

2016
Audited Financial
Statements

FNBH BANCORP INC



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INDEPENDENT AUDITOR'S REPORT

Board of Directors and Shareholders
FNBH Bancorp, Inc.
Howell, Michigan

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of FNBH Bancorp, Inc., which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for the years then ended, and the related notes to consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

(Continued)

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of FNBH Bancorp, Inc. as of December 31, 2016 and 2015, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

A handwritten signature in black ink that reads "Crowe Horwath LLP". The signature is written in a cursive, slightly stylized font.

Crowe Horwath LLP

Grand Rapids, Michigan
May 18, 2017

FNBH Bancorp, Inc.
Consolidated Balance Sheets

| | December 31, 2016 | December 31, 2015 |
|---|--------------------------------------|----------------------|
| | (in thousands, except share amounts) | |
| Assets | | |
| Cash and due from banks | \$ 16,693 | \$ 29,487 |
| Short term investments | 46 | 198 |
| Total cash and cash equivalents | 16,739 | 29,685 |
| Interest-bearing time deposits with other financial institutions | 941 | 941 |
| Investment securities: | | |
| Investment securities available for sale, at fair value | 142,275 | 141,522 |
| FHLBI and FRB stock, at cost | 1,445 | 1,065 |
| Total investment securities | 143,720 | 142,587 |
| Loans held for investment: | | |
| Commercial | 160,501 | 134,419 |
| Consumer | 30,155 | 23,272 |
| Real estate mortgage | 35,851 | 13,135 |
| Total loans held for investment | 226,507 | 170,826 |
| Less allowance for loan losses | (4,826) | (5,718) |
| Net loans held for investment | 221,681 | 165,108 |
| Premises and equipment, net | 6,836 | 7,161 |
| Other real estate owned, held for sale | 170 | 971 |
| Net deferred tax asset | 7,419 | - |
| Accrued interest receivable and other assets | 1,775 | 1,716 |
| Total assets | \$ 399,281 | \$ 348,169 |
| Liabilities and Shareholders' Equity | | |
| Liabilities | | |
| Deposits: | | |
| Demand (non-interest bearing) | \$ 127,239 | \$ 114,414 |
| NOW | 38,219 | 39,376 |
| Savings and money market | 109,973 | 98,370 |
| Time deposits | 56,634 | 60,906 |
| Total deposits | 332,065 | 313,066 |
| Other borrowings | 20,500 | - |
| Accrued interest payable and other liabilities | 1,565 | 1,070 |
| Total liabilities | 354,130 | 314,136 |
| Shareholders' Equity | | |
| Preferred stock, no par value | | |
| Series A - Authorized 10,000 shares; no shares issued and outstanding | - | - |
| Series B - Authorized 20,000 shares; no shares issued and outstanding | - | - |
| Common stock, no par value. Authorized 40,000,000 shares at both December 31, 2016 and 2015; 27,770,703 shares issued and outstanding at December 31, 2016 and 27,770,423 shares issued and outstanding at December 31, 2015 | | |
| | 25,530 | 25,490 |
| Retained earnings | 20,874 | 8,934 |
| Deferred directors' compensation | 143 | 183 |
| Accumulated other comprehensive loss | (1,396) | (574) |
| Total shareholders' equity | 45,151 | 34,033 |
| Total liabilities and shareholders' equity | \$ 399,281 | \$ 348,169 |

See accompanying notes to consolidated financial statements.

FNBH BANCORP, INC.
Consolidated Statements of Income

| | Year Ended December 31, | |
|--|--|------------|
| | 2016 | 2015 |
| | (in thousands, except per share and share amounts) | |
| Interest and dividend income: | | |
| Interest and fees on loans held for investment | \$ 9,413 | \$ 7,882 |
| Interest and dividends on investment securities: | | |
| Taxable | 2,667 | 2,368 |
| Tax-exempt | 18 | 33 |
| Interest on time deposits with other financial institutions | 21 | 10 |
| Interest on short term investments and due from banks | 48 | 8 |
| Total interest and dividend income | 12,167 | 10,301 |
| Interest expense on deposits and other borrowings | 533 | 550 |
| Net interest income | 11,634 | 9,751 |
| Provision (credit) for loan losses | (3,100) | (2,250) |
| Net interest income after provision (credit) for loan losses | 14,734 | 12,001 |
| Noninterest income: | | |
| Service charges and other fee income | 2,003 | 2,213 |
| Gain on sale of loans held for investment | 123 | - |
| Net gains on sales of investment securities available for sale | 84 | 4 |
| Other-than-temporary impairment loss on investment securities available for sale (no amount is recorded in other comprehensive loss) | (919) | - |
| Net gain (loss) on sales/write-downs of other real estate owned | (46) | 66 |
| Other | 22 | 51 |
| Total noninterest income | 1,267 | 2,334 |
| Noninterest expense: | | |
| Salaries and employee benefits | 5,932 | 5,722 |
| Net occupancy expense | 891 | 860 |
| Equipment expense | 365 | 335 |
| Professional and service fees | 1,125 | 1,382 |
| Loan collection and foreclosed property expenses | 159 | 229 |
| Computer service fees | 718 | 540 |
| Director fees | 303 | 108 |
| FDIC assessment fees | 116 | 436 |
| Insurance | 103 | 143 |
| Printing and supplies | 150 | 121 |
| Advertising and marketing expenses | 140 | 165 |
| Other | 1,111 | 826 |
| Total noninterest expense | 11,113 | 10,867 |
| Income before income tax expense (benefit) | 4,888 | 3,468 |
| Income tax expense (benefit) | (7,052) | 62 |
| Net income | \$ 11,940 | \$ 3,406 |
| Per share statistics: | | |
| Earnings per basic common share | \$ 0.43 | \$ 0.12 |
| Weighted-average common shares outstanding | 27,771,678 | 27,771,678 |

See accompanying notes to consolidated financial statements.

FNBH BANCORP, INC.
Consolidated Statements of Comprehensive Income

| | Year Ending December 31, | |
|---|--------------------------|----------|
| | 2016 | 2015 |
| | (in thousands) | |
| Net income | \$ 11,940 | \$ 3,406 |
| Other comprehensive loss: | | |
| Unrealized gains/losses on investment securities available for sale: | | |
| Net unrealized holding losses arising during the year | (2,082) | (513) |
| Reclassification adjustment for net gains included in net income (presented in net gains on sales of investment securities available for sale) | (84) | (4) |
| Reclassification adjustment for other-than-temporary impairment loss included in net income (presented in other-than-temporary impairment loss on investment securities available for sale) | 919 | - |
| Income tax benefit (includes \$284 and \$0 of income tax benefit related to reclassification adjustments included in income tax expense (benefit)) | 425 | - |
| Total other comprehensive loss, net of income tax benefit | (822) | (517) |
| Comprehensive income | \$ 11,118 | \$ 2,889 |

See accompanying notes to consolidated financial statements.

FNBH BANCORP, INC.
Consolidated Statements of Shareholders' Equity

| | Preferred Stock | Common Stock | Retained Earnings | Deferred Directors' Compensation | Accumulated Other Comprehensive Loss | Total Shareholders' Equity |
|--|--------------------|------------------|----------------------|--|---|----------------------------------|
| | (in thousands) | | | | | |
| Balances at January 1, 2015 | \$ - | \$ 25,449 | \$ 5,528 | \$ 224 | \$ (57) | 31,144 |
| Issued 280 shares for deferred directors' fees | - | 41 | - | (41) | - | - |
| Net income | - | - | 3,406 | - | - | 3,406 |
| Other comprehensive loss | - | - | - | - | (517) | (517) |
| Balances at December 31, 2015 | - | 25,490 | 8,934 | 183 | (574) | 34,033 |
| Issued 280 shares for deferred directors' fees | - | 40 | - | (40) | - | - |
| Net income | - | - | 11,940 | - | - | 11,940 |
| Other comprehensive loss | - | - | - | - | (822) | (822) |
| Balances at December 31, 2016 | <u>\$ -</u> | <u>\$ 25,530</u> | <u>\$ 20,874</u> | <u>\$ 143</u> | <u>\$ (1,396)</u> | <u>\$ 45,151</u> |

See accompanying notes to consolidated financial statements.

FNBH BANCORP, INC.
Consolidated Statements of Cash Flows

| | Year Ended December 31, | |
|---|-------------------------|-----------|
| | 2016 | 2015 |
| | (in thousands) | |
| Cash flows from operating activities: | | |
| Net income | \$ 11,940 | \$ 3,406 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision (credit) for loan losses | (3,100) | (2,250) |
| Depreciation and amortization | 469 | 481 |
| Deferred income tax expense and change in valuation allowance | (6,996) | - |
| Net amortization on investment securities available for sale | 1,464 | 1,511 |
| Net gain on sales of investment securities available for sale | (84) | (4) |
| Other-than-temporary impairment loss on investment securities available for sale | 919 | - |
| Gain on sale of loans held for investment | (123) | - |
| Net (gain) loss on sales/write-downs of other real estate owned | 46 | (66) |
| Change in assets and liabilities: | | |
| Accrued interest receivable and other assets | (81) | (73) |
| Accrued interest payable and other liabilities | 495 | (233) |
| Net cash provided by operating activities | 4,949 | 2,772 |
| Cash flows for investing activities: | | |
| Purchases of investment securities available for sale | (62,097) | (57,693) |
| Proceeds from sales of investment securities available for sale | 26,130 | 12,703 |
| Proceeds from maturities and calls of investment securities available for sale | 7,220 | 8,600 |
| Proceeds from principal paydowns on investment securities available for sale | 24,448 | 25,019 |
| (Purchase) redemption of FHLBI stock | (380) | 75 |
| Purchases of interest-bearing time deposits with other financial institutions | - | (941) |
| Proceeds from sales of other real estate owned | 854 | 745 |
| Net increase in loans held for investment (loans originated, net of principal payments) | (13,641) | (10,348) |
| Purchases of loans held for investment | (41,192) | - |
| Proceeds from sale of loans held for investment | 1,427 | - |
| Capital expenditures | (163) | (270) |
| Net cash used in investing activities | (57,394) | (22,110) |
| Cash flows from financing activities: | | |
| Net change in deposits | 18,999 | 22,687 |
| Net proceeds from other borrowings | 20,500 | - |
| Net cash provided by financing activities | 39,499 | 22,687 |
| Net change in cash and cash equivalents | (12,946) | 3,349 |
| Cash and cash equivalents at beginning of year | 29,685 | 26,336 |
| Cash and cash equivalents at end of year | \$ 16,739 | \$ 29,685 |
| Supplemental disclosures: | | |
| Interest paid | \$ 534 | \$ 557 |
| Loans held for investment transferred to other real estate owned | 56 | 396 |
| Cash paid for income taxes | - | 61 |

See accompanying notes to consolidated financial statements.

FNBH Bancorp, Inc.
Notes to Consolidated Financial Statements

1. Summary of Significant Accounting Policies

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions based on available information that affect the amounts reported in the consolidated financial statements and the disclosures provided, and actual results could differ.

Principles of Consolidation

The consolidated financial statements include the accounts of FNBH Bancorp, Inc. and its wholly owned subsidiaries, First National Bank in Howell (“the Bank”) and H.B. Realty Co. (herein collectively the “Corporation”). All significant intercompany balances and transactions have been eliminated in consolidation.

The Bank is a full-service bank offering a wide range of commercial and personal banking services. These services include checking accounts, savings accounts, certificates of deposit, commercial loans, real estate loans, consumer loans, collections, night depository, safe deposit box, and wealth management services. The Bank serves primarily five communities – Howell, Brighton, Green Oak Township, Hartland, and Fowlerville – all of which are located in Livingston County, Michigan. The Bank is not dependent upon any single industry or business for its banking opportunities.

H.B. Realty Co. was established to purchase land for a future branch site of the Bank and to hold title to other Bank real estate when it is considered prudent to do so.

The accounting and reporting policies of the Corporation conform to accounting principles generally accepted in the United States of America and to general practice within the banking industry. The following is a description of the more significant of these policies.

(a) *Cash and Cash Equivalents*

Cash and cash equivalents include cash on hand, due from banks and short-term investments (securities with maturities equal to or less than 90 days and federal funds sold). Cash flows are reported net for customer loan and deposit transactions, interest-bearing time deposits with other financial institutions and short-term borrowings with maturities of 90 days or less (“other borrowings”), as applicable.

(b) *Interest-Bearing Time Deposits with Other Financial Institutions*

Interest-bearing time deposits with other financial institutions are recorded at cost and are federally insured. Reported balances at December 31, 2016 are scheduled to mature in 2020.

(c) *Investment Securities*

The Bank classifies debt and equity investments as follows:

Investment securities the Bank may not hold until maturity are accounted for as available for sale and are stated at fair value, with unrealized gains and losses reported as a separate component of other comprehensive income (loss) until realized. Fair value measurement for investment securities available for sale is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as present value of future cash flows, adjusted for the security’s credit rating, prepayment assumptions and other factors such as credit loss assumptions. Interest income includes amortization or accretion of purchase premium or discount. Premiums and discounts are amortized or accreted using the level-yield method without anticipating prepayments, except for mortgage-backed securities and collateralized mortgage obligations where prepayments are anticipated. Realized gains or losses on the sale of investment securities available for sale are recorded on the trade date and determined using the specific identification method.

Investment securities available for sale are reviewed quarterly for possible other-than-temporary impairment (OTTI). Management’s evaluation considers various qualitative and quantitative factors regarding each investment category, including if investment securities were U.S. government issued, the credit rating on the securities, credit outlook, payment status and financial condition, the length of time a security has been in an unrealized loss position, the size of the unrealized loss position and other meaningful information. In addition, with respect to the Corporation’s non-government agency CMO security, management regularly completes a cash flow analysis with the assistance of a third party specialist. The analysis considers assumptions regarding voluntary prepayment speed, default rate, and loss severity using the CMO’s original yield as the discount rate.

For debt securities, the Corporation distinguishes between the credit and noncredit components of an OTTI event. The credit component of an OTTI charge is the difference between the present value of the cash flows expected to be collected and the amortized cost basis of the debt security. If the Corporation does not intend to sell the security and it is more likely than not that the Corporation will not have to sell the security before the anticipated recovery of the remaining amortized cost basis, the credit component of the OTTI charge is recognized in earnings and the remaining noncredit portion is reported in other comprehensive income (loss). If either of the above criteria is met, the entire difference between the amortized cost and fair value is recognized in earnings.

(d) *Federal Home Loan Bank of Indianapolis (“FHLBI”) and Federal Reserve Bank (“FRB”) Stock*

The Bank is a member of the Federal Home Loan Bank System of Indianapolis (“FHLBI”) and the Federal Reserve Bank (“FRB”) and is required to invest in capital stock of the FHLBI and the FRB. The amount of required investment in the FHLBI is based on the level of borrowings and other factors, and the Bank may invest in additional amounts. FHLBI stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on the ultimate recovery of par value. The amount of the required investment in the FRB is determined by the FRB and is carried at cost based on the Bank’s capital and surplus. Both cash and stock dividends on FHLBI and FRB stock are recorded in interest and dividends on investment securities in the consolidated statements of income.

(e) ***Loans Held for Investment (“Loans”)***

Loans are classified within loans held for investment when management has the intent and ability to hold the loan for the foreseeable future, or until maturity or payoff. The foreseeable future is a management judgment which is determined based upon the type of loan, business strategies, current market conditions, balance sheet management and liquidity needs. Management’s view of the foreseeable future may change based on changes in these conditions. When a decision is made to sell or securitize a loan that was not originated or initially acquired with the intent to sell or securitize, the loan is reclassified from loans held for investment into loans held for sale. Loans are classified as held for sale when management has the intent and ability to sell or securitize. Due to changing market conditions or other strategic initiatives, management’s intent with respect to the disposition of the loan may change, and accordingly, loans previously classified as held for sale may be reclassified into loans held for investment. Loans transferred between loans held for sale and loans held for investment classifications are recorded at the lower of cost or market at the date of transfer.

Loans held for investment are carried at the principal amount outstanding net of unamortized purchase premiums or discounts, deferred loan origination fees and costs, the allowance for loan losses, and fair value adjustments, if any.

Interest income on loans is accrued daily based on the outstanding principal balance. In general, for each loan class, the accrual of interest income is discontinued when a loan becomes 90 days past due and the borrower’s capacity to repay the loan and collateral values appear insufficient. However, loans may be placed on nonaccrual status regardless of whether or not such loans are considered past due if, in management’s judgement, the borrower is unable to meet payment obligations as they become due or as required by regulatory provisions. All interest accrued but not received for all loans placed on nonaccrual is reversed from interest income. Delinquency status for all loans is based on the actual number of days past due as required by the contractual terms of the loan agreement.

Loan origination fees and certain direct loan origination costs are deferred and recognized in interest income using the level-yield method without anticipating prepayments. Net unamortized deferred loan fees amounted to \$201,000 and \$179,000 at December 31, 2016 and 2015, respectively.

(f) ***Allowance for Loan Losses and Credit Commitments***

Some loans will not be repaid in full. Therefore, an allowance for loan losses is established based on management’s periodic evaluation of the loan portfolio and reflects an amount that, in management’s judgement, is adequate to absorb probable incurred credit losses in the existing portfolio. In evaluating the portfolio, management takes into consideration numerous factors, including current economic conditions, prior loan loss experience, nonperforming loan levels, the composition of the loan portfolio, and management’s evaluation of the collectability of specific loans, which includes analysis of the value of the underlying collateral or the present value of expected future cash flows. This overall evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. In addition, although management evaluates the adequacy of the allowance for loan losses based on information known to management at a given time, various regulatory agencies, based on the timing of their normal examination process, may require future additions to the allowance for loan losses.

The methodology for measuring the appropriate level of allowance for loan losses and related provision (credit) for loan losses for each portfolio segment relies on several key elements, which include specific allowances for loans considered impaired and general allowances for non-impaired loans, based on our internal loan grading system. General allocations, based primarily on historical trends, are provided for homogeneous groups or classes of loans with similar risk characteristics.

Loss factors are determined based on either actual loss history or migration analysis, by portfolio class and loan grade, and adjusted for significant qualitative and environmental factors that, in management’s judgement, affect the collectability of the portfolio at the analysis date. Migration analysis is used to determine loss factors for those portfolio classes containing a sufficient number and volume of loans (e.g., commercial, owner occupied, non-owner occupied, consumer home equity, residential mortgages and consumer loans) to generate loss rate information. For other portfolio classes, a rolling 12 quarter net loss history is used to compute historical loss experience, which may also be weighted to give emphasis to more recent quarters. However, in successive periods of either limited losses or net recoveries, look-back periods may be extended and/or current period weighting may be suspended to allow for inclusion of some representative estimate of probable credit losses to provide general allowance allocations.

In determining qualitative and environmental factor adjustments, especially in instances where current facts and circumstances have changed significantly enough to cause estimated credit losses to differ from historical loss experience, management considers both internal and external factors specific to each portfolio segment including, but not limited to, changes in lending policies and procedures, underwriting standards in effect when existing loans were originated, current economic conditions, and values for underlying collateral for collateral dependent loans, as examples.

Within each commercial portfolio segment, a general allowance allocation is assigned to non-impaired loans based on the internal risk grade and class of such loans, as primarily determined based on underlying collateral; and if real estate secured, the type of real estate. Each risk grade within a portfolio class is assigned a loss allocation factor, adjusted for qualitative and environmental factors, as deemed appropriate. The higher a risk grade, the greater the assigned loss allocation factor.

Groups of homogeneous noncommercial loans, such as mortgage - residential, home equity and home equity lines of credit, and consumer and other loans receive allowance allocations using loss rates determined by migration analysis, based on loan type rather than by risk grade. These allocations are adjusted for consideration of general economic and business conditions, credit quality and delinquency trends, collateral values, and recent loss experience for these similar pools of loans.

The Bank also maintains a reserve for losses on unfunded credit commitments and letters of credit to provide for the risk of loss inherent in these arrangements. The reserve is computed using the same methodology as that used to determine the allowance for loan losses. This reserve is reported as a liability in the consolidated balance sheets within accrued interest payable and other liabilities, while the corresponding provision for these losses is recorded in noninterest expense-other in the consolidated statements of income.

(g) Nonperforming Assets

Nonperforming assets are comprised of loans for which the accrual of interest has been discontinued, loans 90 days past due and still accruing, and other real estate owned, which has been acquired primarily through foreclosure and is awaiting disposition. Troubled debt restructured loans (TDRs) that are on accrual status and not past due 90 days or more are excluded from nonperforming loan totals.

Loans are generally placed on a nonaccrual status when principal or interest is past due 90 days or more and when, in the judgement of management, full collection of principal and interest is unlikely. At the time a loan is placed on nonaccrual status, interest previously accrued but not yet collected is charged against current interest income. Income on such loans is then recognized only to the extent that cash is received and where future collection of principal is probable. Payments on such loans are generally applied to the principal balance until qualifying to be returned to accrual status. Loans are considered for return to accrual status on an individual basis when interest and principal payments are current and future payments are reasonably assured.

TDRs represent loan modifications, including renewals, where concessions have been extended by the Bank due to financial difficulties experienced by the borrower. In addition, if the restructured loan is renewed at a market rate of interest and is structured consistent with normal lending practices, TDR classification may be removed. TDR loans may be considered for return to accrual status upon satisfaction of the timely, sustained performance requirements identified above and management's determination that future payments under the modified terms are reasonably assured.

The Bank considers a loan to be impaired when it is probable that it will be unable to collect all or part of amounts due according to the contractual terms of the loan agreement or the loan has been restructured and is classified as a troubled debt restructuring. Using an internal loan grading system, commercial purpose loans graded 7 and higher are individually evaluated for impairment if reported as nonaccrual and are greater than \$100,000 or part of an aggregate relationship exceeding \$100,000. Noncommercial purpose loans within the consumer real estate and consumer and other portfolio segments are subjected to impairment assessment upon certain triggering events such as delinquency, bankruptcy and restructuring, etc. Impairment is measured by comparing the Bank's recorded investment in the loan to the present value of expected future cash flows at the loan's effective interest rate, or, as a practical expedient, at the loan's observable market price, or the fair value of the collateral less costs to sell if the loan is collateral dependent. Interest income on impaired loans is accrued based on the principal amounts outstanding. The accrual of interest is generally discontinued when an impaired loan becomes 90 days past due.

All cash payments received on impaired nonaccrual loans are generally applied to the principal balance until qualifying to be returned to accrual status. Cash payments received on accruing impaired loans, including accruing TDRs are applied to principal and interest pursuant to the terms of the related loan agreement.

The Bank charges off all or part of loans when amounts are deemed to be uncollectible, although collection efforts may continue and future recoveries may occur. In general, when available information confirms that loans or portions thereof, other than collateral dependent loans, are uncollectible, such amounts are promptly charged-off against the allowance for loan losses. When an impaired loan is collateral dependent, any portion of the loan balance in excess of the fair value of the collateral (or fair value less cost to sell) is promptly charged-off against the allowance for loan losses.

(h) Other Real Estate Owned

Other real estate owned is recorded at the asset's estimated fair value, net of estimated disposal costs, at the time of foreclosure, establishing a new cost basis. Any write-downs at the time of foreclosure are charged to the allowance for loan losses. Expenses incurred in maintaining assets are recorded in loan collection and foreclosed property expenses in the consolidated statements of income. Any subsequent write-down to reflect a decline in fair value is recorded through a valuation allowance and a charge to net gain (loss) on sales/write-downs of other real estate owned in the consolidated statements of income.

(i) Transfers of Financial Assets

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Bank, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

(j) Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. Depreciation, computed on the straight-line method, is recorded over the estimated useful lives of the assets. Estimated useful lives range up to 40 years for buildings, up to 7 years for furniture and equipment and up to 15 years for land improvements. Leasehold improvements are generally depreciated over the shorter of the respective lease term or estimated useful life.

Premises and equipment are evaluated periodically for impairment when events or changes in circumstances indicate the carrying amount may not be recoverable. Impairment exists when the expected undiscounted future cash flows of a long-lived asset are less than its carrying value. In that event, the Bank recognizes a loss for the difference between the carrying amount and the estimated fair value of the asset based on a quoted market price, if applicable, or a discounted cash flow analysis. Impairment losses on premises and equipment are recorded in noninterest expense-other in the consolidated statements of income.

(k) Income Tax Expense (Benefit)

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the consolidated financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

A valuation allowance, if needed, reduces deferred tax assets to the expected amount more likely than not that is to be realized. Realization of the Corporation's deferred tax assets is primarily dependent upon the generation of a sufficient level of future taxable income.

In preparation of income tax returns, tax positions are taken based on interpretation of federal and state income tax laws for which the outcome is uncertain. Management reviews and evaluates the status of tax positions. There were no unrecognized tax benefits during 2016 or 2015. Interest or penalties related to unrecognized tax benefits would be recorded in income tax expense (benefit).

(l) Stock-Based Compensation

The Corporation has one legacy stock-based compensation plan which is described more fully in Note 13.

(m) Loan Commitments and Related Financial Instruments

Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded. Financial instruments with off-balance risk are disclosed more fully in Note 14.

(n) Fair Value of Financial Instruments

Fair values of financial instruments are estimated using market information and other assumptions (as more fully described in Note 18) and involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, assumptions and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or market conditions could significantly affect such estimates.

(o) Common Stock Repurchases

The Corporation records common stock repurchases at cost. A portion of the repurchase is charged to common stock based on the average per share dollar amount of stock outstanding, multiplied by the number of shares repurchased, with the remainder charged to retained earnings. Shares repurchased are retired. No common stock repurchases were made by the Corporation during 2016 or 2015.

(p) Comprehensive Income

Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains and losses on investment securities available for sale which is also recognized as a separate component of shareholders' equity.

(q) Earnings Per Basic Common Share

Earnings per basic common share is calculated by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the year.

(r) Loss Contingencies

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there now are such matters that will have a material effect on the consolidated financial statements.

(s) Reclassifications

Certain reclassifications in the prior years' consolidated financial statements have been made to conform to the current year presentation. Reclassifications had no effect on prior year net income or total shareholders' equity.

2. Investment Securities Available for Sale

Investment securities available for sale consist of the following:

| | Amortized Cost | Unrealized | | Fair Value |
|---|-------------------|---------------|-------------------|-------------------|
| | | Gains | Losses | |
| (in thousands) | | | | |
| December 31, 2016 | | | | |
| Mortgage-backed/CMO - residential | \$ 104,110 | \$ 91 | \$ (917) | \$ 103,284 |
| U.S. agency | 1,972 | 13 | (9) | 1,976 |
| Obligations of state and political subdivisions | 33,209 | 5 | (1,552) | 31,662 |
| Corporate bonds | 4,756 | 6 | (33) | 4,729 |
| Preferred stock ⁽¹⁾ | 49 | 575 | - | 624 |
| Total investment securities available for sale | <u>\$ 144,096</u> | <u>\$ 690</u> | <u>\$ (2,511)</u> | <u>\$ 142,275</u> |
| December 31, 2015 | | | | |
| Mortgage-backed/CMO - residential | \$ 124,966 | \$ 179 | \$ (1,000) | \$ 124,145 |
| U.S. agency | 7,924 | 30 | - | 7,954 |
| Obligations of state and political subdivisions | 4,892 | 20 | (13) | 4,899 |
| Corporate bonds | 4,265 | 6 | (19) | 4,252 |
| Preferred stock ⁽¹⁾ | 49 | 223 | - | 272 |
| Total investment securities available for sale | <u>\$ 142,096</u> | <u>\$ 458</u> | <u>\$ (1,032)</u> | <u>\$ 141,522</u> |

⁽¹⁾ Represents preferred stocks issued by Freddie Mac and Fannie Mae

Securities are reviewed quarterly for possible other-than-temporary impairment (OTTI) based on guidance included in ASC Topic 320, *Investments—Debt and Equity Instruments*. This guidance requires an entity to assess whether it intends to sell, or whether it is more likely than not that it will be

required to sell, a security in an unrealized loss position before the recovery of the security's amortized cost basis. If either of these criteria is met, the entire difference between the amortized cost and fair value is recognized in earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment recognized in earnings is limited to the amount related to credit losses, while impairment related to other factors is recognized in other comprehensive income (loss).

At December 31, 2016, an other-than-temporary-impairment charge of \$919,000, based on year-end fair values, was recognized on approximately \$43.4 million of available for sale mortgage-backed/CMO - residential investment securities which were identified for sale prior to December 31, 2016. These securities were sold in January 2017 to retire \$20.5 million of other borrowings and to provide funding for more attractive (i.e., higher yielding) loan and investment opportunities. Actual losses realized upon sale of these securities in January 2017 was approximately \$729,000 due to lower prevailing interest rates at the time of sale compared to rates at December 31, 2016. Accordingly, \$190,000 of gain on sales of investment securities available for sale was recognized in January 2017.

Management's review of the investment securities available for sale portfolio for the existence of OTTI considers various qualitative and quantitative factors regarding each investment category, including if the securities were U.S. government issued, the credit rating on the securities, credit outlook, payment status and financial condition, the length of time the security has been in an unrealized loss position, the size of the unrealized loss position and other meaningful information.

As of December 31, 2016, the Corporation's investment securities portfolio consisted of 142 securities, 97 of which were in an unrealized loss position.

At December 31, 2016, the Corporation held 28 mortgage-backed/CMO - residential securities and one U.S. Agency (SBIC) security in an unrealized loss position, all of which were issued by either Ginnie Mae, Fannie Mae, Freddie Mac or the SBA which are U.S. government-sponsored agencies that the government has affirmed its commitment to support. Additionally, the Corporation held 60 obligations of state and political subdivision securities and 8 corporate bonds in an unrealized loss position. Because the decline in the market value of these securities is attributable to changes in interest rates and illiquidity, and not credit quality and because the Corporation does not have the intent to sell these securities and it is likely that it will not be required to sell these securities before their anticipated recovery, the Corporation does not consider these securities to be other than temporarily impaired at December 31, 2016.

The Corporation makes a quarterly assessment of OTTI on its non-government agency collateralized mortgage obligation (CMO) security primarily based on a quarterly cash flow analysis performed by an independent third-party specialist. The evaluation includes a comparison of the present value of the expected cash flows to previous estimates to determine whether adverse changes in cash flows resulted during the period. The analysis considers attributes of the security, such as its super tranche position, and specific loan level collateral underlying the security. A summary of the par value, book value, carrying value (fair value) and unrealized loss for the security is presented below:

| | December 31, | | | |
|-----------------|------------------------|-----------------|---------------|-----------------|
| | 2016 | | 2015 | |
| | Amount | % of Par | Amount | % of Par |
| | (dollars in thousands) | | | |
| Par value | \$ 801 | 100.00% | \$ 1,054 | 100.00% |
| Book value | 638 | 79.65% | 941 | 89.28% |
| Carrying value | 683 | 85.27% | 969 | 91.94% |
| Unrealized loss | - | 0.00% | - | 0.00% |

Certain key attributes of the underlying loans supporting the security included the following:

| | December 31, | |
|--|---------------------|-------------|
| | 2016 | 2015 |
| Weighted average remaining credit score (based on original FICO) | 735 | 736 |
| Primary location of underlying loans: | | |
| California | 69% | 71% |
| Other | 31% | 29% |
| Delinquency status of underlying loans: | | |
| Past due 30-59 days | 0.67% | 3.53% |
| Past due 60-89 days | 0.00% | 0.00% |
| Past due 90 days or more | 1.36% | 2.04% |
| In process of foreclosure | 10.23% | 10.24% |
| Held as other real estate owned | 0.00% | 0.00% |

The specialist calculates an estimate of the fair value of the security's cash flows using an INTEX valuation model, subject to certain assumptions regarding collateral related cash flows such as expected prepayment rates, default rates, loss severity estimates, and discount rates as key valuation inputs.

| | December 31, | |
|---|---------------------|-------------|
| | 2016 | 2015 |
| Voluntary repayment rate (CRR) | 14.05% | 11.90% |
| Default rates: | | |
| Within next 24 months | 6.90% | 7.18% |
| Decreasing to (by month 37) | 1.78% | 3.41% |
| Decreasing to (by month 176 at December 31, 2016 and by month 188 at December 31, 2015) | 0.00% | 0.00% |
| Loss severity rates: | | |
| Initial loss upon default (Year 1) | 47.00% | 43.50% |
| Per annum decrease (Years 2 - 11) | 3.00% | 3.50% |
| Floor (Year 12) | 23.00% | 23.00% |
| Discount rate ⁽¹⁾ : | 7.25% | 6.00% |
| Remaining credit support provided by other collateral pools of underlying loans within the security: | 0.01% | 0.03% |

⁽¹⁾ Intended to reflect estimated uncertainty and liquidity premiums, after adjustment for estimated credit loss cash flows.

The prepayment assumptions used within the model consider borrowers' incentive to prepay based on market interest rates and borrowers' ability to prepay based on underlying assumptions for borrowers' ability to qualify for a new loan based on their credit and appraised property value, by location. As such, prepayment speeds decrease as credit quality and home prices deteriorate, reflecting a diminished ability to refinance.

In addition, collateral cash flow assumptions utilize a valuation technique under a "Liquidation Scenario" whereby loans are evaluated by delinquency and are assigned probability of default and loss factors deemed appropriate in the current economic environment. The liquidation scenarios assume that all loans 60 or more days past due migrate to default, are liquidated, and losses are realized over a period of between six and twenty four months based in part upon initial loan to value ratios and estimated changes in both historical and future property values since origination as obtained from financial data sources.

At December 31, 2016 and 2015, based on a present value at a prospective yield of future cash flows for the investment as provided by the specialist and after management's evaluation of the reasonableness of the specialist's underlying assumptions regarding Level 2 and Level 3 inputs, the Corporation concluded that the security's expected cash flows continued to support the amortized cost of the security and no additional other-than-temporary impairment had been incurred. Approximately \$290,000 of cumulative credit-loss OTTI charges have been incurred on the security, but none during either 2016 or 2015.

The following is a summary of the gross unrealized losses and fair value of investment securities available for sale by length of time that individual securities have been in a continuous loss position:

| | Less than 12 months | | 12 months or more | | Total | |
|---|----------------------------|------------------|--------------------------|------------------|----------------------|------------------|
| | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value |
| | (in thousands) | | | | | |
| December 31, 2016 | | | | | | |
| Mortgage-backed/CMO - residential | \$ (856) | \$ 53,951 | \$ (61) | \$ 2,078 | \$ (917) | \$ 56,029 |
| U.S. agency | (9) | 989 | - | - | (9) | 989 |
| Obligations of state and political subdivisions | (1,552) | 29,641 | - | - | (1,552) | 29,641 |
| Corporate bonds | (33) | 3,013 | - | - | (33) | 3,013 |
| Total | \$ (2,450) | \$ 87,594 | \$ (61) | \$ 2,078 | \$ (2,511) | \$ 89,672 |
| December 31, 2015 | | | | | | |
| Mortgage-backed/CMO - residential | \$ (440) | \$ 64,802 | \$ (560) | \$ 25,840 | \$ (1,000) | \$ 90,642 |
| Obligations of state and political subdivisions | (13) | 1,532 | - | - | (13) | 1,532 |
| Corporate bonds | (19) | 3,678 | - | - | (19) | 3,678 |
| Total | \$ (472) | \$ 70,012 | \$ (560) | \$ 25,840 | \$ (1,032) | \$ 95,852 |

The amortized cost and fair value of investment securities available for sale, by contractual maturity, follow. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | December 31, 2016 | | December 31, 2015 | |
|--|--------------------------|-------------------|--------------------------|-------------------|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| | (in thousands) | | | |
| Maturing after one year but within five years | \$ 7,990 | \$ 7,949 | \$ 12,120 | \$ 12,125 |
| Maturing after five years but within ten years | 30,973 | 29,512 | 4,436 | 4,448 |
| Maturing after ten years | 1,023 | 1,530 | 574 | 804 |
| | <u>\$ 39,986</u> | <u>\$ 38,991</u> | <u>\$ 17,130</u> | <u>\$ 17,377</u> |
| Mortgage-backed/CMO securities - residential | 104,110 | 103,284 | 124,966 | 124,145 |
| Total | <u>\$ 144,096</u> | <u>\$ 142,275</u> | <u>\$ 142,096</u> | <u>\$ 141,522</u> |

Proceeds from sales and calls of investment securities available for sale and the associated gains and losses are as follows:

| | 2016 | | 2015 | |
|--------------|----------------|-----------|-------------|--|
| | (in thousands) | | | |
| Proceeds | \$ 33,350 | \$ 21,053 | | |
| Gross gains | 110 | 8 | | |
| Gross losses | (26) | (4) | | |

At December 31, 2016 and 2015, the Corporation did not own any investment securities issued by states and political subdivisions in which the amortized cost and fair value of such securities individually exceeded 10% of shareholders' equity.

Investment securities, with an amortized cost of approximately \$62.2 million at December 31, 2016 were pledged to secure public deposits and for other purposes required or permitted by law, including approximately \$29.8 million of securities pledged as collateral at the Federal Home Loan Bank of Indianapolis (FHLBI) to support potential liquidity needs of the Bank. At December 31, 2015, the amortized cost of pledged investment securities totaled \$47.5 million of which \$14.4 million of securities were pledged as collateral at the FHLBI for contingent liquidity needs of the Bank.

The Bank owns stock in both the Federal Home Loan Bank of Indianapolis (FHLBI) and the Federal Reserve Bank (FRB), both of which are recorded at cost. The Bank is required to hold stock in the FHLBI equal to 5% of the institution's borrowing capacity with the FHLBI. The Bank's investment in FHLBI stock amounted to \$922,000 at December 31, 2016 and \$542,000 at December 31, 2015. The Bank's investment in FRB stock, which totaled \$523,000 at December 31, 2016 and December 31, 2015, is a requirement for the Bank's membership in the Federal Reserve System. These investments can only be resold to, or redeemed by, the issuer.

3. Loans Held for Investment

Loans held for investment consists of the following:

| | December 31, | |
|--|---------------------|-------------------|
| | 2016 | 2015 |
| | (in thousands) | |
| Commercial | \$ 21,755 | \$ 14,413 |
| Commercial real estate: | | |
| Construction, land development, and other land | 5,375 | 4,678 |
| Owner occupied | 51,151 | 49,949 |
| Nonowner occupied | 74,049 | 58,604 |
| Consumer real estate: | | |
| Commercial purpose | 8,478 | 6,931 |
| Mortgage - residential | 38,072 | 15,154 |
| Home equity and home equity lines of credit | 14,307 | 13,084 |
| Consumer and other | <u>13,521</u> | <u>8,192</u> |
| Subtotal | 226,708 | 171,005 |
| Net deferred fees | (201) | (179) |
| Total loans held for investment | <u>\$ 226,507</u> | <u>\$ 170,826</u> |

Included in the consumer real estate loans above are residential first mortgages reported as "real estate mortgages" in the consolidated balance sheets. In addition, a portion of these consumer real estate loans include commercial purpose loans where the borrower has pledged a 1-4 family residential property as collateral. Loans also include the reclassification of demand deposit overdrafts, which amounted to \$47,000 and \$60,000 at December 31, 2016 and 2015, respectively.

Loans serviced for others, including commercial participations sold, are not reported as assets of the Bank and approximated \$3.6 million at December 31, 2016 and \$1.4 million at December 31, 2015, respectively.

4. Allowance for Loan Losses and Credit Quality of Loans

The Corporation separates its loan portfolio into segments to perform the calculation and analysis of the allowance for loan losses. The four portfolio segments analyzed are Commercial, Commercial Real Estate, Consumer Real Estate, and Consumer and Other. The Commercial portfolio segment includes loans to finance commercial and industrial businesses that are not secured by real estate. A portion of such loans includes discounted equipment finance leases purchased from and originated by a leasing company known to the Bank. The Commercial Real Estate portfolio segment includes: i) construction real estate loans to finance construction and land development and/or loans secured by vacant land and ii) commercial real estate loans secured by non-farm, non-residential real estate which are further classified as either owner occupied or non-owner occupied based on the underlying collateral type. The Consumer Real Estate portfolio segment includes (commercial and non-commercial purpose) loans that are secured by 1 – 4 family residential real estate properties, including first mortgages on residential properties and home equity loans and lines of credit that are secured by first or second liens on residential properties. The Consumer and Other portfolio segment includes all loans not included in any other portfolio segments. These are primarily loans to consumers for household, family, and other personal expenditures, such as autos, boats, and recreational vehicles.

Activity in the allowance for loan losses by portfolio segment is as follows:

| | Commercial | Commercial Real Estate | Consumer Real Estate | Consumer and Other | Total |
|----------------------------|---------------|------------------------|----------------------|--------------------|-----------------|
| | | | (in thousands) | | |
| 2016 | | | | | |
| Allowance for loan losses: | | | | | |
| Beginning balance | \$ 339 | \$ 3,344 | \$ 1,451 | \$ 584 | \$ 5,718 |
| Charge offs | (29) | (10) | (21) | (62) | (122) |
| Recoveries | 449 | 1,249 | 600 | 32 | 2,330 |
| Provision (credit) | (253) | (2,094) | (778) | 25 | (3,100) |
| Ending balance | <u>\$ 506</u> | <u>\$ 2,489</u> | <u>\$ 1,252</u> | <u>\$ 579</u> | <u>\$ 4,826</u> |

| | | | | | |
|----------------------------|---------------|-----------------|-----------------|---------------|-----------------|
| 2015 | | | | | |
| Allowance for loan losses: | | | | | |
| Beginning balance | \$ 415 | \$ 5,371 | \$ 1,084 | \$ 239 | \$ 7,109 |
| Charge offs | - | - | (22) | (99) | (121) |
| Recoveries | 288 | 367 | 239 | 86 | 980 |
| Provision (credit) | (364) | (2,394) | 150 | 358 | (2,250) |
| Ending balance | <u>\$ 339</u> | <u>\$ 3,344</u> | <u>\$ 1,451</u> | <u>\$ 584</u> | <u>\$ 5,718</u> |

The following presents the balance in allowance for loan losses and loan balances by portfolio segment based on impairment method:

| | Commercial | Commercial Real Estate | Consumer Real Estate | Consumer and Other | Total |
|---------------------------------------|------------------|------------------------|----------------------|--------------------|-------------------|
| | | | (in thousands) | | |
| December 31, 2016 | | | | | |
| Allowance for loan losses: | | | | | |
| Individually evaluated for impairment | \$ - | \$ - | \$ - | \$ - | \$ - |
| Collectively evaluated for impairment | 506 | 2,489 | 1,252 | 579 | 4,826 |
| Total allowance for loan losses | <u>\$ 506</u> | <u>\$ 2,489</u> | <u>\$ 1,252</u> | <u>\$ 579</u> | <u>\$ 4,826</u> |
| Recorded investment in loans: | | | | | |
| Individually evaluated for impairment | \$ - | \$ 3,829 | \$ 47 | \$ - | \$ 3,876 |
| Collectively evaluated for impairment | 21,755 | 126,746 | 60,810 | 13,521 | 222,832 |
| Total recorded investment in loans | <u>\$ 21,755</u> | <u>\$ 130,575</u> | <u>\$ 60,857</u> | <u>\$ 13,521</u> | <u>\$ 226,708</u> |
| December 31, 2015 | | | | | |
| Allowance for loan losses: | | | | | |
| Individually evaluated for impairment | \$ - | \$ 201 | \$ - | \$ - | \$ 201 |
| Collectively evaluated for impairment | 339 | 3,143 | 1,451 | 584 | 5,517 |
| Total allowance for loan losses | <u>\$ 339</u> | <u>\$ 3,344</u> | <u>\$ 1,451</u> | <u>\$ 584</u> | <u>\$ 5,718</u> |
| Recorded investment in loans: | | | | | |
| Individually evaluated for impairment | \$ 55 | \$ 6,078 | \$ 133 | \$ - | \$ 6,266 |
| Collectively evaluated for impairment | 14,358 | 107,153 | 35,036 | 8,192 | 164,739 |
| Total recorded investment in loans | <u>\$ 14,413</u> | <u>\$ 113,231</u> | <u>\$ 35,169</u> | <u>\$ 8,192</u> | <u>\$ 171,005</u> |

Management's on-going monitoring of the credit quality of the loan portfolio relies on an extensive credit risk monitoring process that considers several factors including: current economic conditions affecting the Bank's customers, the payment performance of individual loans and pools of homogenous loans, portfolio seasoning, changes in collateral values, and detailed reviews of specific relationships.

Our internal loan grading system assigns a risk grade to all commercial, commercial real estate, and consumer real estate - commercial purpose loans ("commercial loans"). This grading system is similar to those employed by banking regulators. Grades 1 through 5 are considered "pass" credits and grade 6 are considered "special mention" credits and are subject to greater scrutiny. Those loans graded 7 and higher are considered "substandard" and are individually evaluated for impairment if reported as nonaccrual and are greater than \$100,000 or part of an aggregate relationship exceeding \$100,000. All commercial loans are graded at inception and reviewed, and if appropriate, re-graded at various intervals thereafter. Additionally, our commercial loan portfolio and assigned risk grades are periodically subjected to review by external loan reviewers and banking regulators. Certain of the key factors considered in assigning loan grades include: cash flows, operating performance, financial condition, collateral, industry condition, management, and the strength, liquidity and willingness of guarantors' support.

A description of the general characteristics of each risk grade follows:

- **RATING 1 (Satisfactory – Minimal Risk)** - Loans in this category are to persons or entities of unquestioned financial strength, a highly liquid financial position, with collateral that is liquid and well margined. These borrowers have performed without question on past obligations, and the Bank expects their performance to continue. Internally generated cash flow covers current maturities of long-term debt by a substantial margin.
- **RATING 2 (Satisfactory – Modest Risk)** – These loans to persons or entities with strong financial condition and above-average liquidity who have previously satisfactorily handled their obligations with the Bank. Collateral securing the Bank's debt is margined in accordance with policy guidelines. Internally generated cash flow covers current maturities of long-term debt more than adequately.
- **RATING 3 (Satisfactory - Average)** – These are loans with average cash flow and ratios compared to peers. Usually industry peer data comparisons show where companies fall in the performance spectrum. These companies have consistent performance for 3 or more years.
- **RATING 4 (Satisfactory – Acceptable Risk)** – Loans to persons or entities with an average financial condition, adequate collateral margins, adequate cash flow to service long-term debt, and net worth comprised mainly of fixed assets are included in this category. These entities are minimally profitable now, with projections indicating continued profitability into the foreseeable future. Overall, these loans are basically sound.
- **RATING 5 (Satisfactory - Acceptable – Monitor)** - These loans are characterized by borrowers who have marginal, but adequate cash flow, marginal profitability, but currently have been meeting the obligations of their loan structure. However, adverse changes in the borrower's circumstances and/ or current economic conditions are more likely to impair their capacity for repayment. The borrower has in the past satisfactorily handled debts with the Bank, but may be experiencing some minor delinquency in making payments, or other signs of temporary cash flow issues. Borrower may be experiencing declining margins or other negative financial trends, despite the borrower's continued satisfactory condition and positive cash flow. Other characteristics of borrowers in this class include inadequate credit information, weakness of financial statements, or declining but positive repayment capacity. This classification includes loans to new or established borrowers with satisfactory loan structure, but where near term economic or business issues appears to remain stable and the near term projections would limit the ability for an improvement in the financial trends of the borrower.
- **RATING 6 (Special Mention - OAEM)** - Loans in this class have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Bank's credit position at some future date. These potential weaknesses may result in a deterioration of the repayment of the loan and increase the credit risk. Special mention assets are not adversely classified and do not expose the Bank to sufficient risk to warrant adverse classification. Special mention credits may include a borrower that pays the Bank on a timely basis (occasional 30 day delinquent) and may be experiencing temporary cash flow deficiencies.
- **RATING 7 (Substandard)** – A substandard loan is inadequately protected by the current net worth and paying capacity of the borrower or of the collateral pledged, if any. Loans so classified must have a well-defined weakness, or weaknesses, that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard loans, does not have to exist in individual loans. Substandard credits may include a borrower that pays consistently past due, has significant cash flow shortages and may have a collateral shortfall that requires a specific reserve.
- **RATING 8 (Doubtful)** - This risk rating class has all of the weaknesses inherent in the substandard rating but with the added characteristic that the weaknesses make collection in full or liquidation, on the basis of currently known existing facts, condition, and values, highly questionable and improbable. These are poor quality loans in which neither the collateral, if any, nor the financial condition of the borrower presently ensure collectability in full within a reasonable period of time; in fact, there is permanent impairment in the collateral securing the Bank's loan. These loans are in a work-out status, are on non-accrual status and have a defined work-out strategy.

This is a transitional risk rating class while collateral value and other factors are assessed. Loans will remain in this class for the assessment period, but in no event for more than one year. If there is no improvement in the Bank's position during that time, a charge-off will be taken to best reflect known asset collateral value. If the loan goes into a "Deeds in Redemption" status before one year, any shortfall will be charged-off immediately.

The assessment of compensating factors may result in a rating plus or minus one grade from those listed above. These factors include, but are not limited to collateral, guarantors, environmental conditions, history, plan/projection reasonableness, quality of information, and payment delinquency.

The internal loan grading system is applied to the residential real estate portion of our consumer loan portfolio upon certain triggering events (e.g., delinquency, bankruptcy, restructuring, etc.). However, large groups of smaller balance homogeneous loans, such as mortgage – residential, home

equity and home equity lines of credit and consumer and other are collectively evaluated for impairment and are not separately identified for impairment disclosures. The primary risk element for these classes of loans is the timeliness of borrowers' scheduled payments. We rely primarily on our internal reporting system to monitor past due loans and have internal policies and procedures to pursue collection and protect our collateral interests in order to mitigate losses.

Our monitoring of credit quality is further denoted by classification of loans as nonperforming, which reflects loans where the accrual of interest has been discontinued and loans that are past due 90 days or more and still accruing interest. Nonperforming loans include troubled debt restructured loans (as discussed below) that are on nonaccrual status or past due 90 days or more. Troubled debt restructured loans that are accruing interest and not past due 90 days or more are excluded from nonperforming loans.

The following presents the recorded investment in loans by risk grade and a summary of nonperforming loans, by class of loan:

| | Pass | Special Mention | Substandard | Total | Nonperforming |
|--|-------------------|-----------------|-----------------|-------------------|-----------------|
| | (in thousands) | | | | |
| December 31, 2016 | | | | | |
| Commercial | \$ 21,755 | \$ - | \$ - | \$ 21,755 | \$ - |
| Commercial real estate: | | | | | |
| Construction, land development, and other land | 5,167 | 9 | 199 | 5,375 | 199 |
| Owner occupied | 50,163 | 454 | 534 | 51,151 | 500 |
| Nonowner occupied | 71,107 | 2,827 | 115 | 74,049 | 115 |
| Consumer real estate: | | | | | |
| Commercial purpose | 8,431 | - | 47 | 8,478 | 47 |
| Mortgage - residential | 36,989 | - | 1,083 | 38,072 | 1,026 |
| Home equity and home equity lines of credit | 14,112 | - | 195 | 14,307 | 195 |
| Consumer and other | 13,500 | - | 21 | 13,521 | 21 |
| Total | <u>\$ 221,224</u> | <u>\$ 3,290</u> | <u>\$ 2,194</u> | <u>\$ 226,708</u> | <u>\$ 2,103</u> |

| | Pass | Special Mention | Substandard | Total | Nonperforming |
|--|-------------------|-----------------|-----------------|-------------------|-----------------|
| | (in thousands) | | | | |
| December 31, 2015 | | | | | |
| Commercial | \$ 14,342 | \$ 6 | \$ 65 | \$ 14,413 | \$ 62 |
| Commercial real estate: | | | | | |
| Construction, land development, and other land | 2,827 | 234 | 1,617 | 4,678 | 1,617 |
| Owner occupied | 48,507 | 858 | 584 | 49,949 | 584 |
| Nonowner occupied | 55,606 | 1,829 | 1,169 | 58,604 | 1,000 |
| Consumer real estate: | | | | | |
| Commercial purpose | 6,348 | 375 | 208 | 6,931 | 208 |
| Mortgage - residential | 13,396 | - | 1,758 | 15,154 | 1,642 |
| Home equity and home equity lines of credit | 12,807 | - | 277 | 13,084 | 277 |
| Consumer and other | 8,118 | - | 74 | 8,192 | 74 |
| Total | <u>\$ 161,951</u> | <u>\$ 3,302</u> | <u>\$ 5,752</u> | <u>\$ 171,005</u> | <u>\$ 5,464</u> |

The recorded investment in loans excludes accrued interest receivable and net deferred fees due to immateriality.

Loans are considered past due when contractually required principal or interest has not been received. The amount classified as past due is the entire principal balance outstanding of the loan, not just the amount of payments that are past due.

An aging analysis of the recorded investment in past due loans, segregated by class of loans follows:

| | Loans Past Due | | | | Current | Total | 90+ Days Past Due and Accruing |
|--|----------------|---------------|---------------|---------------|-------------------|-------------------|--------------------------------|
| | 30-59 Days | 60-89 Days | 90+ Days | Total | | | |
| | (in thousands) | | | | | | |
| December 31, 2016 | | | | | | | |
| Commercial | \$ - | \$ 9 | \$ - | \$ 9 | \$ 21,746 | \$ 21,755 | \$ - |
| Commercial real estate: | | | | | | | |
| Construction, land development, and other land | 10 | - | - | 10 | 5,365 | 5,375 | - |
| Owner occupied | 115 | - | - | 115 | 51,036 | 51,151 | - |
| Nonowner occupied | - | - | 49 | 49 | 74,000 | 74,049 | - |
| Consumer real estate: | | | | | | | |
| Commercial purpose | - | - | - | - | 8,478 | 8,478 | - |
| Mortgage - residential | 323 | 86 | 164 | 573 | 37,499 | 38,072 | - |
| Home equity and home equity lines of credit | 22 | - | - | 22 | 14,285 | 14,307 | - |
| Consumer and other | 75 | 10 | - | 85 | 13,436 | 13,521 | - |
| Total | <u>\$ 545</u> | <u>\$ 105</u> | <u>\$ 213</u> | <u>\$ 863</u> | <u>\$ 225,845</u> | <u>\$ 226,708</u> | <u>\$ -</u> |

| | Loans Past Due | | | | Current | Total | 90+ Days Past Due and Accruing |
|--|-----------------------|-------------------|-----------------|-----------------|-------------------|-------------------|---|
| | 30-59 Days | 60-89 Days | 90+ Days | Total | | | |
| | (in thousands) | | | | | | |
| December 31, 2015 | | | | | | | |
| Commercial | \$ 18 | \$ - | \$ - | \$ 18 | \$ 14,395 | \$ 14,413 | \$ - |
| Commercial real estate: | | | | | | | |
| Construction, land development, and other land | - | - | 47 | 47 | 4,631 | 4,678 | - |
| Owner occupied | 227 | - | - | 227 | 49,722 | 49,949 | - |
| Nonowner occupied | - | - | 62 | 62 | 58,542 | 58,604 | - |
| Consumer real estate: | | | | | | | |
| Commercial purpose | 95 | - | - | 95 | 6,836 | 6,931 | - |
| Mortgage - residential | 3,607 | 291 | 199 | 4,097 | 11,057 | 15,154 | - |
| Home equity and home equity lines of credit | 66 | - | 2 | 68 | 13,016 | 13,084 | - |
| Consumer and other | 71 | 32 | - | 103 | 8,089 | 8,192 | - |
| Total | \$ 4,084 | \$ 323 | \$ 310 | \$ 4,717 | \$ 166,288 | \$ 171,005 | \$ - |

The recorded investment in loans excludes accrued interest receivable and net deferred fees due to immateriality.

Loans are placed on nonaccrual when, in the judgement of management, the collection of additional interest is doubtful. Loans are generally placed on nonaccrual upon becoming 90 days past due. However, loans may be placed on nonaccrual regardless of whether or not they are past due. All cash received on nonaccrual loans is applied to the principal balance. Loans are considered for return to accrual status on an individual basis when all principal and interest amounts contractually due are brought and future payments reasonably assured.

The following is a summary of the recorded investment in nonaccrual loans, by class of loan:

| | December 31, | |
|--|---------------------|-----------------|
| | 2016 | 2015 |
| | (in thousands) | |
| Commercial | \$ - | \$ 62 |
| Commercial real estate: | | |
| Construction, land development, and other land | 199 | 1,617 |
| Owner occupied | 500 | 584 |
| Nonowner occupied | 115 | 1,000 |
| Consumer real estate: | | |
| Commercial purpose | 47 | 208 |
| Mortgage - residential | 1,026 | 1,642 |
| Home equity and home equity lines of credit | 195 | 277 |
| Consumer and other | 21 | 74 |
| Total | \$ 2,103 | \$ 5,464 |

The recorded investment in loans excludes accrued interest receivable and net deferred fees due to immateriality.

The following presents information pertaining to impaired loans and related allowance for loan losses by class of loan:

| | December 31, 2016 | | | December 31, 2015 | | |
|--|---------------------|--------------------------|---------------------------|---------------------|--------------------------|---------------------------|
| | Recorded Investment | Unpaid Principal Balance | Allowance for Loan Losses | Recorded Investment | Unpaid Principal Balance | Allowance for Loan Losses |
| | (in thousands) | | | | | |
| With an allowance for loan losses recorded: | | | | | | |
| Commercial | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - |
| Commercial real estate: | | | | | | |
| Construction, land development, and other land | - | - | - | 1,969 | 4,298 | 191 |
| Owner occupied | - | - | - | 1,095 | 1,095 | 10 |
| Nonowner occupied | - | - | - | - | - | - |
| Consumer real estate: | | | | | | |
| Commercial purpose | - | - | - | - | - | - |
| Mortgage - residential | - | - | - | - | - | - |
| Home equity and home equity lines of credit | - | - | - | - | - | - |
| Consumer and other | - | - | - | - | - | - |
| Total | - | - | - | 3,064 | 5,393 | 201 |
| With no related allowance for loan losses recorded: | | | | | | |
| Commercial | - | - | - | 55 | 63 | - |
| Commercial real estate: | | | | | | |
| Construction, land development, and other land | 196 | 258 | - | 263 | 361 | - |
| Owner occupied | 678 | 886 | - | 1,032 | 1,206 | - |
| Nonowner occupied | 2,955 | 3,118 | - | 1,719 | 1,962 | - |
| Consumer real estate: | | | | | | |
| Commercial purpose | 47 | 108 | - | 133 | 194 | - |
| Mortgage - residential | - | - | - | - | - | - |
| Home equity and home equity lines of credit | - | - | - | - | - | - |
| Consumer and other | - | - | - | - | - | - |
| Total | 3,876 | 4,370 | - | 3,202 | 3,786 | - |
| Total: | | | | | | |
| Commercial | - | - | - | 55 | 63 | - |
| Commercial real estate: | | | | | | |
| Construction, land development, and other land | 196 | 258 | - | 2,232 | 4,659 | 191 |
| Owner occupied | 678 | 886 | - | 2,127 | 2,301 | 10 |
| Nonowner occupied | 2,955 | 3,118 | - | 1,719 | 1,962 | - |
| Consumer real estate: | | | | | | |
| Commercial purpose | 47 | 108 | - | 133 | 194 | - |
| Mortgage - residential | - | - | - | - | - | - |
| Home equity and home equity lines of credit | - | - | - | - | - | - |
| Consumer and other | - | - | - | - | - | - |
| Total impaired loans | <u>\$ 3,876</u> | <u>\$ 4,370</u> | <u>\$ -</u> | <u>\$ 6,266</u> | <u>\$ 9,179</u> | <u>\$ 201</u> |

The recorded investment in loans excludes accrued interest receivable and net deferred fees due to immateriality. Unpaid principal balance represents the contractual amount due and is not reduced by partial charge-offs or other adjustments.

The following presents information pertaining to the recorded investment in impaired loans as follows:

| | December 31, 2016 | | December 31, 2015 | |
|--|-----------------------------|----------------------------|-----------------------------|----------------------------|
| | Average Outstanding Balance | Interest Income Recognized | Average Outstanding Balance | Interest Income Recognized |
| | (in thousands) | | | |
| Commercial | \$ 1 | \$ 1 | \$ 67 | \$ 9 |
| Commercial real estate: | | | | |
| Construction, land development, and other land | 1,454 | 5 | 2,294 | 148 |
| Owner occupied | 820 | 18 | 2,111 | 215 |
| Nonowner occupied | 1,655 | 226 | 1,774 | 203 |
| Consumer real estate: | | | | |
| Commercial purpose | 141 | 11 | 143 | 38 |
| Mortgage - residential | - | - | - | - |
| Home equity and home equity lines of credit | - | - | - | - |
| Consumer and other | - | - | - | - |
| Total | \$ 4,071 | \$ 261 | \$ 6,389 | \$ 613 |

The recorded investment in loans excludes accrued interest receivable and net deferred fees due to immateriality.

For loans where impairment is measured based on the present value of expected future cash flows, subsequent changes in present value and related allowance for loan loss adjustments resulting from the passage of time are accounted for within the provision (credit) for loan losses rather than interest income.

Troubled Debt Restructurings

The Corporation may agree to modify the terms of a loan to improve its ability to collect amounts due. The modified terms are intended to enable customers to mitigate the risk of foreclosure by creating a payment structure that provides for continued loan payment requirements based on their current cash flow ability. Modifications, including renewals, where concessions are made by the Bank and result from the debtor's financial difficulties are considered troubled debt restructurings (TDRs).

Loan modifications are considered TDRs when the modification includes terms outside of normal lending practices (i.e., concessions) 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 debt with similar risk characteristics
3. Forbearance of principal
4. Forbearance of accrued interest

To determine if a borrower is experiencing financial difficulties, the Corporation considers if:

1. The borrower is currently in default on any other of their debt
2. It is likely that the borrower would default on any of their debt if the concession was not granted
3. The borrower's cash flow was sufficient 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 a going concern (if the entity is a business)

The following summarizes troubled debt restructurings:

| | December 31, 2016 | | | December 31, 2015 | | |
|--|---------------------------------|-----------------|-----------------|---------------------------------|-----------------|-----------------|
| | Outstanding Recorded Investment | | | Outstanding Recorded Investment | | |
| | Accruing | Nonaccrual | Total | Accruing | Nonaccrual | Total |
| | (in thousands) | | | | | |
| Commercial | \$ - | \$ - | \$ - | \$ - | \$ 36 | \$ 36 |
| Commercial real estate: | | | | | | |
| Construction, land development, and other land | 9 | 10 | 19 | 687 | 1,570 | 2,257 |
| Owner occupied | 178 | 556 | 734 | 1,598 | 432 | 2,030 |
| Nonowner occupied | 2,840 | 49 | 2,889 | 963 | 852 | 1,815 |
| Consumer real estate: | | | | | | |
| Commercial purpose | - | 47 | 47 | - | 133 | 133 |
| Mortgage - residential | 829 | 487 | 1,316 | 797 | 768 | 1,565 |
| Home equity and home equity lines of credit | 2 | 66 | 68 | 50 | 4 | 54 |
| Consumer and other | - | 3 | 3 | 2 | 4 | 6 |
| Total | <u>\$ 3,858</u> | <u>\$ 1,218</u> | <u>\$ 5,076</u> | <u>\$ 4,097</u> | <u>\$ 3,799</u> | <u>\$ 7,896</u> |

Troubled debt restructurings of consumer real estate-mortgage residential, consumer real estate-home equity and home equity lines of credit, and consumer and other loans included in the table above are not separately identified for impairment disclosures and are excluded from the impaired loan disclosures as previously presented.

Troubled debt restructured loans may qualify for return to accrual status if the borrower complies with the revised terms and conditions and has demonstrated sustained payment performance consistent with the modified terms for a minimum of six consecutive payment cycles after the restructuring date. In addition, the collection of future payments must be reasonably assured.

The following presents information regarding existing loans that were restructured, resulting in the loan being classified as a troubled debt restructuring:

| | Loans Restructured in 2016 | | | Loans Restructured in 2015 | | |
|--|-----------------------------------|---------------------|---------------------|-----------------------------------|---------------------|---------------------|
| | Number of Loans | Pre-Modification | Post-Modification | Number of Loans | Pre-Modification | Post-Modification |
| | | Recorded Investment | Recorded Investment | | Recorded Investment | Recorded Investment |
| | (dollars in thousands) | | | | | |
| Commercial | - | \$ - | \$ - | 1 | \$ 14 | \$ 14 |
| Commercial real estate: | | | | | | |
| Construction, land development, and other land | 1 | 11 | 11 | - | - | - |
| Owner occupied | - | - | - | - | - | - |
| Nonowner occupied | 2 | 3,447 | 3,447 | 2 | 122 | 122 |
| Consumer real estate: | | | | | | |
| Commercial purpose | - | - | - | - | - | - |
| Mortgage - residential | 1 | 49 | 49 | 1 | 15 | 15 |
| Home equity and home equity lines of credit | 1 | 66 | 66 | 1 | 64 | 64 |
| Consumer and other | 1 | 2 | 2 | - | - | - |
| Total | <u>6</u> | <u>\$ 3,575</u> | <u>\$ 3,575</u> | <u>5</u> | <u>\$ 215</u> | <u>\$ 215</u> |

During the year ended December 31, 2016, there were no troubled debt restructured loans that defaulted within 12 months of restructuring. During the year ended December 31, 2015, the Corporation had three troubled debt restructured loans with a recorded investment of \$118,000 that defaulted within 12 months of restructuring. A loan is considered to be in payment default generally once it is 90 days contractually past due under the modified terms. The 2015 payment defaults on troubled debt restructured loans had an immaterial impact on the allowance for loan losses and resulted in an immaterial amount of charge offs during the year ended December 31, 2015.

The following summarizes the nature of concessions granted by the Corporation to borrowers experiencing financial difficulties which resulted in troubled debt restructurings:

| | <u>Non-Market Interest Rate</u> | | <u>Extension of Amortization Period</u> | |
|--|---------------------------------|---|---|---|
| | <u>Number of Loans</u> | <u>Pre-Modification Recorded Investment</u> | <u>Number of Loans</u> | <u>Pre-Modification Recorded Investment</u> |
| (dollars in thousands) | | | | |
| December 31, 2016 | | | | |
| Commercial | - | \$ - | - | \$ - |
| Commercial real estate: | | | | |
| Construction, land development, and other land | - | - | 1 | 11 |
| Owner occupied | - | - | - | - |
| Nonowner occupied | - | - | 2 | 3,447 |
| Consumer real estate: | | | | |
| Commercial purpose | - | - | - | - |
| Mortgage - residential | 1 | 49 | - | - |
| Home equity and home equity lines of credit | - | - | 1 | 66 |
| Consumer and other | - | - | 1 | 2 |
| Total | <u>1</u> | <u>\$ 49</u> | <u>5</u> | <u>\$ 3,526</u> |
| December 31, 2015 | | | | |
| Commercial | - | \$ - | 1 | \$ 14 |
| Commercial real estate: | | | | |
| Construction, land development, and other land | - | - | - | - |
| Owner occupied | - | - | - | - |
| Nonowner occupied | - | - | 2 | 122 |
| Consumer real estate: | | | | |
| Commercial purpose | - | - | - | - |
| Mortgage - residential | - | - | 1 | 15 |
| Home equity and home equity lines of credit | - | - | 1 | 64 |
| Consumer and other | - | - | - | - |
| Total | <u>-</u> | <u>\$ -</u> | <u>5</u> | <u>\$ 215</u> |

The troubled debt restructurings identified above had an immaterial impact on the allowance for loan losses and resulted in an immaterial amount of charge offs during the years ended December 31, 2016 and 2015.

5. Premises and Equipment

A summary of premises and equipment and related accumulated depreciation follows:

| | December 31, | |
|-------------------------------|---------------------|-----------------|
| | <u>2016</u> | <u>2015</u> |
| | (in thousands) | |
| Land and land improvements | \$ 2,888 | \$ 2,888 |
| Premises | 10,258 | 10,209 |
| Furniture and equipment | 3,833 | 3,779 |
| | <u>16,979</u> | <u>16,876</u> |
| Less accumulated depreciation | (10,143) | (9,715) |
| Premises and equipment, net | <u>\$ 6,836</u> | <u>\$ 7,161</u> |

6. Other Real Estate Owned

At December 31, 2016, the Bank owned one commercial and one residential foreclosed property with an aggregate carrying value of \$170,000. During 2016, one residential property was transferred into other real estate owned at a cost basis of \$90,000, which included a \$34,000 valuation write-up based on a current appraisal less estimated selling costs. In 2016, capital improvements of \$9,000 and valuation write-downs of \$89,000 were recognized on the Bank's remaining commercial property. Proceeds from the sale of four other real estate owned properties totaled \$854,000 and resulted in net gain of \$43,000 for 2016. At December 31, 2015, the bank owned five foreclosed properties with a carrying value of \$971,000. In 2015, net gain on sales/write-downs of other real estate owned totaled \$66,000. Net gain (loss) on the sales/write-downs of other real estate owned is included in noninterest income in the consolidated statements of income.

7. Time Deposits

The scheduled maturities of time deposits at December 31, 2016 and 2015 were:

| | <u>2016</u> | <u>2015</u> |
|--------------------------|------------------|------------------|
| Year ending December 31: | (in thousands) | |
| 2016 | \$ - | \$ 38,622 |
| 2017 | 34,504 | 13,685 |
| 2018 | 17,586 | 6,370 |
| 2019 | 1,939 | 1,793 |
| 2020 | 1,585 | 436 |
| 2021 and thereafter | 1,020 | - |
| Total | <u>\$ 56,634</u> | <u>\$ 60,906</u> |

Included in time deposits are certificates of deposit in excess of \$250,000. These certificates and their remaining maturities at December 31, 2016 and 2015 are as follows:

| | <u>2016</u> | <u>2015</u> |
|--------------------------|-----------------|-----------------|
| Year ending December 31: | (in thousands) | |
| 2016 | \$ - | \$ 3,604 |
| 2017 | 3,287 | 271 |
| 2018 | 2,225 | 1,166 |
| Total | <u>\$ 5,512</u> | <u>\$ 5,041</u> |

Interest expense on time deposits, including time deposits issued in denominations of \$250,000 or more, amounted to approximately \$388,000 and \$421,000 in 2016 and 2015, respectively.

8. Other Borrowings

The Bank maintains a line of credit with the Federal Home Loan Bank of Indianapolis ("FHLBI") which provides maximum borrowing capacity of \$29.5 million as of December 31, 2016. The line is secured by unencumbered investment securities available for sale with a fair value of \$29.9 million (amortized cost of \$29.8 million) and unencumbered qualified residential mortgage and home equity loans with outstanding principal balances of approximately \$5.2 million. Advances totaling \$20.5 million were outstanding on the FHLBI line of credit as of December 31, 2016. The advances were made for short-term general liquidity needs and to fund purchase of \$16.5 million of residential mortgage loans in December 2016. At December 31, 2016, the advances bore interest at a daily variable rate of 0.90% and had scheduled matured within 30-days. Interest expense incurred on FHLBI advances during 2016 totaled approximately \$10,000. The Bank repaid all \$20.5 million of FHLBI advances on January 30, 2017 using proceeds from the aforementioned sale of investment securities available for sale (Note 2). No amounts were drawn against the FHLBI line of credit during 2015.

9. Income Tax Expense (Benefit)

Income tax expense (benefit) consists of the following for the year-ending December 31:

| | <u>2016</u> | <u>2015</u> |
|--|-------------------|--------------|
| | (in thousands) | |
| Current expense (benefit) | \$ (58) | \$ 62 |
| Deferred expense | 1,687 | - |
| Valuation allowance - change in estimate | (8,681) | - |
| Total income tax expense (benefit) | <u>\$ (7,052)</u> | <u>\$ 62</u> |

Income tax expense (benefit) differed from the amounts computed by applying the U.S. Federal income tax rate of 34% to income before taxes as a result of the following:

| | <u>2016</u> | <u>2015</u> |
|---|-------------------|--------------|
| | (in thousands) | |
| Computed "expected" income tax expense | \$ 1,662 | \$ 1,179 |
| Increase (reduction) in tax resulting from: | | |
| Tax-exempt interest and dividends, net | (14) | (21) |
| Change in valuation allowance | (8,681) | (1,172) |
| Other, net | (19) | 76 |
| Total income tax expense (benefit) | <u>\$ (7,052)</u> | <u>\$ 62</u> |

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are presented below:

| | December 31, | |
|---|---------------------|--------------|
| | 2016 | 2015 |
| | (in thousands) | |
| Deferred tax assets: | | |
| Allowance for loan losses | \$ - | \$ 348 |
| Net operating loss carryforward | 6,069 | 6,992 |
| AMT credit carryforward | 26 | 39 |
| Charitable contributions carryforward | - | 92 |
| Other-than-temporary impairment on investment securities available for sale | 1,081 | 769 |
| Premises and equipment | 233 | 249 |
| Non-accrual interest | 98 | - |
| Deferred directors' fees | 49 | 62 |
| Reserve for other real estate owned | 43 | 26 |
| Unrealized loss on investment securities available for sale | 620 | 195 |
| Other | 22 | 18 |
| Total gross deferred tax assets | <u>8,241</u> | <u>8,790</u> |
| Deferred tax liabilities: | | |
| Allowance for loan losses | (706) | - |
| Deferred loan fees | (67) | (61) |
| Accretion | (29) | (28) |
| Other | (20) | (20) |
| Total gross deferred tax liabilities | <u>(822)</u> | <u>(109)</u> |
| Net deferred tax asset before valuation allowance | 7,419 | 8,681 |
| Valuation allowance | - | (8,681) |
| Net deferred tax asset | <u>\$ 7,419</u> | <u>\$ -</u> |

Accounting guidance requires that companies assess whether a valuation allowance should be established against their deferred tax assets based on the consideration of all available evidence using a “more likely than not” standard. At December 31, 2016, management’s evaluation of the Corporation’s financial results and favorable profitability trends over the past four years provided significant objective and verifiable positive evidence that the Corporation has more likely than not returned to a level of sustained profitability sufficient to realize its net deferred tax assets in future years, including full utilization of its remaining net operating loss carry forward. Consequently, management reversed the entire remaining valuation allowance carried against the Corporation’s net deferred tax asset.

It is the Corporation’s policy to evaluate the realizability of deferred tax assets related to unrealized losses on investment securities available for sale separately from its other deferred tax assets when it has the intent and ability to hold the security to recovery (maturity, if necessary). Because the future taxable income implicit in the recovery of the basis of investment securities available for sale for financial reporting purposes will offset the deductions underlying the deferred tax asset, a valuation allowance would generally not be necessary, even in cases where a valuation allowance might be necessary related to the Corporation’s other deferred tax assets.

At December 31, 2016, the Corporation had a net operating loss carryforward of approximately \$17.8 million that expires beginning in 2029 if not previously utilized.

The Corporation has no unrecognized tax benefits and does not anticipate any increase to unrecognized tax benefits in the next twelve months. Tax years from 2013 through the current year remain open to examination. The Corporation does not believe the results from any exam of these open years would have a material adverse effect on the Corporation.

10. Related Party Transactions

Certain directors and executive officers, including their immediate families and companies in which they are principal owners, were loan customers of the Bank during 2016 and 2015. Deposits from such individuals and their related interests totaled approximately \$1.7 million and \$1.3 million at December 31, 2016 and 2015, respectively. Loans were made to such individuals in the ordinary course of business, in accordance with the Bank’s normal lending policies, including the interest rate charged and collateralization, and do not represent more than a normal credit risk.

Loans to related parties are summarized below for the periods indicated:

| | December 31, | |
|------------------------------|---------------------|--------------|
| | 2016 | 2015 |
| | (in thousands) | |
| Balance at beginning of year | \$ 72 | \$ 175 |
| New loans to related parties | 16 | 60 |
| Loan repayments | (10) | (163) |
| Balance at end of year | <u>\$ 78</u> | <u>\$ 72</u> |

11. Leases

The Bank has noncancelable operating leases for a branch facility and space at third-party location that houses auxiliary communications equipment. The branch facility lease provides for a 5-year renewal option beginning in October 2017 which the Bank expects to exercise. Total expected future minimum lease payments under the noncancelable leases as of December 31, 2016, are as follows:

Year ending December 31 (in thousands):

| | | |
|----------------------|----|------------|
| 2017 | \$ | 71 |
| 2018 | | 58 |
| 2019 | | 54 |
| 2020 | | 54 |
| 2021 and after | | 95 |
| Total lease payments | \$ | <u>332</u> |

Rental expense included in noninterest expense - net occupancy expense in the consolidated statements of income amounted to approximately \$72,000 in both 2016 and 2015, respectively, including amounts paid under short term, cancelable leases.

12. Retirement Plan

The Bank sponsors a 401(k) defined contribution plan covering all employees 21 years of age or older who have completed six months of service as defined in the plan agreement. Plan expenses recognized for discretionary employer contributions equal to 50% of an employee's contribution, limited to 3% of the employee's base compensation or the maximum amount permitted by the Internal Revenue Code, totaled approximately \$110,000 and \$97,000 in 2016 and 2015, respectively.

13. Director Compensation

Under a legacy Director Stock Fee Plan, nonemployee directors could receive stock in lieu of all or a portion of the fees payable to them as directors. Under the Plan, director fees consisted of a fixed per-meeting fee paid for attendance at board and committee meetings and a variable fee based on a director's fixed fees earned during the preceding calendar year, multiplied by the bonus percentage of base compensation paid to Bank officers in the preceding calendar year.

The Plan allowed for payment of director fees into a deferred stock account for which stock units were recorded until converted to shares and issued upon retirement, pursuant to a director's installment payment election. At December 31, 2016, there were approximately 986 remaining shares earned and available for distribution in deferred stock accounts owned by former directors. No director fee compensation expense related to the legacy Plan was recognized in 2016 or 2015.

Under the current Director Compensation Plan, nonemployee directors are paid a fixed monthly fee for their services to the Corporation and Bank. In 2016, director fee compensation also included \$162,000 of one-time bonuses awarded to directors in recognition of their efforts related to the Corporation's recent financial performance. Total director fee compensation in 2016 and 2015 amounted to \$303,000 and \$108,000, respectively.

14. Financial Instruments with Off-Balance-Sheet Risk

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

The Bank's exposure to credit loss in the event of the nonperformance by the other party to the financial instruments for loan commitments to extend credit and letters of credit is represented by the contractual amounts of these instruments. The Bank uses the same credit policies in making credit commitments as it does for on-balance-sheet loans.

Financial instruments whose contract amounts represent credit risk are as follows:

| | December 31, | |
|--------------------------|------------------|------------------|
| | 2016 | 2015 |
| | (in thousands) | |
| Commercial | \$ 13,743 | \$ 15,752 |
| Commercial real estate | 11,208 | 12,949 |
| Consumer real estate | 10,288 | 7,614 |
| Consumer and other | 2,189 | 2,302 |
| Total credit commitments | <u>\$ 37,428</u> | <u>\$ 38,617</u> |

Loan commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable;

inventory; property, plant, and equipment; residential real estate; and income-producing commercial properties. Market risk may arise if interest rates move adversely subsequent to the extension of commitments.

As of December 31, 2016 and 2015, the Bank had outstanding irrevocable standby letters of credit, which carry a maximum potential commitment of approximately \$581,000 and \$537,000, respectively. These letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The majority of these letters of credit are short term guarantees of one year or less, although some have maturities which extend as long as two years. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. The Bank primarily holds real estate as collateral supporting those commitments for which collateral is deemed necessary. The extent of collateral held on those commitments at December 31, 2016 and 2015, where there is collateral, is in excess of the committed amount. A letter of credit is not recorded in the consolidated balance sheets until a customer fails to perform.

15. Regulatory Capital

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

The final rules implementing Basel Committee on Banking Supervision's capital guidelines for US banks (Basel III rules) became effective for the Bank on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. Under the Basel III rules, a capital conservation buffer must be maintained above the adequately capitalized risk-based capital ratios. The capital conservation buffer is being phased in from 0.0% for 2015 to 2.50% by 2019. The capital conservation buffer at December 31, 2016 is 0.625%. The net unrealized gain or loss on investment securities available for sale is not included in computing regulatory capital. Management believes as of December 31, 2016, the Bank met all capital adequacy requirements to which it is subject.

Prompt corrective action ("PCA") regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required. At December 31, 2016 and 2015, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for PCA. There are no conditions or events since that notification that management believes have changed the Bank's category.

Actual and required capital amounts and ratios, including the phase-in of the capital conservation buffer, are presented in the following table:

| As of December 31, 2016 | Actual | | Minimum Required For Capital Adequacy Purposes | | To be Well Capitalized Under Prompt Corrective Action Provision | |
|--|-----------|--------|---|--------|---|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total Capital (to risk weighted assets) | | | (dollars in thousands) | | | |
| Bank | \$ 40,125 | 15.16% | \$ 22,834 | 8.625% | \$ 26,474 | 10.00% |
| Consolidated | 44,096 | 16.59% | 22,924 | 8.625% | N/A | N/A |
| Tier 1 Capital (to risk weighted assets) | | | | | | |
| Bank | 36,507 | 13.79% | 17,539 | 6.625% | 21,179 | 8.00% |
| Consolidated | 40,465 | 15.22% | 17,608 | 6.625% | N/A | N/A |
| Common Equity Tier 1 Capital (to risk weighted assets) | | | | | | |
| Bank | 36,507 | 13.79% | 13,568 | 5.125% | 17,208 | 6.50% |
| Consolidated | 40,465 | 15.22% | 13,622 | 5.125% | N/A | N/A |
| Tier 1 Capital (to average assets) | | | | | | |
| Bank | 36,507 | 10.00% | 14,598 | 4.00% | 18,247 | 5.00% |
| Consolidated | 40,465 | 11.07% | 14,620 | 4.00% | N/A | N/A |

| As of December 31, 2015 | Actual | | Minimum Required For Capital Adequacy Purposes | | To be Well Capitalized Under Prompt Corrective Action Provision | |
|--|-----------|--------|---|-------|---|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total Capital (to risk weighted assets) | | | (dollars in thousands) | | | |
| Bank | \$ 36,206 | 16.88% | \$ 17,158 | 8.00% | \$ 21,448 | 10.00% |
| Consolidated | 37,431 | 17.44% | 17,174 | 8.00% | N/A | N/A |
| Tier 1 Capital (to risk weighted assets) | | | | | | |
| Bank | 33,384 | 15.57% | 12,869 | 6.00% | 17,158 | 8.00% |
| Consolidated | 34,606 | 16.12% | 12,880 | 6.00% | N/A | N/A |
| Common Equity Tier 1 Capital (to risk weighted assets) | | | | | | |
| Bank | 33,384 | 15.57% | 9,651 | 4.50% | 13,941 | 6.50% |
| Consolidated | 34,606 | 16.12% | 9,660 | 4.50% | N/A | N/A |
| Tier 1 Capital (to average assets) | | | | | | |
| Bank | 33,384 | 9.90% | 13,493 | 4.00% | 16,866 | 5.00% |
| Consolidated | 34,606 | 10.22% | 13,542 | 4.00% | N/A | N/A |

Consolidated capital amounts and ratios are not required to be disclosed due to total consolidated assets being less than \$1 billion; however, such consolidated disclosures are provided to illustrate the overall capital position of the Corporation.

16. Dividend Restrictions

On a parent company-only basis, the Corporation's only source of funds is dividends paid by the Bank. The ability of the Bank to pay dividends is subject to limitations under various laws and regulations and to prudent and sound banking principles. The Bank may declare a dividend without the approval of the Office of the Comptroller of the Currency (OCC) unless the total dividends in a calendar year exceeds the total of its net profits for the year combined with its retained profits of the two preceding years. Under these provisions, the Bank paid a \$3.0 million dividend to the Corporation in December 2016. Approximately \$15.4 million remains available for dividends by the Bank to the Corporation as of December 31, 2016, without the approval of the OCC. The payment of dividends may be further limited because of the Bank's need to maintain capital ratios satisfactory to applicable regulatory agencies.

17. Fair Value Measurements

ASC Topic 820 defines fair value and establishes a consistent framework for measuring fair value and expands disclosure requirements for fair value measurements. Fair values represent the estimated price that would be received from selling an asset or paid to transfer a liability, otherwise known as an "exit price". The three levels of inputs that may be used to measure fair value are as follows:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; or other inputs that are observable or can be derived from or corroborated by observable market data by correlation or other means.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The following is a description of the Corporation's valuation methodologies used to measure and disclose the fair values of its financial assets on a recurring basis:

Investment securities available for sale. Investment securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based on quoted prices, if available (Level 1). If quoted prices are not available, fair values are measured using independent pricing models such as matrix pricing models (Level 2). Matrix pricing is a mathematical technique widely used in the financial industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices. Level 2 securities include U.S. agency securities, U.S. government and agency mortgage-backed securities, obligations of state and political subdivisions, corporate bonds and preferred stock securities. Level 3 securities include private collateralized mortgage obligations. The fair value measurement of our only Level 3 security, a non-investment grade, non-government agency CMO, and details regarding significant inputs and assumptions used in estimating its fair value, is detailed in Note 2.

Fair value of assets measured on a recurring basis:

| | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|-------------------|---|--|--|
| | (in thousands) | | | |
| December 31, 2016 | | | | |
| Mortgage-backed/CMO - residential | \$ 103,284 | \$ - | \$ 102,601 | \$ 683 |
| U.S. agency | 1,976 | - | 1,976 | - |
| Obligations of state and political subdivisions | 31,662 | - | 31,662 | - |
| Corporate bonds | 4,729 | - | 4,729 | - |
| Preferred stock | 624 | - | 624 | - |
| Total investment securities available for sale | <u>\$ 142,275</u> | <u>\$ -</u> | <u>\$ 141,592</u> | <u>\$ 683</u> |
| December 31, 2015 | | | | |
| Mortgage-backed/CMO - residential | \$ 124,145 | \$ - | \$ 123,176 | \$ 969 |
| U.S. agency | 7,954 | - | 7,954 | - |
| Obligations of state and political subdivisions | 4,899 | - | 4,899 | - |
| Corporate bonds | 4,252 | - | 4,252 | - |
| Preferred stock | 272 | - | 272 | - |
| Total investment securities available for sale | <u>\$ 141,522</u> | <u>\$ -</u> | <u>\$ 140,553</u> | <u>\$ 969</u> |

The reconciliation of the beginning and ending balances of the asset classified by the Corporation within Level 3 of the valuation hierarchy is as follows:

| | 2016 | 2015 |
|---|---|---|
| | Fair Value Measurement Using Significant Unobservable Inputs (Level 3) | Fair Value Measurement Using Significant Unobservable Inputs (Level 3) |
| Fair value of non-government agency CMO security, beginning of year ⁽¹⁾ | \$ 969 | \$ 1,195 |
| Total gains (losses) realized/unrealized: | | |
| Included in earnings ⁽²⁾ | - | - |
| Included in other comprehensive income (loss) ⁽²⁾ | 17 | (38) |
| Purchases, sales, issuances, and other settlements | (303) | (188) |
| Transfers into Level 3 | - | - |
| Fair value of non-government agency CMO security, end of year | <u>\$ 683</u> | <u>\$ 969</u> |
| Total amount of losses for the year included in earnings attributable to the change in unrealized losses relating to assets still held at end of year | <u>\$ -</u> | <u>\$ -</u> |

⁽¹⁾ Non-government agency CMO security classified as available for sale is valued using internal valuation models and pricing information from third parties.

⁽²⁾ Realized gains (losses), including unrealized losses deemed other-than-temporary, are reported in noninterest income. Unrealized gains (losses) are reported in accumulated other comprehensive loss.

The following is a description of the Corporation's valuation methodologies used to measure and disclose the fair values of its financial assets on a non-recurring basis:

Loans Held for Investment. The Corporation does not record loans at fair value on a recurring basis. However, from time to time, the Corporation records nonrecurring fair value adjustments to collateral dependent loans to reflect partial write-downs or specific reserves that are based on the observable market price or current appraised value of the collateral. These loans are reported in the nonrecurring table below at initial recognition of impairment and on an ongoing basis until recovery or charge off. When the fair value of the collateral is based on an observable market price or a current appraised value, the Corporation records the impaired loan as nonrecurring Level 2. When a current appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Corporation records the impaired loan as nonrecurring Level 3.

Other real estate owned. Real estate acquired through foreclosure or deed-in-lieu is adjusted to fair value less costs to sell upon transfer of the loan to other real estate owned, usually based on an appraisal of the property. Subsequently, other real estate owned is carried at the lower of carrying value or fair value, less cost to sell. A valuation based on a current appraisal or by a broker's opinion is considered a Level 2 fair value. If management determines the fair value of the property is further impaired below the appraised value and there is no observable market price, the Corporation records the property as nonrecurring Level 3.

Appraisals for both collateral dependent impaired loans and other real estate owned are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Corporation. Management reviews the assumptions and approaches utilized in the appraisal. Management periodically evaluates the appraised values and will discount a property's appraised value to account for a number of factors including but not limited to the cost of liquidating the collateral, the age of the appraisal, observable deterioration since the appraisal, or other factors unique to the property.

Fair value of assets on a non-recurring basis:

| | Total | Active Markets for Identical Assets (Level 1) | Observable Inputs (Level 2) | Unobservable Inputs (Level 3) |
|-------------------------------|----------------|---|-----------------------------------|-------------------------------------|
| | (in thousands) | | | |
| December 31, 2016 | | | | |
| Other real estate owned | \$ 80 | \$ - | \$ - | \$ 80 |
| December 31, 2015 | | | | |
| Impaired loans ⁽¹⁾ | \$ 1,251 | \$ - | \$ - | \$ 1,251 |
| Other real estate owned | 505 | - | - | 505 |

⁽¹⁾ Represents carrying value and related write-downs and specific reserves pertaining to collateral dependent loans for which adjustments are based on the appraised value of the collateral or by other unobservable inputs.

At December 31, 2016 there were no impaired collateral dependent loans with carrying values determined net of specific allowance allocations measured using the fair value of collateral method of impairment. At December 31, 2015, the Corporation had one collateral dependent impaired loan measured for impairment using the fair value of collateral with a carrying value of approximately \$1.3 million after a specific allowance allocation of \$98,000. Impaired collateral dependent loans at December 31, 2015 resulted in no additional provision for loan losses for the year then ended.

Other real estate owned as of December 31, 2016 and 2015 carried at fair values of \$80,000 and \$505,000, net of a valuation allowances of \$126,000 and \$74,000, resulted in write-downs of \$89,000 and \$74,000 during the years then ended, respectively.

As discussed previously, the fair values of collateral dependent impaired loans and other real estate owned carried at fair value are determined by third party appraisals. Management makes adjustments to these appraised values based on the age of the appraisal and the type of the property. The following table presents quantitative information about Level 3 fair value measurements for the larger classes of financial instruments measured at fair value on a non-recurring basis at December 31, 2016 and 2015, respectively:

| | Fair Value | Valuation Techniques | Unobservable Inputs | Range (Weighted Average) |
|---|------------|------------------------------|--|--------------------------------|
| 2016 | | | | |
| Other real estate owned - Commercial | \$ 80 | Sales comparison approach | Management discount for property type and recent market volatility | 38% (38%) |
| 2015 | | | | |
| Impaired loans | | | | |
| Commercial real estate | \$ 1,251 | Sales comparison approach | Management discount for property type and recent market volatility | 7% (7%) |
| Other real estate owned - Commercial | 505 | Sales comparison approach | Management discount for property type and recent market volatility | 9% - 19% (13%) |

18. Fair Value of Financial Instruments

Fair value disclosures require fair-value information about financial instruments for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair-value estimates cannot be substantiated by comparison to independent markets and, in many cases, cannot be realized in immediate settlement of the instrument.

Fair-value methods and assumptions for the Corporation's financial instruments are as follows:

Cash and cash equivalents – The carrying amounts reported in the consolidated balance sheets for cash, due from banks and short-term investments reasonably approximate those assets' fair values.

Interest-bearing time deposits with other financial institutions – The fair value of interest-bearing time deposits with other financial institutions is based on current rates for similar certificates of deposit.

Investment securities available for sale – Fair values for investment securities available for sale are determined as discussed above.

FHLBI and FRB stock – It is not practicable to determine the fair value of Federal Home Loan Bank Stock of Indianapolis and Federal Reserve Bank Stock due to restrictions placed on their transferability.

Loans held for investment – For variable-rate loans that reprice frequently, fair values are generally based on carrying values, adjusted for credit risk. The fair value of fixed-rate loans is estimated by discounting future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Accrued interest receivable – The carrying amount of accrued interest receivable is a reasonable estimate of fair value.

Deposits – The fair value of deposits with no stated maturity, such as demand deposit, NOW, savings, and money market accounts, is equal to the amount payable on demand. The fair value of time deposits is estimated using rates currently offered for wholesale funds with similar remaining maturities.

Other borrowings – The carrying amount of other borrowings approximates fair value given the short-term duration of the borrowings.

Accrued interest payable – The carrying amount of accrued interest payable is a reasonable estimate of fair value.

Off-balance-sheet instruments – The fair value of commitments to extend credit is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of commitments to extend credit, including letters of credit, is estimated to approximate their aggregate book balance and is not considered material and therefore not included in the following table.

| | December 31, 2016 | | December 31, 2015 | |
|--|-------------------|------------|-------------------|------------|
| | Carrying Value | Fair Value | Carrying Value | Fair Value |
| | (in thousands) | | | |
| Financial assets: | | | | |
| Cash and cash equivalents | \$ 16,739 | \$ 16,739 | \$ 29,685 | \$ 29,685 |
| Interest-bearing time deposits with other financial institutions | 941 | 948 | 941 | 941 |
| Investment securities available for sale | 142,275 | 142,275 | 141,522 | 141,522 |
| FHLBI and FRB stock | 1,445 | N/A | 1,065 | N/A |
| Net loans held for investment | 221,681 | 222,872 | 165,108 | 165,124 |
| Accrued interest receivable | 1,078 | 1,078 | 851 | 851 |
| Financial liabilities: | | | | |
| Deposits | \$ 332,065 | \$ 331,896 | \$ 313,066 | \$ 313,011 |
| Other borrowings | 20,500 | 20,500 | - | - |
| Accrued interest payable | 51 | 51 | 52 | 52 |

Limitations

Fair-value estimates are made at a specific point in time based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discounts that could result from offering for sale at one time the Corporation's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Corporation's financial instruments, fair-value estimates are based on judgments regarding future loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment, and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

19. New Accounting Standards

FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This ASU supersedes and replaces nearly all existing revenue recognition guidance, including industry-specific guidance, establishes a new control-based revenue recognition model, changes the basis for deciding when revenue is recognized over time or at a point in time, provides new and more detailed guidance on specific topics and expands and improves disclosures about revenue. In addition, this ASU specifies the accounting for some costs to obtain or fulfill a contract with a customer. The new guidance does not apply to certain contracts within the scope of other ASC Topics, such as lease contracts, insurance contracts, financing arrangements, financial instruments, guarantees other than product or service warranties, and nonmonetary exchanges between entities in the same line of business to facilitate sales to customers. The amendments are effective for annual periods beginning after December 15, 2017, including interim periods within that reporting period. The amendments should be applied retrospectively to all periods presented or retrospectively with the cumulative effect recognized at the date of initial application. Due to the nature of the Corporation's revenues, the impact of adoption of this ASU by the Corporation is not expected to be material.

FASB issued ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10) – Recognition and Measurement of Financial Assets and Financial Liabilities*. This ASU amends existing guidance related to the accounting for certain financial assets and liabilities. These amendments, among other things, require equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income, require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset and eliminate the requirement for public business entities 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. These amendments are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The new ASU is not expected to have a significant impact on the Corporation's operations or financial statement disclosures.

FASB issued ASU 2016-02, *Leases (Topic 842)*. This ASU amends existing guidance related to the accounting for leases. These amendments, among other things, require lessees to account for most leases on the balance sheet while recognizing expense on the income statement in a manner similar to existing guidance. For lessors the guidance modifies the classification criteria and the accounting for sales-type and direct finance leases. This amended guidance is effective for fiscal years beginning after December 15, 2018. Due to the nature and limited number of the Corporation's existing operating leases (see Note 11), management does expect the amended guidance to have a material impact on the Corporation's consolidated operating results or financial condition.

FASB issued ASU 2016-13, *Financial Instruments — Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments*. This ASU significantly changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. This ASU will replace today's "incurred loss" approach with an "expected loss" model for instruments measured at amortized cost. For securities available for sale, allowances will be recorded rather than reducing the carrying amount as is done under the current other-than-temporary impairment model. This ASU also simplifies the accounting model for purchased credit-impaired debt securities and loans. The amended guidance is effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. To date, management has sought to learn and stay informed of the new credit loss guidance by attending presentations and webinars, reading industry literature and discussing the new guidance with the Corporation's advisors (e.g., external auditors and consultants). Although the impact of the new standard on the Corporation's consolidated financial statements has not yet been quantified, management generally agrees that the ASU will result in increased levels of allowance for loan losses across the industry as credit losses become accelerated with the elimination of the probable threshold used for "incurred loss" recognition.