 - Vulnerable	4	—	—	4	—	533	533	537
8 - Doubtful	—	—	—	—	—	—	—	—
Total	$424,381	$131,595	$ 19,688	$575,664	$83,837	$42,655	$126,492	$702,156

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

1. EXCELLENT – Substantially Risk Free

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

- High liquidity, strong cash flow, low leverage.
- Unquestioned ability to meet all obligations when due.
- Experienced management, with management succession in place.
- Secured by cash.

2. HIGH QUALITY – Limited Risk

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

- Favorable liquidity and leverage ratios.
- Ability to meet all obligations when due.
- Management with successful track record.
- Steady and satisfactory earnings history.
- If loan is secured, collateral is of high quality and readily marketable.
- Access to alternative financing.
- Well defined primary and secondary source of repayment.
- If supported by guaranty, the financial strength and liquidity of the guarantor(s) are clearly evident.

3. HIGH SATISFACTORY – Reasonable Risk

Credit with satisfactory financial condition and further characterized by:

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

4. LOW SATISFACTORY – Acceptable Risk

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

- Would include most start-up businesses.

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- Occasional instances of trade slowness or repayment delinquency – may have been 10-30 days slow within the past year.
- Management's abilities are apparent, yet unproven.
- Weakness in primary source of repayment with adequate secondary source of repayment.
- Loan structure generally in accordance with policy.
- If secured, loan collateral coverage is marginal.
- Adequate cash flow to service debt, but coverage is low.

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

5. SPECIAL MENTION – Criticized

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

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

6. SUBSTANDARD – Classified

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

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

7. VULNERABLE – Classified

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

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

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

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

Our primary credit quality indicator for residential real estate and consumer loans is the individual loan's past due aging. The following tables summarize the past due and current loans as of December 31:

	2017						
	Accruing Interest and Past Due:				Total Past Due and Nonaccrual		
	30-59 Days	60-89 Days	90 Days or More	Nonaccrual		Current	Total
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

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	2016						
	Accruing Interest and Past Due:				Total Past Due and Nonaccrual		
	30-59 Days	60-89 Days	90 Days or More	Nonaccrual		Current	Total
Commercial							
Commercial real estate	$1,580	$—	$ 35	$ 4	$ 1,619	$422,762	$424,381
Commercial other	1,693	35	—	—	1,728	129,867	131,595
Advances to mortgage brokers	—	—	—	—	—	19,688	19,688
Total commercial	3,273	35	35	4	3,347	572,317	575,664
Agricultural							
Agricultural real estate	191	—	508	—	699	83,138	83,837
Agricultural other	19	—	—	533	552	42,103	42,655
Total agricultural	210	—	508	533	1,251	125,241	126,492
Residential real estate							
Senior liens	1,638	174	22	498	2,332	216,681	219,013
Junior liens	15	—	—	25	40	8,317	8,357
Home equity lines of credit	270	6	68	—	344	38,336	38,680
Total residential real estate	1,923	180	90	523	2,716	263,334	266,050
Consumer							
Secured	110	—	—	—	110	38,582	38,692
Unsecured	5	—	—	—	5	3,712	3,717
Total consumer	115	—	—	—	115	42,294	42,409
Total	$5,521	$215	$ 633	$ 1,060	$ 7,429	$1,003,186	$1,010,615

Impaired Loans

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

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

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

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We do not recognize interest income on impaired loans in nonaccrual status. For impaired loans not classified as nonaccrual, interest income is recognized daily, as earned, according to the terms of the loan agreement and the principal amount outstanding. The following summarizes information pertaining to impaired loans as of, and for the years ended, December 31:

	2017				
	Recorded Balance	Unpaid Principal Balance	Valuation Allowance	Average Recorded Balance	Interest Income Recognized
Impaired loans with a valuation allowance					
Commercial real estate	$4,089	$4,378	$ 626	$4,608	$ 277
Commercial other	995	995	24	1,427	93
Agricultural real estate	—	—	—	—	—
Agricultural other	—	—	—	17	—
Residential real estate senior liens	7,816	8,459	1,473	8,296	323
Residential real estate junior liens	44	44	7	71	2
Home equity lines of credit	—	—	—	23	—
Consumer secured	—	—	—	—	—
Total impaired loans with a valuation allowance	12,944	13,876	2,130	14,442	695
Impaired loans without a valuation allowance					
Commercial real estate	1,791	1,865		1,585	111
Commercial other	1,224	1,224		246	23
Agricultural real estate	7,913	7,913		6,421	307
Agricultural other	2,685	2,685		2,494	126
Home equity lines of credit	79	379		106	19
Consumer secured	17	17		21	—
Total impaired loans without a valuation allowance	13,709	14,083		10,873	586
Impaired loans					
Commercial	8,099	8,462	650	7,866	504
Agricultural	10,598	10,598	—	8,932	433
Residential real estate	7,939	8,882	1,480	8,496	344
Consumer	17	17	—	21	—
Total impaired loans	$26,653	$27,959	$ 2,130	$25,315	$ 1,281

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	2016				
	Recorded Balance	Unpaid Principal Balance	Valuation Allowance	Average Recorded Balance	Interest Income Recognized
Impaired loans with a valuation allowance					
Commercial real estate	$5,811	$5,992	$ 716	$5,746	$ 343
Commercial other	1,358	1,358	25	568	27
Agricultural real estate	—	—	—	91	6
Agricultural other	134	134	1	92	2
Residential real estate senior liens	8,464	9,049	1,615	9,214	362
Residential real estate junior liens	72	82	14	113	3
Home equity lines of credit	—	—	—	—	—
Consumer secured	—	—	—	—	—
Total impaired loans with a valuation allowance	15,839	16,615	2,371	15,824	743
Impaired loans without a valuation allowance					
Commercial real estate	604	617		895	69
Commercial other	86	97		87	8
Agricultural real estate	4,037	4,037		3,515	182
Agricultural other	1,374	1,374		708	42
Home equity lines of credit	102	402		115	16
Consumer secured	26	26		32	3
Total impaired loans without a valuation allowance	6,229	6,553		5,352	320
Impaired loans					
Commercial	7,859	8,064	741	7,296	447
Agricultural	5,545	5,545	1	4,406	232
Residential real estate	8,638	9,533	1,629	9,442	381
Consumer	26	26	—	32	3
Total impaired loans	$22,068	$23,168	$ 2,371	$21,176	$ 1,063

We had committed to advance $472 and $117 in connection with impaired loans, which includes TDRs, as of December 31, 2017 and 2016, 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:

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

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

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

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The following is a summary of information pertaining to TDRs granted in the years ended December 31:

	2017			2016		
	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
Commercial other	6	$ 1,702	$ 1,702	6	$ 2,066	$ 2,066
Agricultural other	15	6,092	6,092	7	1,610	1,610
Residential real estate						
Senior liens	6	464	464	4	143	143
Junior liens	1	8	8	—	—	—
Total residential real estate	7	472	472	4	143	143
Consumer unsecured	—	—	—	1	2	2
Total	28	$ 8,266	$ 8,266	18	$ 3,821	$ 3,821

The following tables summarize concessions we granted to borrowers in financial difficulty in the years ended December 31:

	2017				2016			
	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 Loans	Pre-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment
Commercial other	—	$ —	6	$ 1,702	—	$ —	6	$ 2,066
Agricultural other	11	1,972	4	4,120	2	419	5	1,191
Residential real estate								
Senior liens	—	—	6	464	2	27	2	116
Junior liens	1	8	—	—	—	—	—	—
Total residential real estate	1	8	6	464	2	27	2	116
Consumer unsecured	—	—	—	—	—	—	1	2
Total	12	$ 1,980	16	$ 6,286	4	$ 446	14	$ 3,375

We did not restructure any loans by forgiving principal or accrued interest during 2017 or 2016.

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 years ended December 31, 2017 and 2016, which were modified within 12 months prior to the default date.

The following is a summary of TDR loan balances as of December 31:

	2017	2016
TDRs	$26,197	$21,382

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Note 6 – Premises and Equipment

A summary of premises and equipment at December 31 follows:

	2017	2016
Land	$6,336	$6,336
Buildings and improvements	29,661	28,941
Furniture and equipment	33,466	33,125
Total	69,463	68,402
Less: accumulated depreciation	41,013	39,088
Premises and equipment, net	$28,450	$29,314

Depreciation expense amounted to $2,902, $2,821, and $2,677 in 2017, 2016, and 2015, respectively.

Note 7 – Goodwill and Other Intangible Assets

The carrying amount of goodwill was $48,282 at December 31, 2017 and 2016.

Identifiable intangible assets were as follows as of December 31:

	2017		
	Gross Intangible Assets	Accumulated Amortization	Net Intangible Assets
Core deposit premium resulting from acquisitions	$5,579	$ 5,314	$ 265

	2016		
	Gross Intangible Assets	Accumulated Amortization	Net Intangible Assets
Core deposit premium resulting from acquisitions	$5,579	$ 5,195	$ 384

Amortization expense associated with identifiable intangible assets was $119, $162, and $169 in 2017, 2016, and 2015, respectively.

Estimated amortization expense associated with identifiable intangibles for each of the next five years succeeding December 31, 2017, and thereafter is as follows:

	Estimated Amortization Expense
2018	$ 96
2019	71
2020	48
2021	29
2022	15
Thereafter	6
Total	$ 265

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Note 8 – Foreclosed Assets

Foreclosed assets are included in other assets in the consolidated balance sheets and consist of other real estate owned and repossessed assets. The following is a summary of foreclosed assets as of December 31:

	2017	2016
Consumer mortgage loans collateralized by residential real estate foreclosed as a result of obtaining physical possession	$103	$18
All other foreclosed assets	188	213
Total	$291	$231

There were $0 and $18 consumer mortgage loans collateralized by residential real estate in the process of foreclosure as of December 31, 2017 and 2016.

Below is a summary of changes in foreclosed assets during the years ended December 31:

	2017	2016
Balance, January 1	$231	$421
Properties transferred	331	306
Impairments	(2)	(10)
Proceeds from sale	(269)	(486)
Balance, December 31	$291	$231

Note 9 – Deposits

Scheduled maturities of time deposits for the next five years, and thereafter, are as follows:

	Scheduled Maturities of Time Deposits
2018	$ 191,012
2019	113,153
2020	37,604
2021	50,814
2022	38,843
Thereafter	21,840
Total	$ 453,266

Interest expense on time deposits greater than $250 was $825 in 2017, $678 in 2016 and $592 in 2015.

Note 10 – Borrowed Funds

Borrowed funds consist of the following obligations at December 31:

	2017		2016	
	Amount	Rate	Amount	Rate
FHLB advances	$290,000	1.94%	$270,000	1.82%
Securities sold under agreements to repurchase without stated maturity dates	54,878	0.12%	60,894	0.13%
Federal funds purchased	—	— %	6,800	1.00%
Total	$344,878	1.65%	$337,694	1.50%

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

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The following table lists the maturities and weighted average interest rates of FHLB advances as of December 31:

	2017		2016	
	Amount	Rate	Amount	Rate
Fixed rate due 2017	—	— %	70,000	1.39%
Fixed rate due 2018	70,000	1.96%	50,000	2.16%
Fixed rate due 2019	85,000	1.87%	60,000	1.99%
Fixed rate due 2020	35,000	1.80%	10,000	1.98%
Fixed rate due 2021	50,000	1.91%	50,000	1.91%
Variable rate due 2021 [1]	10,000	1.72%	10,000	1.21%
Fixed rate due 2022	20,000	1.97%	—	— %
Fixed rate due 2023	10,000	3.90%	10,000	3.90%
Fixed rate due 2026	10,000	1.17%	10,000	1.17%
Total	$290,000	1.94%	$270,000	1.82%

(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 $54,898 and $60,918 at December 31, 2017 and 2016, respectively. Such securities remain under our control. We may be required to provide additional collateral based on the fair value of underlying securities.

Securities sold under repurchase agreements without stated maturity dates, federal funds purchased, and FRB Discount Window advances generally mature within one to four days from the transaction date. The following table provides a summary of securities sold under repurchase agreements without stated maturity dates, federal funds purchased, and FRB Discount.

	December 31, 2017			December 31, 2016		
	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	$58,464	$55,206	0.13 %	$61,783	$57,702	0.09 %
Federal funds purchased	5,965	2,726	1.15 %	27,300	8,546	0.60 %
FRB Discount Window	—	43	1.54 %	—	—	— %

We had pledged AFS securities and 1-4 family residential real estate loans in the following amounts at December 31:

	2017	2016
Pledged to secure borrowed funds	$410,988	$363,427
Pledged to secure repurchase agreements	54,898	60,918
Pledged for public deposits and for other purposes necessary or required by law	27,976	33,916
Total	$493,862	$458,261

AFS securities pledged to repurchase agreements without stated maturity dates consisted of the following at December 31:

	2017	2016
States and political subdivisions	$7,332	$5,676
Mortgage-backed securities	13,199	11,383
Collateralized mortgage obligations	34,367	43,859
Total	$54,898	$60,918

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

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As of December 31, 2017, we had the ability to borrow up to an additional $139,381, based on assets pledged as collateral. We had no investment securities that are 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:

	December 31, 2017					
	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	3.3	$ 10,000	Other Assets	$ 291

	December 31, 2016					
	Pay Rate	Receive Rate	Remaining Life (Years)	Notional Amount	Balance Sheet Location	Fair Value
Derivatives designated as hedging instruments						
Cash Flow Hedges:						
Interest rate swaps	1.56%	3-Month LIBOR	4.3	$ 10,000	Other Assets	$ 248

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

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Note 11 – Other Noninterest Expenses

A summary of expenses included in other noninterest expenses is as follows for the years ended December 31:

	2017	2016	2015
ATM and debit card fees	$1,181	$887	$742
Audit and related fees	1,008	944	889
Consulting fees	790	800	487
Director fees	856	851	827
Donations and community relations	657	582	841
FDIC insurance premiums	642	719	813
Marketing costs	568	586	497
Loan underwriting fees	556	535	347
Interest and fees on retirement plans	515	312	638
Education and travel	471	536	343
Printing and supplies	415	391	461
Postage and freight	509	396	381
Legal fees	245	208	295
Amortization of deposit premium	119	162	169
Other losses	71	241	150
OTTI on AFS securities	—	770	—
All other	1,441	1,305	1,559
Total other	$10,044	$10,225	$9,439

Note 12 – Federal Income Taxes

Components of the consolidated provision for federal income taxes are as follows for the years ended December 31:

	2017	2016	2015
Currently payable	$180	$2,630	$1,596
Deferred expense (benefit)	2,836	(282)	1,692
Income tax expense	$3,016	$2,348	$3,288

In 2017 we implemented tax strategies which resulted in changes to our federal income tax components, as illustrated above. These strategies, which were primarily related to premises and equipment, significantly decreased our taxes currently payable and led to an increase in our level of alternative minimum tax. Changes in these deferred tax components are displayed in the deferred tax assets and liabilities table on the following page.

On December 22, 2017, the Tax Cuts and Jobs Act was enacted. The new law establishes a flat corporate federal statutory income tax rate of 21% and eliminates the corporate alternative minimum tax which will be carried forward and used to reduce future income tax. The new tax law provides for a wide array of changes, only some of which will have a direct impact on our future federal income tax expense. Some of these changes include, but are not limited to, the following items: limits to the deduction for net interest expense; immediate expense (for tax purposes) for certain qualified depreciable assets; elimination or reduction of certain deductions related to meals and entertainment expenses; and limits to the deductibility of deposit insurance premiums.

In accordance with ASC 740, Income Taxes, the effect of income tax law changes on deferred taxes are recognized as a component of income tax expense related to continuing operations in the period in which the law is enacted. As such, federal income tax expense for the year ended December 31, 2017 reflects the effect of the tax rate change on net deferred tax assets and liabilities. This requirement also applies to items initially recognized in other comprehensive income. In January 2018, FASB issued ASU 2018-02 which allowed for the "stranded" tax effects in AOCI to be reclassified to retained earnings rather than income tax expense. We early adopted this guidance and applied this accounting alternative in our consolidated statements of changes in shareholders equity as of December 31, 2017.

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The reconciliation of the provision for federal income taxes and the amount computed at the federal statutory tax rate of 34% of income before federal income tax expense is as follows for the year ended December 31:

	2017	2016	2015
Income taxes at 34% statutory rate	$5,526	$5,490	$6,262
Effect of nontaxable income			
Interest income on tax exempt municipal securities	(1,889)	(1,938)	(2,026)
Earnings on corporate owned life insurance policies	(247)	(419)	(262)
Deferred tax adjustment resulting from the statutory rate reduction pursuant to the Tax Act	319	—	—
Other	34	(154)	(88)
Total effect of nontaxable income	(1,783)	(2,511)	(2,376)
Effect of nondeductible expenses	149	143	157
Effect of tax credits	(876)	(774)	(755)
Federal income tax expense	$3,016	$2,348	$3,288

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for federal income tax purposes. Significant components of our deferred tax assets and liabilities, included in other assets in the accompanying consolidated balance sheets, are as follows as of December 31:

	2017	2016
Deferred tax assets		
Allowance for loan losses	$1,076	$1,576
Deferred directors' fees	1,758	2,758
Employee benefit plans	70	115
Core deposit premium and acquisition expenses	733	1,157
Net unrecognized actuarial losses on pension plan	857	1,531
Life insurance death benefit payable	497	804
Alternative minimum tax	1,463	717
Other	607	618
Total deferred tax assets	7,061	9,276
Deferred tax liabilities		
Prepaid pension cost	455	809
Premises and equipment	1,728	115
Accretion on securities	40	58
Core deposit premium and acquisition expenses	909	1,403
Net unrealized gains on available-for-sale securities	204	418
Net unrealized gains on derivative instruments	61	84
Other	1,684	1,502
Total deferred tax liabilities	5,081	4,389
Net deferred tax assets	$1,980	$4,887

We are subject to U.S. federal income tax; however, we are no longer subject to examination by taxing authorities for years before 2014. There are no material uncertain tax positions requiring recognition in our consolidated financial statements. We do not expect the total amount of unrecognized tax benefits to significantly increase in the next twelve months.

We recognize interest and/or penalties related to income tax matters in income tax expense. We do not have any amounts accrued for interest and penalties at December 31, 2017 and 2016 and we are not aware of any claims for such amounts by federal income tax authorities.

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Note 13 – Off-Balance-Sheet Activities

Credit-Related Financial Instruments

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

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

	December 31	
	2017	2016
Unfunded commitments under lines of credit	$184,317	$168,840
Commercial and standby letters of credit	1,622	1,223
Commitments to grant loans	24,782	29,339

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

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

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

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

Note 14 – On-Balance Sheet Activities

Derivative Loan Commitments

Mortgage loan commitments are referred to as derivative loan commitments if the loan that will result from exercise of the commitment will be held for sale upon funding. We enter into commitments to fund residential mortgage loans at specific times in the future, with the intention that these loans will subsequently be sold in the secondary market. A mortgage loan commitment binds us to lend funds to a potential borrower at a specified interest rate within a specified period of time, generally up to 60 days after inception of the rate lock.

Outstanding derivative loan commitments expose us to the risk that the price of the loans arising from the exercise of the loan commitment might decline from the inception of the rate lock to funding of the loan due to increases in mortgage interest rates. If interest rates increase, the value of these loan commitments decreases. Conversely, if interest rates decrease, the value of these loan commitments increase. The notional amount of undesignated interest rate lock commitments was $805 and $750 at December 31, 2017 and 2016, respectively.

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Forward Loan Sale Commitments

To protect against the price risk inherent in derivative loan commitments, we utilize both "mandatory delivery" and "best efforts" forward loan sale commitments to mitigate the risk of potential decreases in the values of loan that would result from the exercise of the derivative loan commitments.

With a "mandatory delivery" contract, we commit to deliver a certain principal amount of mortgage loans to an investor at a specified price on or before a specified date. If we fail to deliver the amount of mortgages necessary to fulfill the commitment by the specified date, we are obligated to pay a "pair-off" fee, based on then current market prices, to the investor to compensate the investor for the shortfall.

With a "best efforts" contract, we commit to deliver an individual mortgage loan of a specified principal amount and quality to an investor if the loan to the underlying borrower closes. Generally, the price the investor will pay the seller for an individual loan is specified prior to the loan being funded (e.g. on the same day the lender commits to lend funds to a potential borrower).

We expect that these forward loan sale commitments will experience changes in fair value opposite to the change in fair value of derivative loan commitments. The notional amount of undesignated forward loan sale commitments was $1,843 and $1,877 at December 31, 2017 and 2016, respectively.

The fair values of the rate lock loan commitments related to the origination of mortgage loans that will be held for sale and the forward loan sale commitments are deemed insignificant by management and, accordingly, are not recorded in our consolidated financial statements.

Note 15 – Commitments and Other Matters

Banking regulations require us to maintain cash reserve balances in currency or as deposits with the FRB. At December 31, 2017 and 2016, the reserve balances amounted to $1,458 and $1,273, respectively.

Banking regulations limit the transfer of assets in the form of dividends, loans, or advances from the Bank to the Corporation. At December 31, 2017, substantially all of the Bank's assets were restricted from transfer to the Corporation in the form of loans or advances. Consequently, Bank dividends are the principal source of funds for the Corporation. Payment of dividends without regulatory approval is limited to the current year's retained net income plus retained net income for the preceding two years, less any required transfers to common stock. At January 1, 2018, the amount available to the Corporation for dividends from the Bank, without regulatory approval, was approximately $24,200.

Note 16 – Minimum Regulatory Capital Requirements

The Corporation (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the FRB and the FDIC. Failure to meet minimum capital requirements can initiate mandatory and possibly additional discretionary actions by the FRB and the FDIC that if undertaken, could have a material effect on our financial statements. Under regulatory capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that include quantitative measures of assets, liabilities, capital, and certain off-balance-sheet items, as calculated under regulatory accounting standards. Our capital amounts and classifications are also subject to qualitative judgments by the FRB and the FDIC about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require us to maintain minimum amounts and ratios (set forth in the following table) of total, tier 1 capital, and common equity tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined) and tier 1 capital to average assets (as defined). We believe, as of December 31, 2017 and 2016, that we met all capital adequacy requirements.

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

we have historically.

Effective January 1, 2015, the minimum standard for primary, or tier 1, capital increased from 4.00% to 6.00%. The minimum standard for total capital remained at 8.00%. Also effective January 1, 2015 was the new common equity tier 1 capital ratio

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which had a minimum requirement of 4.50%. Beginning on January 1, 2016 the capital conservation buffer went into effect which will further increase the required levels each year through 2019.
As of December 31, 2017 and 2016, the most recent notifications from the FRB and the FDIC categorized us as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain total risk-based, Tier 1 risk-based, Common Equity Tier 1, and Tier 1 leverage ratios as set forth in the following tables. There are no conditions or events since the notifications that we believe have changed our categories. Our actual capital amounts and ratios are also presented in the table.

	Actual		Minimum Capital Requirement		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2017						
Common equity Tier 1 capital to risk weighted assets						
Isabella Bank	$139,897	11.56%	$48,404	5.750%	$72,605	6.50 %
Consolidated	149,013	12.23%	48,744	5.750%	N/A	N/A
Tier 1 capital to risk weighted assets						
Isabella Bank	139,897	11.56%	48,404	7.250%	72,605	8.00 %
Consolidated	149,013	12.23%	48,744	7.250%	N/A	N/A
Total capital to risk weighted assets						
Isabella Bank	147,597	12.20%	96,807	9.250%	121,009	10.00%
Consolidated	156,713	12.86%	97,488	9.250%	N/A	N/A
Tier 1 capital to average assets						
Isabella Bank	139,897	8.07 %	69,373	4.00 %	86,717	5.00 %
Consolidated	149,013	8.54 %	69,827	4.00 %	N/A	N/A

	Actual		Minimum Capital Requirement		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2016						
Common equity Tier 1 capital to risk weighted assets						
Isabella Bank	$132,900	11.69%	$45,462	5.125%	$68,193	6.50 %
Consolidated	142,165	12.39%	45,881	5.125%	N/A	N/A
Tier 1 capital to risk weighted assets						
Isabella Bank	132,900	11.69%	45,462	6.625%	68,193	8.00 %
Consolidated	142,165	12.39%	45,881	6.625%	N/A	N/A
Total capital to risk weighted assets						
Isabella Bank	140,300	12.34%	90,923	8.625%	113,654	10.00%
Consolidated	149,565	13.04%	91,761	8.625%	N/A	N/A
Tier 1 capital to average assets						
Isabella Bank	132,900	8.06 %	65,972	4.000%	82,465	5.00 %
Consolidated	142,165	8.56 %	66,449	4.000%	N/A	N/A

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Note 17 – Benefit Plans

401(k) Plan

We have a 401(k) plan in which substantially all employees are eligible to participate. Employees may contribute up to 100% of their compensation subject to certain limits based on federal tax laws. The plan was amended in 2013 to provide a matching safe harbor contribution for all eligible employees equal to 100% of the first 5.0% of an employee's compensation contributed to the Plan during the year. Employees are 100% vested in the safe harbor matching contributions.

For 2017, 2016 and 2015, expenses attributable to the Plan were $713, $686, and $664, respectively.

Defined Benefit Pension Plan

We maintain a noncontributory defined benefit pension plan, which was curtailed effective March 1, 2007. As a result of the curtailment, future salary increases are no longer considered (the projected benefit obligation is equal to the accumulated benefit obligation), and plan benefits are based on years of service and the individual employee’s five highest consecutive years of compensation out of the last ten years of service through March 1, 2007.

Changes in the projected benefit obligation and plan assets during each year, the funded status of the plan, and the net amount recognized in our consolidated balance sheets using an actuarial measurement date of December 31, are summarized as follows during the years ended December 31:

	2017	2016
Change in benefit obligation		
Benefit obligation, January 1	$11,448	$11,977
Interest cost	444	485
Actuarial (gain) loss	578	(328)
Benefits paid, including plan expenses	(1,089)	(686)
Benefit obligation, December 31	11,381	11,448
Change in plan assets		
Fair value of plan assets, January 1	9,325	9,572
Investment return	1,033	439
Contributions	200	—
Benefits paid, including plan expenses	(1,089)	(686)
Fair value of plan assets, December 31	9,469	9,325
Deficiency in funded status at December 31, included on the consolidated balance sheets in accrued interest payable and other liabilities	$(1,912)	$(2,123)

	2017	2016
Change in accrued pension benefit costs		
Accrued benefit cost at January 1	$(2,123)	$(2,405)
Contributions	200	—
Net periodic benefit cost	(412)	(238)
Net change in unrecognized actuarial loss and prior service cost	423	520
Accrued pension benefit cost at December 31	$(1,912)	$(2,123)

We have recorded the funded status of the plan in our consolidated balance sheets. We adjust the underfunded status in a liability account to reflect the current funded status of the plan. Any gains or losses that arise during the year but are not recognized as components of net periodic benefit cost are recognized as a component of other comprehensive income (loss).

The components of net periodic benefit cost are as follows for the years ended December 31:

	2017	2016	2015
Interest cost on benefit obligation	$444	$485	$494
Expected return on plan assets	(546)	(560)	(607)
Amortization of unrecognized actuarial net loss	279	313	355
Settlement loss	235	—	250
Net periodic benefit cost	$412	$238	$492

During 2017, 2016 and 2015, additional settlement losses of $235, $0 and $250 were recognized in connection with lump-sum benefit distributions. Many plan participants elect to receive their retirement benefit payments in the form of lump-sum settlements. Pro rata settlement losses, which can occasionally occur as a result of these lump sum distributions, are recognized only in years when the total of such distributions exceed the sum of the service and interest expense components of net periodic benefit cost.

Accumulated other comprehensive income at December 31, 2017 includes net unrecognized pension costs before income taxes of $4,080, of which $76 is expected to be amortized into benefit cost during 2018.

The actuarial assumptions used in determining the benefit obligation are as follows for the years ended December 31:

	2017	2016	2015
Discount rate	3.48%	3.96%	4.13%
Expected long-term rate of return on plan assets	6.00%	6.00%	6.00%

The actuarial weighted average assumptions used in determining the net periodic pension costs are as follows for the years ended December 31:

	2017	2016	2015
Discount rate	3.96%	4.13%	3.80%
Expected long-term rate of return on plan assets	6.00%	6.00%	6.00%

As a result of the curtailment of the Plan, there is no rate of compensation increase considered in the above assumptions.

The expected long term rate of return is an estimate of anticipated future long term rates of return on plan assets as measured on a market value basis. Factors considered in arriving at this assumption include:

- Historical long term rates of return for broad asset classes.
- Actual past rates of return achieved by the plan.
- The general mix of assets held by the plan.
- The stated investment policy for the plan.

The selected rate of return is net of anticipated investment related expenses.

Plan Assets

Our overall investment strategy is to moderately grow the portfolio by investing 50% of the portfolio in equity securities and 50% in fixed income securities. This strategy is designed to generate a long term rate of return of 6.00%. Equity securities primarily consist of the S&P 500 Index with a smaller allocation to the Small Cap and International Index. Fixed income securities are invested in the Bond Market Index. The Plan has appropriate assets invested in short term investments to meet near-term benefit payments.

The asset mix and the sector weighting of the investments are determined by our pension committee, which is comprised of members of our management. To manage the Plan, we retain a third party investment advisor to conduct consultations. We review the performance of the advisor at least annually.

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The fair values of our pension plan assets by asset category were as follows as of December 31:

	2017		2016	
	Total	(Level 2)	Total	(Level 2)
Short-term investments	$300	$ 300	$130	$ 130
Common collective trusts				
Fixed income	3,815	3,815	4,579	4,579
Equity investments	5,354	5,354	4,616	4,616
Total	$9,469	$ 9,469	$9,325	$ 9,325

The following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used at December 31, 2017 and 2016:

- Short-term investments: Shares of a money market portfolio, which is valued using amortized cost, which approximates fair value.
- Common collective trusts: These investments are public investment securities valued using the NAV provided by a third party investment advisor. The NAV is quoted on a private market that is not active; however, the unit price is based on underlying investments which are traded on an active market.

We anticipate contributions to the Plan in 2018 to approximate net contribution costs.

The components of projected net periodic benefit cost are as follows for the year ending:

	December 31, 2018
Interest cost on projected benefit obligation	$ 388
Expected return on plan assets	(554)
Amortization of unrecognized actuarial net loss	242
Net periodic benefit cost	$ 76

Estimated future benefit payments are as follows for the next ten years:

	Estimated Benefit Payments
2018	$ 474
2019	489
2020	523
2021	524
2022	524
2023 - 2027	2,833

Equity Compensation Plan

Pursuant to the terms of the Directors Plan, our directors are required to invest at least 25% of their board fees in our common stock. These stock investments can be made either through deferred fees or through the purchase of shares through the Dividend Reinvestment Plan. Deferred fees, under the Directors Plan, are converted on a quarterly basis into shares of our common stock based on the fair value of a share of common stock as of the relevant valuation date. Stock credited to a participant’s account is eligible for stock and cash dividends as declared. Dividend Reinvestment Plan shares are purchased on a monthly basis pursuant to the Dividend Reinvestment Plan.

Distribution of deferred fees from the Directors Plan occurs when the participant retires from the Board or upon the occurrence of certain other events. The participant is eligible to receive a lump-sum, in-kind, distribution of all of the stock that is then in his or her account, and any unconverted cash will be converted to and rounded up to whole shares of stock and distributed, as well. The Directors Plan does not allow for cash settlement, and therefore, such share-based payment awards qualify for classification as equity. We may use authorized but unissued shares or purchase shares of common stock on the open market to meet our obligations under the Directors Plan.

We maintain the Rabbi Trust to fund the Directors Plan. The Rabbi Trust is an irrevocable grantor trust to which we may contribute assets for the limited purpose of funding a nonqualified deferred compensation plan. Although we may not reach the

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assets of the Rabbi Trust for any purpose other than meeting our obligations under the Directors Plan, the assets of the Rabbi Trust remain subject to the claims of our creditors and are included in the consolidated financial statements. We may contribute cash or common stock to the Rabbi Trust from time-to-time for the sole purpose of funding the Directors Plan. The Rabbi Trust will use any cash that we contributed to purchase shares of our common stock on the open market through our brokerage services department. Shares held in the Rabbi Trust are included in the calculation of earnings per share.

The components of shares eligible to be issued under the Directors Plan were as follows as of December 31:

	2017		2016	
	Eligible Shares	Market Value	Eligible Shares	Market Value
Unissued	195,140	$5,513	187,428	$5,220
Shares held in Rabbi Trust	31,769	897	26,042	725
Total	226,909	$6,410	213,470	$5,945

Other Employee Benefit Plans

We maintain three nonqualified defined contribution retirement plans to provide supplemental retirement benefits to specified participants. Expenses related to these programs for 2017, 2016 and 2015 were $392, $430, and $379, respectively, and are being recognized over the participants' expected years of service.

We maintain a non-leveraged ESOP which was frozen to new participants on December 31, 2006. Contributions to the plan are discretionary and are approved by the Board of Directors and recorded as compensation expense. We made no contributions to the ESOP in 2017, 2016 and 2015. Compensation cost related to the plan for 2017, 2016 and 2015 was $23, $33, and $32, respectively. Total allocated shares outstanding related to the ESOP at December 31, 2017, 2016, and 2015 were 166,833, 204,669, and 217,064, respectively. Such shares are included in the computation of dividends and earnings per share in each of the respective years. On December 21, 2016, the Board approved the termination of the ESOP effective December 31, 2016. Actual dissolution of the ESOP is anticipated to occur in mid-2018.

We maintain a self-funded medical plan under which we are responsible for the first $75 per year of claims made by a covered family. Expenses are accrued based on estimates of the aggregate liability for claims incurred and our experience. Expenses were $2,324 in 2017, $2,150 in 2016 and $1,695 in 2015.

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Note 18 – Accumulated Other Comprehensive Income (Loss)

AOCI includes net income as well as unrealized gains and losses, net of tax, on AFS investment securities owned and changes in the funded status of our defined benefit pension plan, which are excluded from net income. Unrealized AFS securities gains and losses and changes in the funded status of the pension plan, net of tax, are excluded from net income, and are reflected as a direct charge or credit to shareholders' equity. Comprehensive income (loss) and the related components are disclosed in the consolidated statements of comprehensive income.

The following table summarizes the changes in AOCI by component for the years ended December 31 (net of tax):

	Unrealized Holding Gains (Losses) on AFS Securities	Unrealized Gains (Losses) on Derivative Instruments	Change in Unrecognized Pension Cost on Defined Benefit Pension Plan	Total
Balance, January 1, 2015	$ 3,302	$ —	$ (3,808)	$(506)
OCI before reclassifications	310	—	255	565
Amounts reclassified from AOCI	(163)	—	492	329
Subtotal	147	—	747	894
Tax effect	87	—	(254)	(167)
OCI, net of tax	234	—	493	727
Balance, December 31, 2015	3,536	—	(3,315)	221
OCI before reclassifications	(5,865)	248	282	(5,335)
Amounts reclassified from AOCI	525	—	238	763
Subtotal	(5,340)	248	520	(4,572)
Tax effect	1,834	(84)	(177)	1,573
OCI, net of tax	(3,506)	164	343	(2,999)
Balance, December 31, 2016	30	164	(2,972)	(2,778)
OCI before reclassifications	289	43	11	343
Amounts reclassified from AOCI	(142)	—	412	270
Subtotal	147	43	423	613
Tax effect	89	(15)	(144)	(70)
OCI, net of tax	236	28	279	543
One-time non-cash tax rate adjustment due to the Tax Act	125	38	(530)	(367)
Balance, December 31, 2017	$ 391	$ 230	$ (3,223)	$(2,602)

Included in OCI for the years ended December 31, 2017 and 2016 are changes in unrealized holding gains and losses related to auction rate money market preferred and preferred stocks. For federal income tax purposes, these securities are considered equity investments. As such, no deferred federal income taxes related to unrealized holding gains or losses are expected or recorded.

In accordance with the Tax Act, the effect of income tax law changes on deferred taxes also applies to items recognized in other comprehensive income. In January 2018, FASB issued ASU 2018-02 which allowed for the "stranded" tax effects in AOCI to be reclassified to retained earnings rather than income tax expense. We early adopted this guidance and applied this accounting alternative in our consolidated statements of changes in shareholders equity as of December 31, 2017.

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A summary of the components of unrealized holding gains on AFS securities included in OCI follows for the years ended December 31:

	2017 Auction Rate Money Market Preferred and Preferred Stocks	2017 All Other AFS Securities	2017 Total	2016 Auction Rate Money Market Preferred and Preferred Stocks	2016 All Other AFS Securities	2016 Total	2015 Auction Rate Money Market Preferred and Preferred Stocks	2015 All Other AFS securities	2015 Total
Unrealized gains (losses) arising during the period	$407	$ (118)	$289	$54	$(5,919)	$(5,865)	$406	$ (96)	$310
Reclassification adjustment for net realized (gains) losses included in net income	—	(142)	(142)	—	(245)	(245)	—	(163)	(163)
Reclassification adjustment for impairment loss included in net income	—	—	—	—	770	770	—	—	—
Net unrealized gains (losses)	407	(260)	147	54	(5,394)	(5,340)	406	(259)	147
Tax effect	—	89	89	—	1,834	1,834	—	87	87
Unrealized gains (losses), net of tax	$407	$ (171)	$236	$54	$(3,560)	$(3,506)	$406	$ (172)	$234

The following table details reclassification adjustments and the related affected line items in our consolidated statements of income for the years ended December 31:

Details about AOCI components	Amount Reclassified from AOCI 2017	2016	2015	Affected Line Item in the Consolidated Statements of Income
Unrealized holding gains (losses) on AFS securities				
	$142	$245	$163	Net gains on sale of AFS securities
	—	(770)	—	Other noninterest expenses
	142	(525)	163	Income before federal income tax expense
	48	(179)	55	Federal income tax expense (benefit)
	$94	$(346)	$108	Net income
Change in unrecognized pension cost on defined benefit pension plan				
	$412	$238	$492	Other noninterest expenses
	140	81	167	Federal income tax expense
	$272	$157	$325	Net income

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Note 19 – Related Party Transactions

In the ordinary course of business, we grant loans to principal officers and directors and their affiliates (including their families and companies in which they have 10% or more ownership). Annual activity consisted of the following for the years ended December 31:

	2017	2016
Balance, January 1	$3,946	$4,021
New loans	3,895	1,097
Repayments	(3,506)	(1,172)
Balance, December 31	$4,335	$3,946

Total deposits of these principal officers and directors and their affiliates amounted to $5,671 and $5,770 at December 31, 2017 and 2016, respectively. In addition, the ESOP held deposits with the Bank aggregating $266 and $290, respectively, at December 31, 2017 and 2016.

From time-to-time, we make charitable donations to The Isabella Bank Foundation (the "Foundation"), which is a non-controlled nonprofit organization formed for the purpose of distributing charitable donations to recipient organizations generally located in the communities we service. Our donations are expensed when committed to the Foundation. The assets and transactions of the Foundation are not included in our consolidated financial statements. Assets of the Foundation include cash and cash equivalents, certificates of deposit, and shares of Isabella Bank Corporation common stock. The Foundation owned 44,350 shares of our common stock as of December 31, 2017 and 2016. Such shares are included in the computation of dividends and earnings per share.

The following table displays total asset balances of, and our donations to, the Foundation as of, and for the years ended, December 31:

	2017	2016	2015
Total assets	$2,162	$2,213	$2,435
Donations	$—	$—	$258

Note 20 – Fair Value

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

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

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

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

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

We do not record loans at fair value on a recurring basis. However, from time-to-time, loans are classified as impaired and a specific allowance for loan losses may be established. Loans for which it is probable that payment of interest and principal will be significantly different than the contractual terms of the original loan agreement are considered impaired. Once a loan is

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identified as impaired, we measure the estimated impairment. The fair value of impaired loans is estimated using one of several methods, including the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral, less costs to sell, if the loan is collateral dependent. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans.
We review the net realizable values of the underlying collateral for collateral dependent impaired loans on at least a quarterly basis for all loan types. To determine the collateral value, we utilize independent appraisals, broker price opinions, or internal evaluations. We review these valuations to determine whether an additional discount should be applied given the age of market information that may have been considered as well as other factors such as costs to sell an asset if it is determined that the collateral will be liquidated in connection with the ultimate settlement of the loan. We use these valuations to determine if any specific reserves or charge-offs are necessary. We may obtain new valuations in certain circumstances, including when there has been significant deterioration in the condition of the collateral, if the foreclosure process has begun, or if the existing valuation is deemed to be outdated.
The following tables list the quantitative fair value information about impaired loans as of December 31:

	2017		
Valuation Technique	Fair Value	Unobservable Input	Range
		Discount applied to collateral:	
		Real Estate	20% - 30%
		Equipment	20% - 35%
		Cash crop inventory	30% - 40%
Discounted value	$15,956	Livestock	30%
		Other inventory	50% - 75%
		Accounts receivable	50%
		Liquor license	75%
		Furniture, fixtures & equipment	35% - 45%

	2016		
Valuation Technique	Fair Value	Unobservable Input	Range
		Discount applied to collateral:	
		Real Estate	20% - 30%
Discounted value	$9,166	Equipment	20% - 45%
		Cash crop inventory	30% - 40%
		Liquor license	75%
		Furniture, fixtures & equipment	45%

Collateral discount rates may have ranges to accommodate differences in the age of the independent appraisal, broker price opinion, or internal evaluation.
Accrued interest receivable: The carrying amounts of accrued interest receivable approximate fair value. As such, we classify accrued interest receivable as Level 1.
Equity securities without readily determinable fair values: Included in equity securities without readily determinable fair values are FHLB stock and FRB stock as well as our minority ownership interest in Corporate Settlement Solutions, LLC. The investment in Corporate Settlement Solutions, LLC, a title insurance agency, was made in the first quarter 2008 and we account for our investment under the equity method of accounting.
The lack of an active market, or other independent sources to validate fair value estimates coupled with the impact of future capital calls and transfer restrictions, is an inherent limitation in the valuation process. As the fair values of these investments are not readily determinable, they are not disclosed under a specific fair value hierarchy; however, they are reviewed quarterly for impairment. If we were to record an impairment adjustment related to these securities, it would be classified as a nonrecurring Level 3 fair value adjustment. During 2017 and 2016, there were no impairments recorded on equity securities without readily determinable fair values.

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

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

	December 31, 2017		
Valuation Technique	Fair Value	Unobservable Input	Range
Discounted value	$291	Discount applied to collateral: Real Estate	20% - 30%

	December 31, 2016		
Valuation Technique	Fair Value	Unobservable Input	Range
Discounted value	$231	Discount applied to collateral: Real Estate	20% - 30%

Collateral discount rates may have ranges to accommodate differences in the age of the independent appraisal, broker price opinion, or internal evaluations.

Goodwill and other intangible assets: Acquisition intangibles and goodwill are evaluated for potential impairment on at least an annual basis. Acquisition intangibles and goodwill are typically qualitatively evaluated to determine if it is more likely than not that the carrying balance is impaired. If it is determined that the carrying balance of acquisition intangibles or goodwill is more likely than not to be impaired, we perform a cash flow valuation to determine the extent of the potential impairment. If the testing resulted in impairment, we would classify goodwill and other acquisition intangibles subjected to nonrecurring fair value adjustments as Level 3. During 2017 and 2016, there were no impairments recorded on goodwill and other acquisition intangibles.

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

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

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

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

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

Commitments to extend credit, standby letters of credit, and undisbursed loans: Our commitments to extend credit, standby letters of credit, and undisbursed funds have no carrying amount and are estimated to have no realizable fair

value.

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Historically, a majority of the unused commitments to extend credit have not been drawn upon and, generally, we do not receive fees in connection with these commitments other than standby letter of credit fees, which are not significant.

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

Estimated Fair Values of Financial Instruments Not Recorded at Fair Value in their Entirety on a Recurring Basis

Disclosure of the estimated fair values of financial instruments, which differ from carrying values, often requires the use of estimates. In cases where quoted market values in an active market are not available, we use present value techniques and other valuation methods to estimate the fair values of our financial instruments. These valuation methods require considerable judgment and the resulting estimates of fair value can be significantly affected by the assumptions made and methods used.

The carrying amount and estimated fair value of financial instruments not recorded at fair value in their entirety on a recurring basis were as follows as of December 31:

	2017				
	Carrying Value	Estimated Fair Value	Level 1	Level 2	Level 3
ASSETS					
Cash and cash equivalents	$30,848	$ 30,848	$30,848	$ —	$ —
Mortgage loans AFS	1,560	1,587	—	1,587	—
Gross loans	1,091,519	1,056,906	—	—	1,056,906
Less allowance for loan and lease losses	7,700	7,700	—	—	7,700
Net loans	1,083,819	1,049,206	—	—	1,049,206
Accrued interest receivable	7,063	7,063	7,063	—	—
Equity securities without readily determinable fair values (1)	23,454	N/A	—	—	—
OMSR	2,409	2,409	—	2,409	—
LIABILITIES					
Deposits without stated maturities	811,992	811,992	811,992	—	—
Deposits with stated maturities	453,266	443,892	—	443,892	—
Borrowed funds	344,878	342,089	—	342,089	—
Accrued interest payable	680	680	680	—	—

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	2016				
	Carrying Value	Estimated Fair Value	Level 1	Level 2	Level 3
ASSETS					
Cash and cash equivalents	$22,894	$ 22,894	$22,894	$ —	$ —
Mortgage loans AFS	1,816	1,836	—	1,836	—
Gross loans	1,010,615	991,009	—	—	991,009
Less allowance for loan and lease losses	7,400	7,400	—	—	7,400
Net loans	1,003,215	983,609	—	—	983,609
Accrued interest receivable	6,580	6,580	6,580	—	—
Equity securities without readily determinable fair values (1)	21,694	N/A	—	—	—
OMSR	2,306	2,306	—	2,306	—
LIABILITIES					
Deposits without stated maturities	761,626	761,626	761,626	—	—
Deposits with stated maturities	433,414	430,088	—	430,088	—
Borrowed funds	337,694	336,975	—	336,975	—
Accrued interest payable	574	574	574	—	—

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

Financial Instruments Recorded at Fair Value

The table below presents the recorded amount of assets and liabilities measured at fair value on December 31:

	2017				2016			
	Total	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3
Recurring items								
AFS securities								
Government-sponsored enterprises	$216	$—	$216	$—	$10,259	$—	$10,259	$—
States and political subdivisions	208,474	—	208,474	—	212,919	—	212,919	—
Auction rate money market preferred	3,049	—	3,049	—	2,794	—	2,794	—
Preferred stocks	3,577	3,577	—	—	3,425	3,425	—	—
Mortgage-backed securities	208,797	—	208,797	—	227,256	—	227,256	—
Collateralized mortgage obligations	128,194	—	128,194	—	101,443	—	101,443	—
Total AFS securities	552,307	3,577	548,730	—	558,096	3,425	554,671	—
Derivative instruments	291	—	291	—	248	—	248	—
Nonrecurring items								
Impaired loans (net of the ALLL)	15,956	—	—	15,956	9,166	—	—	9,166
Foreclosed assets	291	—	—	291	231	—	—	231
Total	$568,845	$3,577	$549,021	$16,247	$567,741	$3,425	$554,919	$9,397
Percent of assets and liabilities measured at fair value		0.63 %	96.52 %	2.85 %		0.60 %	97.74 %	1.66 %

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The following table provides a summary of the changes in fair value of assets and liabilities recorded at fair value, for which gains or losses were recognized through earnings on a nonrecurring basis, in the years ended December 31:

	2017	2016
Nonrecurring items		
Foreclosed assets	$(2)	$(10)

We had no assets or liabilities recorded at fair value with changes in fair value recognized through earnings, on a recurring basis, as of December 31, 2017.

Note 21 – Parent Company Only Financial Information

Condensed Balance Sheets

	December 31	
	2017	2016
ASSETS		
Cash on deposit at the Bank	$185	$1,297
AFS securities	—	251
Investments in subsidiary	145,962	138,549
Premises and equipment	1,950	1,991
Other assets	52,253	52,846
TOTAL ASSETS	$200,350	$194,934
LIABILITIES AND SHAREHOLDERS’ EQUITY		
Other liabilities	$5,445	$7,035
Shareholders' equity	194,905	187,899
TOTAL LIABILITIES AND SHAREHOLDERS’ EQUITY	$200,350	$194,934

Condensed Statements of Income

	Year Ended December 31		
	2017	2016	2015
Income			
Dividends from subsidiary	$9,600	$7,400	$8,000
Interest income	2	14	78
Management fee and other	6,463	6,574	6,331
Total income	16,065	13,988	14,409
Expenses			
Compensation and benefits	5,196	4,898	5,110
Occupancy and equipment	1,779	1,696	1,634
Audit and related fees	527	536	452
Other	2,566	2,120	2,160
Total expenses	10,068	9,250	9,356
Income before income tax benefit and equity in undistributed earnings of subsidiary	5,997	4,738	5,053
Federal income tax benefit	91	1,058	991
Income before equity in undistributed earnings of subsidiary	6,088	5,796	6,044
Undistributed earnings of subsidiary	7,149	8,003	9,086
Net income	$13,237	$13,799	$15,130

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Condensed Statements of Cash Flows

	Year Ended December 31		
	2017	2016	2015
Operating activities			
Net income	$13,237	$13,799	$15,130
Adjustments to reconcile net income to cash provided by operations			
Undistributed earnings of subsidiary	(7,149)	(8,003)	(9,086)
Undistributed earnings of equity securities without readily determinable fair values	40	791	(310)
Share-based payment awards under equity compensation plan	640	573	550
Depreciation	154	156	154
Deferred income tax expense (benefit)	792	147	131
Changes in operating assets and liabilities which provided (used) cash			
Other assets	42	(44)	506
Accrued interest and other liabilities	(1,590)	(2,669)	142
Net cash provided by (used in) operating activities	6,166	4,750	7,217
Investing activities			
Maturities, calls, principal payments, and sales of AFS securities	249	—	3,000
Purchases of premises and equipment	(113)	(133)	(186)
Net (advances to) repayments from subsidiary	—	—	300
Net cash provided by (used in) investing activities	136	(133)	3,114
Financing activities			
Net increase (decrease) in borrowed funds	—	—	(211)
Cash dividends paid on common stock	(7,990)	(7,645)	(7,273)
Proceeds from the issuance of common stock	6,177	5,023	5,201
Common stock repurchased	(5,181)	(4,440)	(4,590)
Common stock purchased for deferred compensation obligations	(420)	(383)	(368)
Net cash provided by (used in) financing activities	(7,414)	(7,445)	(7,241)
Increase (decrease) in cash and cash equivalents	(1,112)	(2,828)	3,090
Cash and cash equivalents at beginning of period	1,297	4,125	1,035
Cash and cash equivalents at end of period	$185	$1,297	$4,125

Note 22 – Operating Segments

Our reportable segments are based on legal entities that account for at least 10% of net operating results. The operations of the Bank as of December 31, 2017, 2016, and 2015 represent approximately 90% or more of our consolidated total assets and operating results. As such, no additional segment reporting is presented.

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Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure.
None.
Item 9A. Controls and Procedures.
DISCLOSURE CONTROLS AND PROCEDURES
We carried out an evaluation, under the supervision and with the participation of the Principal Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15(d)-15(e) under the Exchange Act) as of December 31, 2017, pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures as of December 31, 2017, were effective to ensure that information required to be disclosed in reports that we file or submit under the Exchange Act are recorded, processed, summarized and reported within the time periods specified in SEC rules and forms.
CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING
We also conducted an evaluation of internal control over financial reporting to determine whether any changes occurred during the quarter ended December 31, 2017, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Based on this evaluation, we have concluded that there have been no such changes during the quarter ended December 31, 2017.
Management’s Report on Internal Control Over Financial Reporting
We are responsible for the preparation and integrity of our published consolidated financial statements. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and, accordingly, include amounts based on judgments and estimates. We also prepared the other information included in the Annual Report on Form 10-K and are responsible for the accuracy and consistency with the consolidated financial statements.
We are responsible for establishing and maintaining a system of internal control over financial reporting, which is intended to provide reasonable assurance to our management and Board of Directors regarding the reliability of our consolidated financial statements. The system includes but is not limited to:

- A documented organizational structure and division of responsibility;
- Established policies and procedures, including a code of conduct to foster a strong ethical climate which is communicated throughout our Corporation;
- Internal auditors that monitor the operation of the internal control system and report findings and recommendations to management and the Audit Committee;
- Procedures for taking action in response to an internal audit finding or recommendation;
- Regular reviews of our consolidated financial statements by qualified individuals; and
- The careful selection, training and development of our people.

There are inherent limitations in the effectiveness of any system of internal control, including the possibility of human error and the circumvention or overriding of controls. Also, the effectiveness of an internal control system may change over time. We have implemented a system of internal control that was designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements for external purposes in accordance with generally accepted accounting principles.
We have assessed our internal control system in relation to criteria for effective internal control over financial reporting described in “Internal Control-Integrated Framework” issued by the Committee of Sponsoring Organizations (2013 framework) of the Treadway Commission.
Based upon these criteria, we believe that, as of December 31, 2017, our system of internal control over financial reporting was effective.
Our independent registered public accounting firm, Rehmann Robson LLC ("Rehmann"), has audited our 2017 consolidated financial statements and internal control over financial reporting as of December 31, 2017. Rehmann was given unrestricted access to all financial records and related data, including minutes of all meetings of stockholders, the Board of Directors and committees of the Board. Rehmann has issued an unqualified audit opinion on our 2017 consolidated financial statements as a result of the integrated audit and an unqualified opinion on the effectiveness of our internal controls as of December 31, 2017.

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Isabella Bank Corporation
By:
/s/ Jae A. Evans
Jae A. Evans
President, Chief Executive Officer
(Principal Executive Officer)
March 15, 2018

/s/ Neil M. McDonnell
Neil M. McDonnell
Chief Financial Officer
(Principal Financial Officer)
March 15, 2018
Item 9B. Other Information.
None.

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PART III

Item 10. Directors, Executive Officers and Corporate Governance.

For information concerning our directors and certain executive officers, see “Election of Directors” and “Section 16(a) Beneficial Ownership Reporting Compliance” in our Proxy Statement for the Annual Meeting of Shareholders to be held May 8, 2018 (“Proxy Statement”) which is incorporated herein by reference.

For Information concerning our Audit Committee financial experts, see “Committees of the Board of Directors and Meeting Attendance” in the Proxy Statement which is incorporated herein by reference.

We have adopted a Code of Business Conduct and Ethics that applies to our Chief Executive Officer and Chief Financial Officer. We shall provide to any person without charge upon request, a copy of our Code of Business Conduct and Ethics. Written requests should be sent to: Secretary, Isabella Bank Corporation, 401 North Main Street, Mount Pleasant, Michigan 48858.

Item 11. Executive Compensation.

For information concerning executive compensation, see “Executive Officers,” “Compensation Committee Report,” “Compensation Committee Interlocks and Insider Participation,” “Compensation Discussion and Analysis,” and “Remuneration of Directors” in the Proxy Statement which is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

For information concerning the security ownership of certain owners and management, see “Security Ownership of Certain Beneficial Owners and Management” in the Proxy Statement which is incorporated herein by reference.

Equity Compensation Plan Information

The following table provides information as of December 31, 2017, with respect to compensation plans under which our common shares are authorized for issuance to directors, officers or employees in exchange for consideration in the form of goods or services.

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants, and Rights (A)	Weighted Average Exercise Price of Outstanding Options, Warrants, and Rights (B)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (A)) (C)
Equity compensation plans approved by shareholders: None	—	—	—
Equity compensation plans not approved by shareholders (1) (2):			
Deferred director compensation plan	195,140	(1) (2)	(1) (2)
Total	195,140		

(1) Pursuant to the terms of the Directors Plan, our directors are required to invest at least 25% of their board fees in our common stock. These stock investments can be made either through deferred fees or through the purchase of shares through the Dividend Reinvestment Plan. Deferred fees, under the Directors Plan, are converted on a quarterly basis into stock units of our common stock based on the fair value of a share of common stock as of the relevant valuation date. Stock credited to a participant’s account is eligible for stock and cash dividends as declared. Dividend Reinvestment Plan shares are purchased on a monthly basis pursuant to the Dividend Reinvestment Plan.

Distribution of deferred fees from the Directors Plan occurs when the participant retires from the board or upon the occurrence of certain other events. The participant is eligible to receive a lump-sum, in-kind, distribution of all of the stock that is then in his or her account, and any unconverted cash will be converted to and rounded up to whole shares of stock and distributed, as well. The Directors Plan does not allow for cash settlement, and therefore, such share

based payment awards qualify for classification as equity. We may use authorized but unissued shares or purchase shares of common stock on the open market to meet our obligations under the Directors Plan. As of December 31, 2017, the Directors Plan had 226,909 shares eligible to be distributed under the Directors Plan.

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(2) The Rabbi Trust holds 31,769 shares for the benefit of participants pursuant to the Directors Plan. Accordingly, such shares are not included in the number of securities issuable in column (A) or the weighted average price calculation in column (B), nor are potential future contributions included in column (C).

Item 13. Certain Relationships and Related Transactions, and Director Independence.

For information, see “Indebtedness of and Transactions with Management” and “Election of Directors” in the Proxy Statement, which is incorporated herein by reference.

Item 14. Principal Accountant Fees and Services.

For information concerning our principal accountant fees and services see “Fees for Professional Services Provided by Rehmann Robson LLC” and “Pre-approval Policies and Procedures” in our Proxy Statement which is incorporated herein by reference.

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PART IV

Item 15. Exhibits and Financial Statement Schedules.

(a) (1) Financial Statements: The following documents are filed as part of Item 8 of this report:

Report of Independent Registered Public Accounting Firm
Consolidated Balance Sheets
Consolidated Statements of Changes in Shareholders' Equity
Consolidated Statements of Income
Consolidated Statements of Comprehensive Income (Loss)
Consolidated Statements of Cash Flows
Notes to Consolidated Financial Statements

(2) Financial Statement Schedules: All schedules are omitted because they are neither applicable nor required, or because the required information is included in the consolidated financial statements or related notes.

(3) See the exhibits listed below under Item 15(b):

(b) The following exhibits required by Item 601 of Regulation S-K are filed as part of this report:

3(a)	Amended Articles of Incorporation (1)
3(b)	Amendment to the Articles of Incorporation (2)
3(c)	Amendment to the Articles of Incorporation (3)
3(d)	Amendment to the Articles of Incorporation (4)
3(e)	Amendment to the Articles of Incorporation (8)
3(f)	Amended Bylaws (6)
3(g)	Amendment to Bylaws (7)
3(h)	Amendment to Bylaws (10)
3(i)	Amendment to Bylaws (11)
10(a)	Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors (9)*
10(b)	Amendment to Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors (12)*
10(c)	Isabella Bank Corporation Split Dollar Plan (13)*
10(d)	Isabella Bank Corporation Retirement Bonus Plan (9)*
10(e)	Isabella Bank Corporation Supplemental Executive Retirement Plan (14)*
10(f)	Isabella Bank Corporation Stock Award Incentive Plan (15)*
14	Code of Business Conduct and Ethics (5)
21	Subsidiaries of the Registrant
23	Consent of Rehmann Robson LLC, Independent Registered Public Accounting Firm
31(a)	Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002 by the Chief Executive Officer
31(b)	Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002 by the Chief Financial Officer
32	Section 1350 Certification of Chief Executive Officer and Chief Financial Officer
101.INS	XBRL Interactive Data File**
101.SCH	XBRL Interactive Data File**
101.CAL	XBRL Interactive Data File**
101.LAB	XBRL Interactive Data File**
101.PRE	XBRL Interactive Data File**
101.DEF	XBRL Interactive Data File**

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* Management Contract or Compensatory Plan or Arrangement.

** As provided by Rule 406T in Regulation S-T, this information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Exchange Act

(1) Previously filed as an Exhibit to the Isabella Bank Corporation Form 10-K, filed March 12, 1991, and incorporated herein by reference

(2) Previously filed as an Exhibit to the Isabella Bank Corporation Form 10-K, filed March 26, 1994, and incorporated herein by reference.

(3) Previously filed as an Exhibit to Isabella Bank Corporation Form 10-K, filed March 22, 2000, and incorporated herein by reference.

(4) Previously filed as an Exhibit to Isabella Bank Corporation Form 10-K, filed March 27, 2001, and incorporated herein by reference.

(5) Previously filed as an Exhibit to Isabella Bank Corporation Form 8-K, filed April 25, 2006, and incorporated herein by reference.

(6) Previously filed as an Exhibit to Isabella Bank Corporation Form 10-K, filed March 16, 2005, and incorporated herein by reference.

(7) Previously filed as an Exhibit to Isabella Bank Corporation Form 8-K, filed November 22, 2006, and incorporated herein by reference.

(8) Previously filed as an Exhibit to Isabella Bank Corporation Form 8-K, filed May 16, 2008, and incorporated herein by reference.

(9) Previously filed as an Exhibit to Isabella Bank Corporation Form 8-K, filed December 19, 2008, and incorporated herein by reference.

(10) Previously filed as an Exhibit to Isabella Bank Corporation Form 8-K, filed August 28, 2009, and incorporated herein by reference.

(11) Previously filed as an Exhibit to Isabella Bank Corporation Form 8-K, filed December 23, 2009, and incorporated herein by reference.

(12) Previously filed as an Exhibit to Isabella Bank Corporation Form 8-K, filed August 30, 2013, and incorporated herein by reference.

(13) Previously filed as an Exhibit to Isabella Bank Corporation Form 8-K, filed March 31, 2015, and incorporated herein by reference.

(14) Previously filed as an Exhibit to Isabella Bank Corporation Form 8-K, filed April 27, 2015, and incorporated herein by reference.

(15) Previously filed as an Exhibit to Isabella Bank Corporation Form 8-K, filed May 6, 2015, and incorporated herein by reference.

Item 16. Form 10-K Summary.

Not applicable.

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SIGNATURES

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

ISABELLA BANK CORPORATION
(Registrant)

By: /s/ Jae A. Evans   Date: March 15, 2018
Jae A. Evans
President, Chief Executive Officer
(Principal Executive Officer)

Pursuant to the requirements of the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

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Signatures	Capacity	Date
/s/ Dr. Jeffrey J. Barnes Dr. Jeffrey J. Barnes	Director	March 15, 2018
/s/ Richard J. Barz Richard J. Barz	Director	March 15, 2018
/s/ Jill Bourland Jill Bourland	Director	March 15, 2018
/s/ Jae A. Evans Jae A. Evans	President, Chief Executive Officer (Principal Executive Officer), and Director	March 15, 2018
/s/ G. Charles Hubscher G. Charles Hubscher	Director	March 15, 2018
/s/ Thomas L. Kleinhardt Thomas L. Kleinhardt	Director	March 15, 2018
/s/ Joseph LaFramboise Joseph LaFramboise	Director	March 15, 2018
/s/ David J. Maness David J. Maness	Director	March 15, 2018
/s/ W. Joseph Manifold W. Joseph Manifold	Director	March 15, 2018
/s/ Neil M. McDonnell Neil M. McDonnell	Chief Financial Officer (Principal Financial Officer)	March 15, 2018
/s/ W. Michael McGuire W. Michael McGuire	Director	March 15, 2018
/s/ Sarah R. Opperman Sarah R. Opperman	Director	March 15, 2018
/s/ Jerome Schwind Jerome Schwind	Isabella Bank President and Director	March 15, 2018
/s/ Rhonda S. Tudor Rhonda S. Tudor	Controller	March 15, 2018
/s/ Gregory V. Varner Gregory V. Varner	Director	March 15, 2018