# ALERUS FINANCIAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2016, 2015 AND 2014

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CliftonLarsonAllen LLP
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## INDEPENDENT AUDITORS' REPORT

Board of Directors and Audit Committee
Alerus Financial Corporation and Subsidiaries
Grand Forks, North Dakota

### Report on Consolidated Financial Statements

We have audited the accompanying consolidated financial statements of Alerus Financial Corporation and Subsidiaries, which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the years ended December 31, 2016, 2015, and 2014, and the related notes to the consolidated financial statements.

### *Management's Responsibility for the Consolidated 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.

### *Auditors' 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 audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the 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 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 financial statements.

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

***Opinion***

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Alerus Financial Corporation and Subsidiaries as of December 31, 2016 and 2015, and the results of their operations and their cash flows for the years ended December 31, 2016, 2015, and 2014 are in conformity with accounting principles generally accepted in the United States of America.

***Other Matters***

*Report on Internal Control over Financial Reporting*

We also have audited in accordance with attestation standards established by the American Institute of Certified Public Accountants, Alerus Financial Corporation and Subsidiaries' internal control over financial reporting as of December 31, 2016, based on criteria established in *2013 Internal Control – Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 3, 2017, expressed an unqualified opinion on the Company's internal control over financial reporting.

CliftonLarsonAllen LLP

**CliftonLarsonAllen LLP**

Minneapolis, Minnesota
March 3, 2017

**ALERUS FINANCIAL CORPORATION AND SUBSIDIARIES**
**CONSOLIDATED BALANCE SHEETS**
**DECEMBER 31, 2016 AND 2015**

| *(dollars in thousands, except share and per share amounts)* | 2016 | 2015 |
|---|---|---|
| **ASSETS** | | |
| Cash and Cash Equivalents | $ 35,441 | $ 28,482 |
| Interest-Bearing Deposits | 171,926 | 237,677 |
| Cash and Due From Banks | 207,367 | 266,159 |
| Investment Securities | | |
| Securities Held for Trading | 1,959 | 1,947 |
| Securities Available for Sale at Fair Value (Amortized Cost $280,004 and $188,743, 2016 and 2015 respectively) | 276,952 | 190,396 |
| Mortgages Held for Sale | 35,063 | 48,642 |
| Loans and Leases | 1,366,952 | 1,126,921 |
| Less: Allowance for Loan and Lease Losses | (15,615) | (14,688) |
| Net Loans and Leases | 1,351,337 | 1,112,233 |
| Premises and Equipment, Net | 24,262 | 22,419 |
| Accrued Interest Receivable | 5,919 | 4,830 |
| Bank-Owned Life Insurance | 29,139 | 28,308 |
| Goodwill | 27,329 | 3,683 |
| Other Intangible Assets, Net | 37,506 | 21,751 |
| Deferred Tax Assets, Net | 19,521 | 13,780 |
| Other Assets | 34,225 | 30,715 |
| Total Assets | $ 2,050,579 | $ 1,744,863 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| **LIABILITIES** | | |
| Deposits: | | |
| Noninterest-Bearing | $ 554,490 | $ 425,608 |
| Interest-Bearing | 1,230,719 | 1,032,413 |
| Total Deposits | 1,785,209 | 1,458,021 |
| Short-Term Borrowings | 729 | - |
| Long-Term Debt | 58,813 | 70,744 |
| Accrued Expenses and Other Liabilities | 37,043 | 33,277 |
| Total Liabilities | 1,881,794 | 1,562,042 |
| **STOCKHOLDERS' EQUITY** | | |
| Preferred Stock, $1 Par Value, 2,000,000 Shares Authorized; 0 and 20,000 Shares Issued and Outstanding | - | 20 |
| Common Stock, $1 Par Value, 30,000,000 Shares Authorized; 13,534,375 and 13,433,801 Issued and Outstanding | 13,534 | 13,434 |
| Additional Paid-In Capital | 23,882 | 42,617 |
| Retained Earnings | 133,307 | 125,701 |
| Accumulated Other Comprehensive Income | (1,938) | 1,049 |
| Total Stockholders' Equity | 168,785 | 182,821 |
| Total Liabilities and Stockholders' Equity | $ 2,050,579 | $ 1,744,863 |

## ALERUS FINANCIAL CORPORATION AND SUBSIDIARIES
## CONSOLIDATED STATEMENTS OF INCOME
## YEARS ENDED DECEMBER 31, 2016, 2015 AND 2014

| | 2016 | 2015 | 2014 |
|---|---|---|---|
| | *(dollars in thousands, except share and per share amounts)* | | |
| **INTEREST INCOME** | | | |
| Loans and Leases, Including Fees | $ 63,644 | $ 51,731 | $ 47,876 |
| Investment Securities | | | |
| Taxable | 4,584 | 3,496 | 5,483 |
| Exempt from Federal Income Taxes | 1,089 | 808 | 817 |
| Other | 625 | 293 | 218 |
| Total Interest Income | 69,942 | 56,328 | 54,394 |
| **INTEREST EXPENSE** | | | |
| Deposits | 3,385 | 2,758 | 2,673 |
| Short-Term Borrowings | 11 | 18 | 22 |
| Long-Term Debt | 3,606 | 682 | 621 |
| Total Interest Expense | 7,002 | 3,458 | 3,316 |
| **NET INTEREST INCOME** | 62,940 | 52,870 | 51,078 |
| **PROVISION FOR CREDIT LOSSES** | 3,060 | 4,200 | (400) |
| **NET INTEREST INCOME, AFTER PROVISION FOR CREDIT LOSSES** | 59,880 | 48,670 | 51,478 |
| **NON-INTEREST INCOME** | | | |
| Retirement Services | 57,804 | 51,059 | 41,058 |
| Wealth Management | 12,640 | 11,418 | 11,119 |
| Mortgage Banking | 28,296 | 24,630 | 18,435 |
| Service Charges on Deposit Accounts | 1,916 | 1,611 | 1,626 |
| Net Gain (Loss) on Investment Securities | (24) | (17) | 2,179 |
| Other | 4,449 | 4,554 | 3,989 |
| Total Non-Interest Income | 105,081 | 93,255 | 78,406 |
| **NON-INTEREST EXPENSES** | | | |
| Salaries | 70,739 | 59,122 | 48,839 |
| Employee Benefits | 15,975 | 12,804 | 11,580 |
| Net Occupancy Expense | 6,437 | 5,203 | 4,424 |
| Furniture and Equipment Expense | 6,018 | 5,018 | 4,658 |
| Intangible Amortization Expense | 7,005 | 4,361 | 4,196 |
| Other | 37,618 | 31,626 | 26,418 |
| Total Non-Interest Expenses | 143,792 | 118,134 | 100,115 |
| **INCOME BEFORE INCOME TAXES** | 21,169 | 23,791 | 29,769 |
| **INCOME TAX EXPENSE** | 7,138 | 6,683 | 8,999 |
| **NET INCOME** | 14,031 | 17,108 | 20,770 |
| **LESS PREFERRED STOCK DIVIDENDS** | 25 | 200 | 200 |
| **NET INCOME APPLICABLE TO COMMON STOCK** | $ 14,006 | $ 16,908 | $ 20,570 |
| **PER SHARE INFORMATION** | | | |
| Earnings per Common Share | $ 1.04 | $ 1.26 | $ 1.55 |
| Diluted Earnings Per Common Share | $ 1.00 | $ 1.21 | $ 1.48 |
| Dividends Declared Per Common Share | $ 0.44 | $ 0.42 | $ 0.38 |
| **Average Common Shares Outstanding** | 13,494,691 | 13,412,586 | 13,289,714 |
| **Diluted Average Common Shares Outstanding** | 14,000,332 | 13,947,136 | 13,877,344 |

**ALERUS FINANCIAL CORPORATION AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**
**YEARS ENDED DECEMBER 31, 2016, 2015 AND 2014**

| | 2016 | 2015 | 2014 |
|---|---|---|---|
| | | *(dollars in thousands)* | |
| **NET INCOME** | $ 14,031 | $ 17,108 | $ 20,770 |
| Other Comprehensive Income, Before Tax: | | | |
| Unrealized Gains (Losses) on Available-for-Sale Securities | (4,721) | (505) | 3,959 |
| Reclassification Adjustment for Losses (Gains) Realized in Income | 17 | - | (2,131) |
| Total Other Comprehensive Income (Loss), Before Tax | (4,704) | (505) | 1,828 |
| Income Tax (Expense) Benefit Related to Items of Other Comprehensive Income | 1,717 | 184 | (667) |
| Other Comprehensive Income (Loss), Net of Tax | (2,987) | (321) | 1,161 |
| **TOTAL COMPREHENSIVE INCOME** | $ 11,044 | $ 16,787 | $ 21,931 |

# ALERUS FINANCIAL CORPORATION AND SUBSIDIARIES
# CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
# YEARS ENDED DECEMBER 31, 2016, 2015 AND 2014

| *(dollars in thousands, except share and per share amounts)* | Preferred Stock | Common Stock | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Income/(Loss) | Total |
|---|---|---|---|---|---|---|
| **BALANCE, DECEMBER 31, 2013** | $ 20 | $ 4,416 | $ 38,826 | $ 109,840 | $ 209 | $ 153,311 |
| Net Income | - | - | - | 20,770 | - | 20,770 |
| Other Comprehensive Income | - | - | - | - | 1,161 | 1,161 |
| Issued 5,877 Shares Under Stock Based Compensation Plans | - | 6 | 309 | - | - | 315 |
| Stock Dividend 3 for 1 | - | 8,895 | 386 | (9,281) | - | - |
| Cash Dividend Declared Preferred - 1.0% | - | - | - | (200) | - | (200) |
| Cash Dividend Declared Common ($.38 Per Share) | - | - | - | (5,332) | - | (5,332) |
| Income Tax Benefit Equity Related Items | - | - | 539 | (539) | - | - |
| Stock-Based Compensation Expense | - | - | 1,061 | - | - | 1,061 |
| Vesting of 28,872 Shares of Restricted Stock | - | 29 | (29) | - | - | - |
| **BALANCE, DECEMBER 31, 2014** | 20 | 13,346 | 41,092 | 115,258 | 1,370 | 171,086 |
| Net Income | - | - | - | 17,108 | - | 17,108 |
| Other Comprehensive Loss | - | - | - | - | (321) | (321) |
| Repurchase of 1,009 Shares | - | (1) | (26) | - | - | (27) |
| Issued 16,326 Shares Under Stock Based Compensation Plans | - | 16 | 299 | - | - | 315 |
| Cash Dividend Declared Preferred - 1.0% | - | - | - | (200) | - | (200) |
| Cash Dividend Declared Common ($.42 Per Share) | - | - | - | (5,859) | - | (5,859) |
| Income Tax Benefit Equity Related Items | - | - | 606 | (606) | - | - |
| Stock-Based Compensation Expense | - | - | 719 | - | - | 719 |
| Vesting of 72,540 Shares of Restricted Stock | - | 73 | (73) | - | - | - |
| **BALANCE, DECEMBER 31, 2015** | 20 | 13,434 | 42,617 | 125,701 | 1,049 | 182,821 |
| Net Income | - | - | - | 14,031 | - | 14,031 |
| Other Comprehensive Loss | - | - | - | - | (2,987) | (2,987) |
| Repurchase of 17,565 Shares | - | (18) | (102) | (237) | - | (357) |
| Issued 19,726 Shares Under Stock Based Compensation Plans | - | 20 | 345 | - | - | 365 |
| Cash Dividend Declared Preferred - 1.0% | - | - | - | (25) | - | (25) |
| Cash Dividend Declared Common ($.44 Per Share) | - | - | - | (6,163) | - | (6,163) |
| Stock-Based Compensation Expense | - | - | 1,100 | - | - | 1,100 |
| Vesting of 98,413 Shares of Restricted Stock | - | 98 | (98) | - | - | - |
| Redemption of 20,000 Shares of Preferred Stock | (20) | - | (19,980) | - | - | (20,000) |
| **BALANCE, DECEMBER 31, 2016** | $ - | $ 13,534 | $ 23,882 | $ 133,307 | $ (1,938) | $ 168,785 |

## ALERUS FINANCIAL CORPORATION AND SUBSIDIARIES
## CONSOLIDATED STATEMENTS OF CASH FLOWS
## YEARS ENDED DECEMBER 31, 2016, 2015 AND 2014

| *(dollars in thousands)* | 2016 | 2015 | 2014 |
|---|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | | |
| Net Income | $ 14,031 | $ 17,108 | $ 20,770 |
| Adjustments to Reconcile Net Income to Net Cash | | | |
| Deferred Income Taxes | (3,044) | 581 | (1,726) |
| Provision for Credit Losses | 3,060 | 4,200 | (400) |
| Provision for Foreclosed Asset Losses | 226 | 53 | - |
| Depreciation and Amortization | 11,385 | 8,727 | 8,160 |
| Compensation Related Stock Plans | 1,465 | 1,034 | 1,376 |
| Investment Security Premium Amortization | 2,364 | 636 | 1,372 |
| Increase in Value of Bank-Owned Life Insurance | (831) | (824) | (821) |
| Realized Loss (Gain) on Forward Sale Derivatives | (81) | (186) | 91 |
| Realized Loss (Gain) on Rate Lock Commitments | 135 | 139 | (104) |
| Realized Loss (Gain) on Sale of Premises and Equipment | 6 | - | 163 |
| Realized Loss (Gain) on Sale of Foreclosed Assets | 73 | 540 | 546 |
| Realized Loss (Gain) on Sale of Investment Securities | 17 | - | (2,130) |
| Realized Loss (Gain) on Servicing Rights | (1,293) | (1,178) | (1,045) |
| Net Change in: | | | |
| Securities Held for Trading | (12) | 13 | (59) |
| Mortgages Held for Sale | 13,579 | (13,600) | (4,788) |
| Accrued Interest Receivable | (1,089) | (56) | 667 |
| Other Assets | 313 | (2,867) | (6,548) |
| Accrued Expenses and Other Liabilities | (6,315) | 10,039 | 5,848 |
| Net Cash Provided by Operating Activities | 33,989 | 24,359 | 21,372 |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | | |
| Proceeds from Sales of Securities Available for Sale | 59,910 | - | 85,549 |
| Proceeds from Maturities of Securities Available for Sale | 42,806 | 40,096 | 21,516 |
| Purchases of Securities Available for Sale | (82,487) | (27,490) | (18,391) |
| Net (Increase) Decrease in Loans and Leases | (38,884) | (38,723) | (88,094) |
| Payments for Business Combinations | (45,441) | (4,314) | (10,843) |
| Proceeds from Bank Owned Life Insurance | 5,331 | - | - |
| Purchases of Bank Premises and Equipment | (1,684) | (3,906) | (2,101) |
| Proceeds from Sales of Bank Premises and Equipment | 404 | - | 3 |
| Proceeds from Sales of Foreclosed Assets | 636 | 2,126 | 3,341 |
| Net Cash Used by Investing Activities | (59,409) | (32,211) | (9,020) |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | | |
| Net Increase (Decrease) in Deposits | 25,020 | 195,853 | (36,359) |
| Net Increase (Decrease) in Short-Term Borrowings | (6,847) | (10,532) | 2,657 |
| Repayments of Notes Payable | (25,000) | (125) | (136) |
| Proceeds from Issuance of Subordinated Debt | - | 49,375 | - |
| Cash Dividends Paid on Preferred Stock | (25) | (200) | (200) |
| Cash Dividends Paid on Common Stock | (6,163) | (5,859) | (5,332) |
| Redemption of Preferred Stock | (20,000) | - | - |
| Repurchase of Common stock | (357) | (27) | - |
| Net Cash Provided (Used) by Financing Activities | (33,372) | 228,485 | (39,370) |
| **NET CHANGE IN CASH AND DUE FROM BANKS** | (58,792) | 220,633 | (27,018) |
| Cash and Due From Banks at Beginning of Year | 266,159 | 45,526 | 72,544 |
| **CASH AND DUE FROM BANKS** | $ 207,367 | $ 266,159 | $ 45,526 |

| | 2016 | 2015 | 2014 |
|---|---|---|---|
| **SUPPLEMENTAL CASHFLOW DISCLOSURES** | | | |
| Loan Collateral Transferred to Foreclosed Assets | $ 1,851 | $ 684 | $ 1,499 |
| Unrealized Gain/(Loss) on Securities Available for Sale | (2,987) | (321) | 1,161 |
| Interest Paid for the Period | 7,263 | 3,381 | 3,394 |
| Income Tax Payments Net of Refunds Received | 1,612 | 10,165 | 11,257 |
| Acquisitions | | | |
| Noncash Assets Acquired | 335,830 | 4,572 | 127,650 |
| Liabilities Assumed | (328,748) | (258) | (116,807) |
| Net Noncash Asset Acquired | 7,082 | 4,314 | 10,843 |
| Cash & Cash Equivalents Acquired | 18,748 | - | 17,690 |

## NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Nature of Operations

Alerus Financial Corporation (Company) is a financial holding company organized under the laws of Delaware. The Company, through its subsidiaries, engages primarily in general commercial banking, mortgage banking, retirement plan administration, trust and investment advisement services. The Company's subsidiary operations also include retail brokerage services.

Alerus Financial, N.A. (Bank), the subsidiary bank, operates under a national charter and provides full banking services. As a national bank, the Bank is subject to regulation by the Office of the Comptroller of Currency and the Federal Deposit Insurance Corporation.

Policies which materially affect the determination of financial position, cash flows, and results of operations are summarized below.

### Principles of Consolidation

The consolidated financial statements include the amounts of Alerus Financial Corporation and all other entities in which Alerus Financial Corporation has a controlling financial interest. All significant intercompany balances and transactions have been eliminated in consolidation.

The Company determines whether there is a controlling financial interest in an entity by first evaluating whether the entity is a voting interest entity or a variable interest entity ("VIE") under accounting principles generally accepted in the United States. Voting interest entities are entities in which the total equity investment at risk is sufficient to enable the entity to finance itself independently and provides the equity holders with the obligation to absorb losses, the right to receive residual returns and the right to make decisions about the entity's activities. We consolidate voting interest entities in which we have all, or at least a majority of, the voting interest. As defined in applicable accounting standards, VIEs are entities that lack one or more of the characteristics of a voting interest entity. A controlling financial interest in a VIE is present when an enterprise has both the power to direct the activities of the VIE that most significantly impact the VIE's economic performance and an obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE. The enterprise with a controlling financial interest, known as the primary beneficiary, consolidates the VIE. The wholly owned subsidiaries Excelsior Financial Trust I and Excelsior Financial Trust II are VIEs for which the Company is not the primary beneficiary. Accordingly, the accounts of these trusts are not included in the consolidated financial statements.

### Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change in the near term include the valuation of securities, determination of the allowance for loan and lease losses,

## NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### Use of Estimates (Continued)
valuation of reporting units for the purpose of testing goodwill and other intangible assets for impairment, fair value of assets acquired and liabilities assumed upon completion of a business combination, valuation of deferred tax assets, and fair values of financial instruments.

### Concentrations of Credit Risk
Substantially all of the Company's lending activities are with customers located within North Dakota, Minnesota and Arizona. At December 31, 2016 and 2015, respectively, 34.4% and 33.8% of the Company's loan portfolio consisted of commercial and industrial loans that were not secured by real estate. The Company does not have any significant loan concentrations in any one industry or customer. Note 4 discusses the Company's loan portfolio.

The Company invests in a variety of securities and does not have any significant securities concentrations in any one industry or to any one issuer. Note 3 discusses the Company's investment securities portfolio.

### Cash and Due From Banks
For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash and balances due from banks, federal funds sold, and securities purchased under agreements to resell, all of which have an original maturity within 90 days. Cash flows from loans and deposits are reported net.

Interest-bearing deposits in banks are carried at cost.

### Investment Securities
Debt securities that are held for short-term resale are classified as trading securities and carried at fair value, with increases and decreases in fair value recognized in net gains (losses) on investment securities within the statement of income. Other marketable securities are classified as available-for-sale and are carried at fair value. Realized gains and losses on securities available-for-sale are included in other income or expense and, when applicable, are reported as a reclassification adjustment, net of tax, in other comprehensive income. Gains and losses on sales of securities are determined using the specific identification method on the trade date. The amortization of premiums and accretion of discounts are recognized in interest income using methods approximating the interest method over the period to maturity.

Declines in the fair value of individual available-for-sale securities below their cost that are other than temporary result in write-downs of the individual securities to their fair value. The Company monitors the investment security portfolio for impairment on an individual security basis and has a process in place to identify securities that could potentially have a credit impairment that is other than temporary. This process involves analyzing the length of time and the extent to which the fair value has been less than the amortized cost basis, the market liquidity for the security, the financial condition and near-term prospects of the issuer, expected cash flows, and the Company's intent and ability to hold the investment for a period of time sufficient to recover the temporary loss. The ability to hold is determined

## NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### Investment Securities (Continued)

whether it is more likely than not that the Company will be required to sell the security before its anticipated recovery. A decline in value due to a credit event that is considered other than temporary is recorded as a loss in noninterest income.

Equity investments for which quoted market values are unavailable are carried at cost in Other Assets on the consolidated balance sheets.

The Company has investments in certain partnerships for which the Company does not have the controlling interest. For these investments, the Company records its interest in Other Assets using the equity method with its portion of income or loss being recorded in Noninterest Income in the consolidated statements of income. The Company periodically evaluates these investments for impairment.

### Derivatives and Hedging Activities

All derivatives are recognized on the balance sheet at their fair value. On the date the derivative contract is entered into, the Company designates the derivative as (1) a hedge of fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge), or (2) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge), or (3) held for trading, customer accommodation or asset/liability risk management purposes, including economic hedges not qualifying for hedge accounting. Changes in the fair value of a derivative that is highly effective, and that is designated and qualifies as a fair value hedge, along with the loss or gain on the hedged asset or liability that is attributable to the hedged risk (including losses or gains on firm commitments), are recorded in current-period earnings. Changes in the fair value of a derivative that is highly effective as, and that is designated and qualifies as, a cash-flow hedge are recorded in other comprehensive income, until earnings are affected by the variability of cash flows (e.g., when periodic settlements on a variable rate asset or liability are recorded in earnings).

The Company formally documents all relationships between hedging instruments and hedged items, as well as its risk-management objective and strategy for undertaking various hedged transactions. This process includes linking all derivatives that are designated as cash-flow hedges to specific assets and liabilities on the balance sheet or to specific firm commitments or forecasted transactions. The Company also formally assesses, both at the hedge’s inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in cash flows of hedged items. When it is determined that a derivative is not highly effective as a hedge or that it has ceased to be a highly effective hedge, the Company discontinues hedge accounting prospectively. When management discontinues hedge accounting because a derivative no longer qualifies as an effective fair value hedge, management continues to carry the derivative in the balance sheet at its fair value with changes in fair value included in earnings, and no longer adjust the previously hedged asset or liability for changes in fair value. Previous adjustments to the hedged item are accounted for in the same manner as other components of the carrying amount of the asset or liability.

## NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### Derivatives and Hedging Activities (Continued)

*Interest Rate Lock Commitments*
The Company enters into rate lock commitments to extend credit to borrowers for generally a 30-day or 60-day period for the origination of mortgage loans. Unfunded loans for which commitments have been entered into are called “pipeline loans.” Some of these rate lock commitments will ultimately expire without being completed. To the extent that a loan is ultimately granted and the borrower ultimately accepts the terms of the loan, these rate lock commitments expose the Company to variability in their fair value due to changes in interest rates. If interest rates increase, the value of these rate lock commitments decreases. Conversely, if interest rates decrease, the value of these rate lock commitments increases.

The Company records the fair value of its rate lock commitments in Other Assets or Other Liabilities, with changes in fair value recorded in other Non-Interest Expenses. Fair value is based on fees currently charged to enter into similar agreements, and for fixed-rate commitments, also considers the difference between current levels of interest rates and the committed rates.

*Forward Loan Sale Commitments*
To mitigate the effect of this interest rate risk, the Company enters into offsetting forward loan sale commitments. The forward loan sale commitments lock in an interest rate and price for the sale of loans similar to the specific rate lock loan commitments classified as derivatives. Both the rate lock commitments and the forward loan sale commitments are undesignated derivatives, and accordingly are marked to market through earnings.

### Mortgages Held for Sale
Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value in the aggregate. Net unrealized losses are recognized through a valuation allowance by charges to income. Gains and losses on loan sales are recorded in Noninterest Income and direct loan origination costs and fees are deferred at origination of the loan and are recognized in Noninterest Income upon sale of the loan.

### Loans and Leases
Loans are stated at the amount of unpaid principal, reduced by an allowance for loan and lease losses. Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for charge-offs, and the allowance for loan and lease losses. Loan fees received that are associated with originating or acquiring certain loans are deferred and amortized over the life of the loan as a yield adjustment to interest income.

The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days past due unless the credit is well-secured and in process of collection. Consumer loans are typically charged off no later than 120 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful.

## NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

**Loans and Leases (Continued)**
All interest accrued but not collected for loans that are placed on nonaccrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

**Loans Acquired with Deteriorated Credit Quality**
The Company has purchased loan portfolios of institutions as a part of business combinations as discussed in notes 2 and 4. The Company accounts for credit impaired loans in this portfolio of loans using the cost recovery method in accordance with the provisions of ASC 310-30.

The Company follows specific accounting guidance related to purchased impaired loans that have evidence of credit deterioration since origination and it is probable at the date of acquisition that the Company will not collect all contractually required principal and interest payments. Evidence of credit quality deterioration as of the purchase date may include statistics such as past due status. The accounting guidance permits the use of the cost recovery method of income recognition for those purchased impaired loans for which the timing and amount of cash flows expected to be collected cannot be reasonably estimated. Under the cost recovery method of income recognition, all cash receipts are initially applied to principal, with interest income being recorded only after the carrying value of the loans has been reduced to zero.

Sales of individual loans within loan portfolios are accounted for in accordance with the revenue recognition method described above. Gains on bulk sales or groups of loans, representing the difference between the sales price and the basis of the loans, are recognized when the loans are sold.

**Allowance for Loan and Lease Losses**
The allowance for loan and lease losses (allowance) is an estimate of loan losses inherent in the Company’s loan portfolio. The allowance is established through a provision for credit losses which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after loan losses and loan growth. Loan losses are charged off against the allowance when the Company determines the loan balance to be uncollectible. Cash received on previously charged off amounts is recorded as a recovery to the allowance.

The allowance consists of three primary components, general reserves, specific reserves related to impaired loans, and unallocated reserves. The general component covers non-impaired loans and is based on historical losses adjusted for current factors. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by the Company over the most recent five years. This actual loss experience is adjusted for economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices;

## NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### Allowance for Loan and Lease Losses (Continued)

experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. These factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Loans determined to be impaired are individually evaluated for impairment. When a loan is impaired, the Company measures impairment based on the present value of expected future cash flows discounted at the original contractual interest rate, except that as a practical expedient, it may measure impairment based on an observable market price, or the fair value of the collateral if collateral dependent. A loan is collateral dependent if the repayment is expected to be provided solely by the underlying collateral.

Allowance allocations other than general and specific are included in the unallocated portion. While allocations are made for loans based upon historical loss analysis, the unallocated portion is designed to cover the uncertainty of how current economic conditions and other uncertainties may impact the existing loan portfolio. Factors to consider include national and state economic conditions such as increases in unemployment and the real estate lending crisis. The unallocated reserve addresses inherent probable losses not included elsewhere in the allowance for loan losses.

Under certain circumstances, the Company will provide borrowers relief through loan restructurings. A restructuring of debt constitutes a troubled debt restructuring (TDR) if the Company for economic or legal reasons related to the borrower’s financial difficulties grants a concession to the borrower that it would not otherwise consider. Restructured loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and measured for impairment as described above in the calendar year of the restructuring. In subsequent years, a restructured loan may cease being classified as impaired if the loan was modified at a market rate and is performing according to the modified terms. TDR concessions can include reduction of interest rates, extension of maturity dates, forgiveness of principal or interest due, or acceptance of other assets in full or partial satisfaction of the debt. Restructured loans can involve loans remaining on nonaccrual, moving to nonaccrual, or continuing on accrual status, depending on the individual facts and circumstances of the borrower. Nonaccrual restructured loans are included and treated with other nonaccrual loans.

The Company assigns a risk rating to all loans except pools of homogeneous loans and periodically performs detailed internal reviews of all such loans over a certain threshold to identify credit risks and to assess the overall collectability of the portfolio. These risk ratings are also subject to examination by the Company’s regulators. During the internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which the borrowers operate and the fair values of collateral securing the loans. These credit quality indicators are used to assign a risk rating

## NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### Allowance for Loan and Lease Losses (Continued)

to each individual loan. The Company's ratings are aligned to Pass and Criticized categories. The Criticized category includes Special Mention, Substandard and Doubtful risk ratings. The risk ratings are defined as follows:

**Pass**: A pass loan is a credit with no existing or known potential weaknesses deserving of management's close attention.

**Special Mention**: Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, this potential weakness may result in deterioration of the repayment prospects for the loan or of the Company's credit position at some future date. Special mention loans are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

**Substandard**: Loans classified as substandard are not adequately protected by the current net worth and paying capacity of the borrower or of the collateral pledged, if any. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the repayment of the debt. Well-defined weaknesses include a borrower's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time, or the failure to fulfill economic expectations. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

**Doubtful**: Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or repayment in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

**Loss**: Loans classified as loss are considered uncollectible and charged off immediately.

The Company maintains a separate general valuation allowance for each portfolio segment. These portfolio segments include commercial, industrial, and agricultural, real estate construction, commercial real estate mortgage, real estate 1-4 family first mortgage, real estate 1-4 family junior mortgage, and other revolving and installment with risk characteristics described as follows:

**Commercial, Industrial, and Agricultural**: Commercial and industrial loans generally possess a lower inherent risk of loss than real estate portfolio segments as these loans are generally underwritten based on the cash flows of the operating business. Repayment is provided by business cash flows. Repayment is influenced by economic trends such as unemployment rates and other key economic factors. Agricultural loans generally possess a lower inherent risk of loss than real estate portfolio segments for the same reasons as commercial and industrial loans. However, they generally possess greater volatility of risk due to commodity pricing, which can lead to cash flow and collateral shortfalls.

## NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

**Allowance for Loan and Lease Losses (Continued)**

**Real Estate Construction**: Real estate construction loans generally possess a higher inherent risk of loss than commercial and retail real estate portfolio segments. Significant inherent risks are project completion, cost overruns, and adherence to construction schedule. Additionally, real estate values could significantly impact the credit quality of these loans.

**Commercial Real Estate Mortgage**: Commercial real estate loans generally possess a higher inherent risk of loss than retail real estate portfolio segments, except real estate construction and agricultural land loans. Adverse economic developments such as high vacancy rates or decreasing real estate values may impact commercial real estate credit quality. Agricultural real estate loans are primarily comprised of loans for the purchase of farmland. Risks associated with farmland include volatility of real estate values driven by commodity prices, among other economic trends.

**Real Estate 1-4 Family First Mortgage and Junior Mortgage**: The degree of risk in residential mortgage lending depends primarily on the loan amount in relation to collateral value, the interest rate, and the borrower's ability to repay in an orderly fashion. These loans generally possess a lower inherent risk of loss than commercial real estate portfolio segments. Credit quality is impacted by unemployment rates and other key economic indicators.

**Other Revolving and Installment**: The consumer loan portfolio is primarily comprised of homogenous loans. Credit quality is impacted by unemployment rates and other key economic indicators.

Although management believes the allowance to be adequate, actual losses may vary from its estimates. On a quarterly basis, the board of directors reviews the adequacy of the allowance, including consideration of the relevant risks in the portfolio, current economic conditions and other factors. If the board of directors and management determine that changes are warranted based on those reviews, the allowance is adjusted. In addition, the Company's primary regulator assesses the adequacy of the allowance. The regulatory agencies may require adjustments to the allowance based on their judgment about information available at the time of their examinations.

**Off-Balance-Sheet Credit Related Financial Instruments**

In the ordinary course of business, the Company enters into commitments to extend credit, including commitments under credit arrangements, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded when they are funded. The Company establishes a reserve for unfunded commitments using historical data and utilization assumptions.

**Premises and Equipment**

Land is carried at cost. Other premises and equipment are carried at cost net of accumulated depreciation. Depreciation is computed on the straight-line method based principally on the estimated useful lives of the assets. Maintenance and repairs are expensed as incurred while major additions and improvements are capitalized. Gains and losses on dispositions are included in current operations.

## NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### Bank Owned Life Insurance

The Company has purchased life insurance policies on certain key executives. Bank owned life insurance is recorded at its cash surrender value, or the amount that can be realized, if lower.

### Impairment of Long-Lived Assets

The Company tests long-lived assets for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of carrying amount or fair value less estimated costs to sell.

### Foreclosed Assets

Assets acquired through, or in lieu of, loan foreclosure are included in other assets and are held for sale and are initially recorded at fair value less estimated selling cost at the date of foreclosure, establishing a new cost basis. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. Subsequent to foreclosure, valuations are periodically performed by management and the assets held for sale are carried at the lower of the new cost basis or fair value less cost to sell. This evaluation is inherently subjective and requires estimates that are susceptible to significant revisions as more information becomes available. Due to potential changes in conditions, it is at least reasonably possible that changes in fair values will occur in the near term and that such changes could materially affect the amounts reported in the Company's consolidated financial statements.

Impairment losses on assets to be held and used are measured at the amount by which the carrying amount of a property exceeds its fair value. Costs of significant asset improvements are capitalized, whereas costs relating to holding assets are expensed. Revenue and expenses from operations and changes in the valuation allowance are included in net expenses from foreclosed assets.

### Goodwill and Other Intangibles

Goodwill resulting from acquisitions is not amortized, but is tested for impairment annually. As part of its testing, the Company first assesses the qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If the Company determines the fair value of a reporting unit is less than its carrying amount using these qualitative factors, the Company then compares the fair value of the goodwill with its carrying amount, and then measures impairment loss by comparing the implied fair value of goodwill with the carrying amount of that goodwill.

Significant judgment is applied when goodwill is assessed for impairment. This judgment includes developing cash flow projections, selecting appropriate discount rates, identifying relevant market comparables, incorporating general economic and market conditions, and selecting an appropriate control premium. At December 31, 2016, the Company believes

## NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### Goodwill and Other Intangibles (Continued)

the Bank does not have any indicators of potential impairment based on the estimated fair value of this reporting unit.

Intangible assets determined to have definite lives are amortized over the remaining useful lives. Intangible and other long-lived assets are reviewed for impairment whenever events occur or circumstances indicate that the carrying amount may not be recoverable.

### Servicing Rights

Servicing rights are recognized as separate assets when rights are acquired through sale of mortgage loans. For sales of mortgage loans, a portion of the cost of originating the loan is allocated to the servicing right based on relative fair value. Fair value is based on market prices for comparable servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds, and default rates and losses. Capitalized servicing rights are reported in other intangible assets and are amortized into noninterest income in proportion to, and over the period of, the estimated future servicing income of the underlying loans.

Servicing rights are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights by predominant characteristics, such as interest rates and terms. Impairment is recognized through a valuation allowance for an individual tranche, to the extent that fair value is less than the capitalized amount for the tranche. If the Company later determines that all or a portion of the impairment no longer exists for a particular tranche, a reduction of the allowance may be recorded as an increase to income.

Servicing fee income is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal, or a fixed amount per loan, and are recorded as income when earned. The amortization of servicing rights is netted against loan servicing fee income.

### Transfers of Financial Assets and Participating Interests

Transfers of an entire financial asset or a participating interest in an entire financial asset 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 Company, (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 Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

The transfer of a participating interest in an entire financial asset must also meet the definition of a participating interest. A participating interest in a financial asset has all of the following characteristics: (1) from the date of transfer, it must represent a proportionate (pro rata) ownership interest in the financial asset, (2) from the date of transfer, all cash flows

## NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

**Transfers of Financial Assets and Participating Interests (Continued)**

received, except any cash flows allocated as any compensation for servicing or other services performed, must be divided proportionately among participating interest holders in the amount equal to their share ownership, (3) the rights of each participating interest holder must have the same priority, (4) no party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to do so.

**Retirement Services and Wealth Management Income**

Retirement Services and Wealth Management income includes revenue earned from trust administration and other related fiduciary services, custody, investment management and advisory services, employee benefit account and IRA administration, estate settlement, tax service fees, shareholder service fees and brokerage. These fees are based on a combination of asset values and flat fee for services provided. Fees are generally recognized over the period that the related service is provided.

Included in Other Assets on the balance sheet is a receivable for trust fees that have been earned but not yet collected.

**Advertising Costs**

Advertising costs are expensed as incurred.

**Income Taxes**

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. 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.

These calculations are based on many complex factors including estimates of the timing of reversals of temporary differences, the interpretation of federal and state income tax laws, and a determination of the differences between the tax and the financial reporting basis of assets and liabilities. Actual results could differ significantly from the estimates and interpretations used in determining the current and deferred income tax liabilities.

Under generally accepted accounting principles, a valuation allowance is required to be recognized if it is “more likely than not” that the deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management’s evaluation of both positive and negative evidence, the forecasts of future income, applicable tax planning strategies, and assessments of the current and future economic and business conditions.

The Company follows standards related to Accounting for Uncertainty in Income Taxes. These rules establish a higher standard for tax benefits to meet before they can be recognized in a Company’s consolidated financial statements. The Company can recognize in financial statements the impact of a tax position taken, or expected to be taken, if it is more likely than not that the position will be sustained on audit based on the technical merit

## NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### Income Taxes (Continued)

of the position. See Note 18, Income Taxes, for additional disclosures. The Company recognizes both interest and penalties as components of other operating expenses.

The amount of the uncertain tax position was not determined to be material. It is not expected that the unrecognized tax benefit will be material within the next 12 months. The Company did not recognize any interest or penalties in 2016, 2015, or 2014.

The Company files consolidated federal and state income tax returns and it is not subject to federal and state income tax examinations for taxable years prior to 2013.

### Comprehensive Income

Recognized revenue, expenses, gains, and losses are included in net income. Certain changes in assets and liabilities, such as unrealized gains and losses on securities available-for-sale, are reported as a separate component of the equity section of the consolidated balance sheets, such items, along with net income, are components of comprehensive income.

### Stock Compensation Plans

Stock compensation accounting guidance requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. The cost will be measured based on the grant date fair value of the equity or liability instruments issued. The stock compensation accounting guidance covers a wide range of share-based compensation arrangements including stock options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans.

The stock compensation accounting guidance requires that compensation cost for all stock awards be calculated and recognized over the employee's service period, generally defined as the vesting period. For awards with graded-vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. The market price of the Company's common stock at the date of grant is used for restricted stock awards.

All share data contained within the financial statements has been retroactively restated for certain stock based transactions (i.e. stock splits effected in the form of dividends).

### Earnings Per Share

Basic earnings per common share is calculated by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings per common share is calculated by dividing net income available to common shareholders by the weighted average number of common shares outstanding plus outstanding non-vested restricted stock awards.

### Reclassification

Certain amounts have been reclassified in prior years to conform to the current period presentation.

## NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

**New Accounting Pronouncements**

In January 2014, FASB Accounting Standards Update (ASU) No. 2014-04, amended ASC Sub-Topic 310-40 “Receivables—Troubled Debt Restructurings by Creditors.” The amendments clarify that an in substance repossession or foreclosure occurs, and the Company is considered to have received physical possession of residential real estate property collateralizing a mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The amendments in this update are effective for the annual periods beginning on or after December 15, 2014 and an entity can elect to adopt the amendments in this update using either a modified retrospective transition method or a prospective transition method as allowed in ASU No. 2014-04. The adoption of ASU No. 2014-04 did not have a material effect on the Company’s consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09 Revenue from Contracts with Customers (Topic 606), which does not apply to financial instruments. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. The amendments can be applied retrospectively to each prior reporting period or retrospectively with the cumulative effect of initially applying this ASU recognized at the date of initial application. Early application is not permitted. In August 2015, the FASB issued ASU No. 2015-14 which deferred the effective date of ASU No. 2014-09 until annual reporting periods beginning after December 15, 2017. No other revisions were made to ASU 2014-09. The Company is currently evaluating the potential impact of ASU 2014-09 on the Company’s consolidated financial statements.

In June 2014, the FASB issued ASU 2014-12, "Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period". This update requires that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. This update is effective for interim and annual periods beginning after December 15, 2015. The amendments can be applied prospectively to all awards granted or modified after the effective date or retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented and to all new or modified awards thereafter. The Company adopted this guidance on January 1, 2016 with no significant impact on the Company's consolidated financial statements.

In February 2015, the FASB issued ASU No. 2015-02, Consolidation (Topic 810) - Amendments to the Consolidated Analysis." ASU 2015-02 implements changes to both the variable interest consolidation model and the voting interest consolidation model. ASU 2015-02 (i) eliminates certain criteria that must be met when determining when fees paid to a decision maker or service provider do not represent a variable interest, (ii) amends the criteria for determining whether a limited partnership is a variable interest entity and (iii) eliminates the presumption that a general partner controls a limited partnership in the voting model. ASU 2015-02 is effective for fiscal years beginning after December 15, 2016, and

## NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

**New Accounting Pronouncements (Continued)**

interim periods within fiscal years beginning after December 15, 2017 and is not expected to have a significant impact on our financial statements.

In April 2015, the FASB issued ASU No. 2015-03, Interest-Imputation of Interest (Subtopic 835-30) - Simplifying the Presentation of Debt Issuance Costs, which requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from that debt liability, consistent with the presentation of a debt discount. ASU 2015-03 is effective for annual reporting periods beginning after December 15, 2015, including interim periods within that reporting period. The amendments must be applied retrospectively to each prior reporting period. Early application is permitted, which the Company has elected for the annual reporting period ended December 31, 2015. Subordinated Notes Payable are carried net of the related debt issuance cost as discussed in Note 11.

In September 2015, the FASB issued ASU No. 2015-16, Business Combinations (Topic 805) - Simplifying the Accounting for Measurement-Period Adjustments, which requires that adjustments to provisional amounts that are identified during the measurement period of a business combination be recognized in the reporting period in which the adjustment amounts are determined. Furthermore, the income statement effects of such adjustments, if any, must be calculated as if the accounting had been completed at the acquisition date. The portion of the amount recorded in current-period earnings that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. Under previous guidance, adjustments to provisional amounts identified during the measurement period are to be recognized retrospectively. The guidance in this ASU was effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. This update did not have a significant impact on the Company's consolidated financial statements.

In January 2016, the FASB issued Accounting Standards Update (ASU) 2016-01, Financial Instruments – Overall, which addresses certain aspects of recognition, measurement, presentation and disclosure of financial instruments. A financial instrument is defined as cash, evidence of ownership interest in a company or other entity, or a contract that both: (i) imposes on one entity a contractual obligation either to deliver cash or another financial instrument to a second entity or to exchange other financial instruments on potentially unfavorable terms with the second entity and (ii) conveys to that second entity a contractual right either to receive cash or another financial instruments from the first entity or to exchange other financial instruments on potentially favorable terms with the first entity. This pronouncement is effective for financial statements issued for annual periods beginning after December 15, 2017 and interim periods within those annual periods with earlier application permitted as of the beginning of the fiscal year of adoption. The Company is evaluating the impact that this new guidance will have on the Company's Consolidated Financial Statements.

In February 2016, the FASB issued Accounting Standards Update ("ASU") No. 2016-02, Leases. From the lessee's perspective, the new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as

## NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### New Accounting Pronouncements (Continued)

either finance or operating, with classification affecting the pattern of expense recognition in the income statement for a lessees. From the lessor's perspective, the new standard requires a lessor to classify leases as either sales-type, finance or operating. A lease will be treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn't convey risks and rewards or control, an operating lease results. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. A modified retrospective transition approach is required for lessors for sales-type, direct financing, and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company is currently evaluating the impact of the pending adoption of the new standard on its consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, "Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting", an update that changes the accounting for certain aspects of share-based payments to employees. The updated guidance requires excess tax benefits and tax deficiencies to be recorded in the income statement when the awards vest or are settled. Previously, excess tax benefits and certain tax deficiencies were recorded in additional paid-in capital. In addition, cash flows related to excess tax benefits will no longer be separately classified as a financing activity. The update also allows entities to repurchase more of an employee's shares for tax withholding purposes without triggering liability accounting, clarifies that all cash payments made on an employee's behalf for withheld shares should be presented as a financing activity on its cash flows statement, and provides an accounting policy election to account for forfeitures as they occur. The update is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption is permitted in any interim or annual period. The Company adopted the updated guidance effective January 1, 2016. This update did not have a significant impact on the Company's consolidated financial statements.

In June 2016, the FASB issued Accounting Standards Update ("ASU") No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. ASU 2016-13 requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts and requires enhanced disclosures related to the significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. In addition, ASU 2016-13 amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. ASU 2016-13 will be effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The Company is currently evaluating the potential impact of ASU 2016-13 on its financial statements.

## NOTE 2 BUSINESS COMBINATIONS

On January 2, 2015, the Company acquired Interactive Retirement Systems, LTD, located in Bloomington, Minnesota, for cash consideration of $4.1 million. The purchased assets and assumed liabilities were recorded at their respective acquisition date fair values, and identified intangible assets were recorded at fair value. The purchase, consisting of approximately 160 retirement plans with more than 16 thousand retirement participants, increased the Company's retirement services division by $1.3 billion in retirement and individual asset managed accounts. As part of the transaction, $3.8 million was allocated to an identified customer intangible and $420 thousand to goodwill.

On January 1, 2016, the Company acquired Alliance Benefit Group North Central States, Inc., located in Albert Lea, Minnesota, for cash consideration of $23.4 million. The purchased assets and assumed liabilities were recorded at their respective acquisition date fair values, and identified intangible assets were recorded at fair value. The purchase, consisting of approximately 900 retirement plans with more than 75 thousand retirement participants, increased the Company's retirement services division by $6.0 billion in retirement and individual asset managed accounts. As part of the transaction, $17.9 million was allocated to an identified customer intangible and $4.8 million to goodwill.

On January 15, 2016, the Company acquired Beacon Bank (Beacon), with locations in Shorewood, Excelsior, Eden Prairie, and Duluth, Minnesota. The purchased assets and assumed liabilities were recorded at their respective acquisition date fair values as indicated in the following table.

***(dollars in thousands, except share and per share amounts)***

## NOTE 2 BUSINESS COMBINATIONS (CONTINUED)

| Assets | As Recorded by Beacon | Fair Value Adjustments | As Recorded by Alerus |
|---|---|---|---|
| Cash and Cash Equivalents | $ 16,821 | $ - | $ 16,821 |
| Fed Funds Sold | 1,617 | - | 1,617 |
| Securities | 113,687 | 183 | 113,870 |
| Loans | 206,999 | (1,867) | 205,132 |
| Premises and Equipment | 3,626 | (44) | 3,582 |
| Foreclosed Assets | 851 | - | 851 |
| Accrued Interest Receivable | 747 | - | 747 |
| Bank-Owned Life Insurance | 5,331 | - | 5,331 |
| Core Deposit Intangible | - | 3,794 | 3,794 |
| Other Assets | 887 | 16 | 903 |
| Total Assets | 350,566 | 2,082 | 352,648 |
| **Liabilities** | | | |
| Deposits | 309,516 | 228 | 309,744 |
| Long-Term Debt | 15,000 | (2,151) | 12,849 |
| Other Liabilities | 2,895 | 41 | 2,936 |
| Total Liabilities | 327,411 | (1,882) | 325,529 |
| Excess of Assets Over Liabilities | $ 23,155 | $ 3,964 | 27,119 |
| Cash Paid for Beacon | | | 45,989 |
| Total Goodwill Recorded | | | $ 18,870 |

***(dollars in thousands, except share and per share amounts)***

## NOTE 3 INVESTMENT SECURITIES

The amortized cost of securities and their approximate fair values, with gross unrealized gains and losses as of December 31, 2016 and 2015 are as follows:

| | 2016 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| **Available-for-Sale Securities:** | | | | |
| U.S. Treasury and Government Agency Securities | $ 20,261 | $ 1 | $ (170) | $ 20,092 |
| Obligations of State and Political Agencies | 73,998 | 225 | (2,271) | 71,952 |
| Mortgage Backed Securities: | | | | |
| Residential Agency | 148,560 | 1,025 | (1,553) | 148,032 |
| Commercial | 23,279 | 79 | (247) | 23,111 |
| Asset Backed Securities | 722 | 18 | - | 740 |
| Corporate Bonds | 7,319 | - | (52) | 7,267 |
| Equity Securities | 5,865 | - | (107) | 5,758 |
| Total | $ 280,004 | $ 1,348 | $ (4,400) | $ 276,952 |

| | 2015 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| **Available-for-Sale Securities:** | | | | |
| U.S. Treasury and Government Agency Securities | $ 70,030 | $ 14 | $ (761) | $ 69,283 |
| Obligations of State and Political Agencies | 23,309 | 795 | - | 24,104 |
| Mortgage Backed Securities: | | | | |
| Residential Agency | 88,979 | 1,906 | (63) | 90,822 |
| Commercial | 950 | 26 | - | 976 |
| Equity Securities | 5,475 | - | (264) | 5,211 |
| Total | $ 188,743 | $ 2,741 | $ (1,088) | $ 190,396 |

The amortized cost and approximate fair value of securities as of December 31, 2016, by contractual maturity, are as follows:

| | Securities Available-for-Sale | |
|---|---|---|
| December 31, 2016 | Amortized Cost | Fair Value |
| Due in One Year or Less | $ 2,735 | $ 2,755 |
| Due After One Year through Five Years | 43,057 | 42,785 |
| Due After Five Years through Ten Years | 72,072 | 71,409 |
| Due After Ten Years | 156,275 | 154,245 |
| No Contractual Maturity | 5,865 | 5,758 |
| Total | $ 280,004 | $ 276,952 |

Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

***(dollars in thousands, except share and per share amounts)***

## NOTE 3 INVESTMENT SECURITIES (CONTINUED)

Securities with a carrying value of $191.2 million and $96.5 million were pledged at December 31, 2016 and 2015, respectively, to secure public deposits, repurchase agreements, and for other purposes required or permitted by law.

Proceeds from the sale of available-for-sale securities for the years ended December 31, 2016, 2015, and 2014 were $59.9 million, $-0- and $85.5 million respectively. Gross losses recognized on these sales were $100 thousand, $-0-, and $33 thousand for the years ended December 31, 2016, 2015, and 2014, respectively. Gross gains recognized on these sales were $83 thousand, $-0-, and $2.2 million for the years ended December 31, 2016, 2015, and 2014, respectively.

Proceeds from the sale and maturity of trading securities for the years ended December 31, 2016, 2015, and 2014 were $101 thousand, $240 thousand, and $527 thousand, respectively. For the years ended December 31, 2016, 2015, and 2014, gross losses recognized on these sales and maturities were $-0-, $-0-, and $3 thousand, respectively. For the years ended December 31, 2016, 2015, and 2014, gross gains recognized on these were $1 thousand, $5 thousand, and $-0-, respectively.

Information pertaining to securities with gross unrealized losses that are not deemed to be other-than-temporarily impaired at December 31, 2016 and 2015 aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

| | Less than 12 Months | | Over 12 Months | | Total | |
|---|---|---|---|---|---|---|
| December 31, 2016 | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value |
| Securities Available-for-Sale | | | | | | |
| U.S. Treasury and Government Agency | $ (170) | $ 12,598 | $ - | $ - | $ (170) | $ 12,598 |
| Obligations of State and Political Agencies | (2,256) | 56,038 | (15) | 306 | (2,271) | 56,344 |
| Mortgage Backed Securities: | | | | | | |
| Residential Agency | (1,546) | 110,349 | (7) | 1,024 | (1,553) | 111,373 |
| Commercial | (247) | 14,975 | - | - | (247) | 14,975 |
| Asset Back Securities | - | 54 | - | - | - | 54 |
| Corporate Bonds | (52) | 6,233 | - | - | (52) | 6,233 |
| Equity Securities | - | - | (107) | 2,330 | (107) | 2,330 |
| Total Securities Available-for-Sale | $ (4,271) | $ 200,247 | $ (129) | $ 3,660 | $ (4,400) | $ 203,907 |

| | Less than 12 Months | | Over 12 Months | | Total | |
|---|---|---|---|---|---|---|
| December 31, 2015 | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value |
| Securities Available-for-Sale | | | | | | |
| U.S. Treasury and Government Agency | $ (457) | $ 34,574 | $ (304) | $ 9,696 | $ (761) | $ 44,270 |
| Obligations of State and Political Agencies | - | - | - | - | - | - |
| Mortgage Backed Securities: | | | | | | |
| Residential Agency | (63) | 19,509 | - | - | (63) | 19,509 |
| Equity Securities | - | - | (264) | 2,173 | (264) | 2,173 |
| Total Securities Available-for-Sale | $ (520) | $ 54,083 | $ (568) | $ 11,869 | $ (1,088) | $ 65,952 |

***(dollars in thousands, except share and per share amounts)***

## NOTE 3 INVESTMENT SECURITIES (CONTINUED)

At December 31, 2016, all of the available-for-sale debt securities in an unrealized loss position were investment grade. During the year ended December 31, 2016, the Company evaluated all of its debt securities for credit impairment and determined there were no credit losses evident and did not record any other-than-temporary impairment. As of December 31, 2016, the Company's evaluation of other securities with continuous unrealized losses indicated that there were no credit losses evident. Furthermore, the Company does not intend to sell and it is more likely than not that the Company will not be required to sell these debt securities before the anticipated recovery of the amortized cost basis.

The Company conducts periodic reviews to identify and evaluate each investment that has an unrealized loss for other-than-temporary impairment. An unrealized loss exists when the current fair value of an individual security is less than its amortized cost basis. Unrealized losses that are determined to be temporary in nature are recorded, net of tax, in accumulated other comprehensive income for available for sale securities.

## NOTE 4 LOANS

As discussed in Note 2, the Company acquired all of the assets and liabilities of Beacon in 2016. In addition, the loans and foreclosed assets acquired in a failed bank transaction during 2009 were covered by loss share agreements between the FDIC and Alerus Financial, N.A. As of December 31, 2014, the commercial loss share agreement expired. The single family loss share agreement is in effect until 2019. The risk of the acquired single family loans and foreclosed assets are significantly different from those assets not covered under the loss share agreements. The Company has applied ASC 310-30 to all impaired loans purchased as a part of FDIC purchase and assumption agreements.

The components of loans in the consolidated balance sheets were as follows:

| | December 31, 2016 | | |
|---|---|---|---|
| | Covered | Noncovered | Total Loans |
| Commercial: | | | |
| Commercial, Industrial and Agricultural | $ - | $ 470,179 | $ 470,179 |
| Real Estate Construction | - | 35,174 | 35,174 |
| Real Estate Mortgage | - | 391,533 | 391,533 |
| Other | - | 2,270 | 2,270 |
| Total Commercial | - | 899,156 | 899,156 |
| Consumer: | | | |
| Real Estate 1-4 Family First Mortgage | 1,032 | 201,185 | 202,217 |
| Real Estate 1-4 Family Junior Mortgage | 2,444 | 176,351 | 178,795 |
| Other Revolving and Installment | - | 86,784 | 86,784 |
| Total Consumer | 3,476 | 464,320 | 467,796 |
| Total Loans | 3,476 | 1,363,476 | 1,366,952 |
| Less: Allowance for Loan Losses | (28) | (15,587) | (15,615) |
| Net Loans | $ 3,448 | $ 1,347,889 | $ 1,351,337 |

***(dollars in thousands, except share and per share amounts)***

## NOTE 4 LOANS (CONTINUED)

| | December 31, 2015 | | |
|---|---|---|---|
| | Covered | Noncovered | Total Loans |
| Commercial: | | | |
| Commercial, Industrial and Agricultural | $ - | $ 417,553 | $ 417,553 |
| Real Estate Construction | - | 16,780 | 16,780 |
| Real estate Mortgage | - | 273,825 | 273,825 |
| Other | - | 3,395 | 3,395 |
| Total Commercial | - | 711,553 | 711,553 |
| Consumer: | | | |
| Real Estate 1-4 Family First Mortgage | 1,097 | 169,566 | 170,663 |
| Real Estate 1-4 Family Junior Mortgage | 3,044 | 160,304 | 163,348 |
| Other Revolving and Installment | - | 81,357 | 81,357 |
| Total Consumer | 4,141 | 411,227 | 415,368 |
| Total Loans | 4,141 | 1,122,780 | 1,126,921 |
| Less: Allowance for Loan Losses | (33) | (14,655) | (14,688) |
| Net Loans | $ 4,108 | $ 1,108,125 | $ 1,112,233 |

***(dollars in thousands, except share and per share amounts)***

## NOTE 4 LOANS (CONTINUED)

Changes in the allowance for years ended December 31, 2016 and 2015 are summarized in the following table:

| | 2016 | 2015 |
|---|---|---|
| Balance - Beginning of Period | $ 14,688 | $ 17,063 |
| Provision for Credit Losses | 3,060 | 4,200 |
| Loan Charge-Offs: | | |
| Commercial: | | |
| Commercial, Industrial and Agricultural | (1,556) | (6,823) |
| Real Estate Construction | (1,655) | - |
| Real Estate Mortgage | (43) | (400) |
| Other | (73) | (83) |
| Total Commercial | (3,327) | (7,306) |
| Consumer: | | |
| Real Estate 1-4 Family First Mortgage | - | (5) |
| Real Estate 1-4 Family Junior Mortgage | (829) | (596) |
| Other Revolving and Installment | (280) | (270) |
| Total Consumer | (1,109) | (871) |
| Total Loan Charge-Offs | (4,436) | (8,177) |
| Loan Recoveries: | | |
| Commercial: | | |
| Commercial, Industrial and Agricultural | 1,064 | 187 |
| Real Estate Construction | 587 | 697 |
| Real Estate Mortgage | 188 | 166 |
| Other | 20 | 46 |
| Total Commercial | 1,859 | 1,096 |
| Consumer: | | |
| Real Estate 1-4 Family First Mortgage | 211 | 10 |
| Real Estate 1-4 Family Junior Mortgage | 94 | 287 |
| Other Revolving and Installment | 139 | 209 |
| Total Consumer | 444 | 506 |
| Total Loan Recoveries | 2,303 | 1,602 |
| Net Loan (Charge-Offs) / Recoveries | (2,133) | (6,575) |
| Balance - End of Period | $ 15,615 | $ 14,688 |

*(dollars in thousands, except share and per share amounts)*

## NOTE 4 LOANS (CONTINUED)

The following tables summarize the activity in the allowance by commercial and consumer portfolio segments for years ended December 31, 2016 and 2015:

| | 2016 | | | |
|---|---|---|---|---|
| | Commercial | Consumer | Unallocated | Total |
| Balance - Beginning of Period | $ 11,055 | $ 2,956 | $ 677 | $ 14,688 |
| Provision for Credit Losses | 2,080 | 141 | 839 | 3,060 |
| Total | 13,135 | 3,097 | 1,516 | 17,748 |
| Loan Charge-Offs | (3,327) | (1,109) | - | (4,436) |
| Loan Recoveries | 1,859 | 444 | - | 2,303 |
| Net Loan Charge-Offs | (1,468) | (665) | - | (2,133) |
| Balance - End of Period | $ 11,667 | $ 2,432 | $ 1,516 | $ 15,615 |

| | 2015 | | | |
|---|---|---|---|---|
| | Commercial | Consumer | Unallocated | Total |
| Balance - Beginning of Period | $ 13,556 | $ 2,761 | $ 746 | $ 17,063 |
| Provision for Credit Losses | 3,709 | 560 | (69) | 4,200 |
| Total | 17,265 | 3,321 | 677 | 21,263 |
| Loan Charge-Offs | (7,306) | (871) | - | (8,177) |
| Loan Recoveries | 1,096 | 506 | - | 1,602 |
| Net Loan Charge-Offs | (6,210) | (365) | - | (6,575) |
| Balance - End of Period | $ 11,055 | $ 2,956 | $ 677 | $ 14,688 |

The following table disaggregates the allowance and recorded investment in loans by impairment methodology:

| | Allowance for Credit Losses | | | | Recorded Investment in Loans | | |
|---|---|---|---|---|---|---|---|
| December 31, 2016 | Commercial | Consumer | Unallocated | Total | Commercial | Consumer | Total |
| Collectively Evaluated | $ 11,371 | $ 2,344 | $ 1,516 | $ 15,231 | $ 894,805 | $ 464,015 | $ 1,358,820 |
| Individually Evaluated | 296 | 88 | - | 384 | 4,042 | 3,781 | 7,823 |
| Purchased Credit Impaired | - | - | - | - | 309 | - | 309 |
| Total | $ 11,667 | $ 2,432 | $ 1,516 | $ 15,615 | $ 899,156 | $ 467,796 | $ 1,366,952 |

| | Allowance for Credit Losses | | | | Recorded Investment in Loans | | |
|---|---|---|---|---|---|---|---|
| December 31, 2015 | Commercial | Consumer | Unallocated | Total | Commercial | Consumer | Total |
| Collectively Evaluated | $ 10,522 | $ 2,956 | $ 677 | $ 14,155 | $ 702,463 | $ 414,496 | $ 1,116,959 |
| Individually Evaluated | 533 | - | - | 533 | 9,090 | 833 | 9,923 |
| Purchased Credit Impaired | - | - | - | - | - | 39 | 39 |
| Total | $ 11,055 | $ 2,956 | $ 677 | $ 14,688 | $ 711,553 | $ 415,368 | $ 1,126,921 |

*(dollars in thousands, except share and per share amounts)*

## NOTE 4 LOANS (CONTINUED)

The tables below provide a breakdown of outstanding commercial loans by risk category as of December 31, 2016 and 2015. All criticized loans are subject to high levels of monitoring by management. The Criticized category includes Special Mention, Substandard and Doubtful categories which are defined by banking regulatory agencies.

| December 31, 2016 | Commercial, Industrial and Ag | Commercial Real Estate | Real Estate Construction | Other | Total |
|---|---|---|---|---|---|
| By Risk Category: | | | | | |
| Pass | $ 452,460 | $ 361,655 | $ 32,390 | $ 2,270 | $ 848,775 |
| Criticized | 17,719 | 29,878 | 2,784 | - | 50,381 |
| Total Commercial Loans | $ 470,179 | $ 391,533 | $ 35,174 | $ 2,270 | $ 899,156 |

| December 31, 2015 | Commercial, Industrial and Ag | Commercial Real Estate | Real Estate Construction | Other | Total |
|---|---|---|---|---|---|
| By Risk Category: | | | | | |
| Pass | $ 393,898 | $ 249,210 | $ 16,017 | $ 3,395 | $ 662,520 |
| Criticized | 23,655 | 24,615 | 763 | - | 49,033 |
| Total Commercial Loans | $ 417,553 | $ 273,825 | $ 16,780 | $ 3,395 | $ 711,553 |

The following tables reflect the past due aging analysis of the loan portfolio, segmented by loans covered by FDIC loss share agreement, as of December 31, 2016 and 2015:

| December 31, 2016 | 30-89 Days Past Due | 90+ Days Past Due Still Accruing | Nonaccrual Loans | Current | Total Loans |
|---|---|---|---|---|---|
| Noncovered Loans | | | | | |
| Commercial: | | | | | |
| Commercial, Industrial and Agricultural | $ 1,544 | $ - | $ 2,866 | $ 465,769 | $ 470,179 |
| Real Estate Construction | - | - | 751 | 34,423 | 35,174 |
| Real Estate Mortgage | 106 | - | 149 | 391,278 | 391,533 |
| Other | - | - | - | 2,270 | 2,270 |
| Total Commercial | 1,650 | - | 3,766 | 893,740 | 899,156 |
| Consumer: | | | | | |
| Real Estate 1-4 Family First Mortgage | 1,345 | 48 | 1,087 | 198,705 | 201,185 |
| Real Estate 1-4 Family Junior Mortgage | 1,464 | - | 2,590 | 172,297 | 176,351 |
| Other Revolving and Installment | 432 | - | 173 | 86,179 | 86,784 |
| Total Consumer | 3,241 | 48 | 3,850 | 457,181 | 464,320 |
| Total Noncovered Loans | 4,891 | 48 | 7,616 | 1,350,921 | 1,363,476 |
| Covered Loans | - | - | - | 3,476 | 3,476 |
| Total Loans | $ 4,891 | $ 48 | $ 7,616 | $ 1,354,397 | $ 1,366,952 |

| December 31, 2015 | 30-89 Days Past Due | 90+ Days Past Due Still Accruing | Nonaccrual Loans | Current | Total Loans |
|---|---|---|---|---|---|
| Noncovered Loans | | | | | |
| Commercial: | | | | | |
| Commercial, Industrial and Agricultural | $ 921 | $ 55 | $ 6,169 | $ 410,408 | $ 417,553 |
| Real Estate Construction | - | - | - | 16,780 | 16,780 |
| Real Estate Mortgage | 3,666 | 27 | 2,552 | 267,580 | 273,825 |
| Other | - | - | - | 3,395 | 3,395 |
| Total Commercial | 4,587 | 82 | 8,721 | 698,163 | 711,553 |
| Consumer: | | | | | |
| Real Estate 1-4 Family First Mortgage | 2,085 | 1,501 | - | 165,980 | 169,566 |
| Real Estate 1-4 Family Junior Mortgage | 831 | - | 825 | 158,648 | 160,304 |
| Other Revolving and Installment | 418 | 22 | - | 80,917 | 81,357 |
| Total Consumer | 3,334 | 1,523 | 825 | 405,545 | 411,227 |
| Total Noncovered Loans | 7,921 | 1,605 | 9,546 | 1,103,708 | 1,122,780 |
| Covered Loans | 52 | - | - | 4,089 | 4,141 |
| Total Loans | $ 7,973 | $ 1,605 | $ 9,546 | $ 1,107,797 | $ 1,126,921 |

*(dollars in thousands, except share and per share amounts)*

## NOTE 4 LOANS (CONTINUED)

Interest income foregone on nonaccrual loans approximated $728 thousand and $478 thousand for the years ended December 31, 2016 and 2015, respectively.

The table below summarizes key information for impaired loans. These impaired loans may have estimated loss which is included in the allowance for loan losses. Impaired loans exclude loans covered under the FDIC shared loss agreement.

| | December 31, 2016 | | |
|---|---|---|---|
| | Unpaid Principal | Recorded Investment | Related Allowance |
| Commercial, Industrial and Agricultural | $ 3,366 | $ 3,366 | $ 296 |
| Real Estate Construction | 751 | 530 | - |
| Real estate Mortgage | 149 | 146 | - |
| 1-4 Family 1st Mortgage | 1,087 | 1,087 | - |
| 1-4 Family Junior Mortgage | 2,720 | 2,627 | 46 |
| Other Revolving and Installment | 75 | 67 | 42 |
| Total Impaired Loans at December 31, 2016 | $ 8,148 | $ 7,823 | $ 384 |

| | December 31, 2015 | | |
|---|---|---|---|
| | Unpaid Principal | Recorded Investment | Related Allowance |
| Commercial, Industrial and Agricultural | $ 6,712 | $ 6,709 | $ 518 |
| Real Estate Construction | - | - | - |
| Real estate Mortgage | 2,381 | 2,381 | 15 |
| 1-4 Family 1st Mortgage | - | - | - |
| 1-4 Family Junior Mortgage | 939 | 833 | - |
| Other Revolving and Installment | - | - | - |
| Total Impaired Loans at December 31, 2015 | $ 10,032 | $ 9,923 | $ 533 |

The table below presents the average recorded investment in impaired loans and interest income for years ended December 31, 2016 and 2015 respectively. No Interest income on impaired loans was recognized using the cash basis of accounting during the years ended December 31, 2016 and 2015.

***(dollars in thousands, except share and per share amounts)***

## NOTE 4 LOANS (CONTINUED)

| | 2016 | | 2015 | |
|---|---|---|---|---|
| | Average Recorded Investments | Interest Income | Average Recorded Investments | Interest Income |
| Commercial: | | | | |
| Commercial, Industrial and Agricultural | $ 4,049 | $ 195 | $ 9,533 | $ 419 |
| Real Estate Mortgage | 752 | 30 | 2,957 | 164 |
| Other | 160 | 9 | 331 | 8 |
| Consumer: | | | | |
| Real Estate 1-4 Family First Mortgage | 1,102 | 50 | 209 | 13 |
| Real Estate 1-4 Family Junior Mortgage | 2,983 | 180 | 1,117 | 60 |
| Other Revolving and Installment | 81 | 6 | - | - |
| Total Impaired Loans | $ 9,127 | $ 470 | $ 14,147 | $ 664 |

The Company does not have material commitments to lend additional funds to borrowers with loans whose terms have been modified in troubled debt restructurings or whose loans are on nonaccrual.

**Purchased Loans**

The Company evaluates purchased loans for impairment in accordance with the provisions of ASC Topic 310-30: Loans and Debt Securities Acquired with Deteriorated Credit Quality. Purchased loans with evidence of credit deterioration since origination and for which it is probable that all contractually required payments will not be collected are considered impaired. The Company has elected to account for purchase credit impaired loans under the cost recovery method. Under the cost recovery method, no yield is accreted into income until the Company's cost is recovered. Thus, no accretable yield is reported as of December 31, 2016 and 2015.

There was no allowance for loan losses related to the purchased impaired loans at December 31, 2016 and 2015.

**Troubled Debt Restructurings**

During 2016 there was one loan that was modified as a troubled debt restructuring as a result of extending the amortization period. The loans is currently performing according to the modified terms and there were no specific reserves for loan losses allocated to loans modified as troubled debt restructurings.

*(dollars in thousands, except share and per share amounts)*

## NOTE 5 PREMISES AND EQUIPMENT

Components of premises and equipment as of December 31, 2016 and 2015 are as follows:

| | 2016 | 2015 |
|---|---|---|
| Land | $ 4,844 | $ 4,823 |
| Buildings and Improvements | 28,669 | 25,977 |
| Assets Under Capital Lease | 2,657 | 2,657 |
| Furniture, Fixtures and Equipment | 30,765 | 29,116 |
| Total | 66,935 | 62,573 |
| Less: Accumulated Depreciation | (42,673) | (40,154) |
| Net | $ 24,262 | $ 22,419 |

Depreciation expense for the years ended December 31, 2016, 2015, and 2014 amounted to $3.3 million, $2.9 million, and $3.1 million, respectively.

Pursuant to the terms of the noncancelable lease agreements in effect at December 31, 2016, pertaining to banking premises, future minimum rent commitments under various operating leases are as follows:

| Year Ending December 31, | Amount |
|---|---|
| 2017 | $ 3,492 |
| 2018 | 3,100 |
| 2019 | 2,870 |
| 2020 | 2,596 |
| 2021 | 2,071 |
| Thereafter | 5,821 |
| Total | $ 19,950 |

Total rent expense for the years ended December 31, 2016, 2015, and 2014 amounted to $3.7 million, $3.2 million, and $2.6 million, respectively.

The annual minimum future rents due to the Company on noncancelable operating leases as of December 31, 2016 are as follows:

| Year Ending December 31, | Amount |
|---|---|
| 2017 | $ 266 |
| 2018 | 216 |
| 2019 | 194 |
| 2020 | 194 |
| 2021 | 203 |
| Thereafter | 316 |
| Total Future Minimum Rentals | $ 1,389 |

*(dollars in thousands, except share and per share amounts)*

## NOTE 6 INTANGIBLE ASSETS

On January 2, 2015, the Company acquired Interactive Retirement Systems, LTD, located in Bloomington, Minnesota. As part of the transaction, $3.8 million was allocated to an identified customer intangible and $420 thousand to goodwill.

On January 1, 2016, the Company acquired Alliance Benefit Group North Central States, Inc., located in Albert Lea, Minnesota. As part of the transaction, $17.9 million was allocated to an identified customer intangible and $4.8 million to goodwill.

On January 15, 2016, the Company acquired Beacon Bank (Beacon), with locations in Shorewood, Excelsior, Eden Prarie, and Duluth, Minnesota. As part of the transaction, $3.8 million was allocated to a core deposit intangible and $18.9 million to goodwill.

The Company follows U.S. GAAP with regard to Goodwill and Other Intangible Assets. Among its provisions is a requirement that the Company classify its intangible assets between assets subject to amortization and assets not subject to amortization. Following is a summary of the Company's intangible assets.

| December 31, 2016 | Estimated Life | Amortization Method | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
|---|---|---|---|---|---|
| Goodwill | | | $ 27,329 | - | $ 27,329 |
| Identifiable Customer Intangibles | 9 years | Straight Line | 55,744 | (26,713) | 29,031 |
| Core Deposit Intangibles | 5 years | Straight Line | 7,216 | (3,518) | 3,698 |
| Servicing Rights | | | 4,777 | - | 4,777 |
| Total | | | $ 95,066 | $ (30,231) | $ 64,835 |

| December 31, 2015 | Estimated Life | Amortization Method | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
|---|---|---|---|---|---|
| Goodwill | | | $ 3,683 | - | $ 3,683 |
| Identifiable Customer Intangibles | 9 years | Straight Line | 37,364 | (20,615) | 16,749 |
| Core Deposit Intangibles | 5 years | Straight Line | 3,422 | (2,565) | 857 |
| Servicing Rights | | | 4,145 | - | 4,145 |
| Total | | | $ 48,614 | $ (23,180) | $ 25,434 |

Aggregate amortization expense for the years ended December 31, 2016, 2015, and 2014 was $7.0 million, $4.4 million, and $4.2 million, respectively.

Estimated aggregate amortization expenses for each of the next five years and thereafter is as follows:

| Year Ending December 31, | Amount |
|---|---|
| 2017 | $ 5,470 |
| 2018 | 4,635 |
| 2019 | 4,234 |
| 2020 | 3,961 |
| 2021 | 3,266 |
| Thereafter | 11,163 |
| Total | $ 32,729 |

*(dollars in thousands, except share and per share amounts)*

## NOTE 7 LOAN SERVICING

Loans serviced for others are not included in the accompanying consolidated balance sheets. The unpaid principal balances of loans serviced for others totaled $625.4 million, and $572.1 million at December 31, 2016 and 2015, respectively.

The balance of servicing rights included in other intangible assets at December 31, 2016 and 2015 is $4.8 million and $4.1 million, respectively. Servicing rights of $1.2 million, $1.1 million and $1.2 million were capitalized in 2016, 2015, and 2014, respectively. Amortization of servicing rights was $818 thousand, $1.4 million, and $796 thousand in 2016, 2015 and 2014, respectively. Changes in fair value of servicing rights arising from adjustments to valuation allowances are recognized in other non-interest expense and were $139 thousand, $52 thousand, and $(111) thousand in 2016, 2015 and 2014, respectively.

The amount of loans servicing obligations included in other liabilities is $134 thousand and $117 thousand as of December 31, 2016 and 2015, respectively.

The fair value of loan servicing rights and obligations were determined using discount rates averaging 9.50% as of December 31, 2016 and 2015, and prepayment speeds averaging 8.44% and 9.88%, respectively.

## NOTE 8 OTHER ASSETS

Other assets on the balance sheet consist of the following balances as of December 31, 2016 and 2015:

| | 2016 | 2015 |
|---|---|---|
| Federal Reserve Board Stock | $ 2,675 | $ 1,542 |
| Foreclosed Assets | 1,721 | 842 |
| Prepaid Expenses | 2,863 | 2,468 |
| Investments in Partnerships | 458 | 2,166 |
| Trust Fees Receivable | 18,575 | 9,360 |
| Income Tax Refund Receivable | - | 6,524 |
| Federal Home Loan Bank Stock | 3,245 | 3,531 |
| Other Assets | 4,688 | 4,282 |
| Total | $ 34,225 | $ 30,715 |

Federal Reserve Board Stock and Federal Home Loan Bank Stock are carried at cost which is the expected recoverability of the par value. The investments are required to be maintained in order to be members of the Federal Reserve Bank and to obtain borrowings from the Federal Home Loan Bank.

*(dollars in thousands, except share and per share amounts)*

## NOTE 9 DEPOSITS

| | 2016 | 2015 |
|---|---|---|
| Savings Accounts | $ 48,371 | $ 37,798 |
| Interest-Bearing Checking Accounts | 325,474 | 291,979 |
| Money Market Savings | 616,341 | 486,181 |
| Certificates of Deposit | 240,533 | 216,455 |
| Total Interest-Bearing Deposits | 1,230,719 | 1,032,413 |
| Non-Interest-Bearing Deposits | 554,490 | 425,608 |
| Total Deposits | $ 1,785,209 | $ 1,458,021 |

Certificates of deposit in excess of $250 thousand totaled $30.2 million and $24.9 million at December 31, 2016 and 2015, respectively.

At December 31, 2016, the scheduled maturities of certificates of deposit are as follows:

| Year Ending December 31, | Amount |
|---|---|
| 2017 | $ 172,826 |
| 2018 | 27,231 |
| 2019 | 13,040 |
| 2020 | 7,048 |
| 2021 | 8,610 |
| Thereafter | 11,778 |
| | $ 240,533 |

## NOTE 10 SHORT-TERM BORROWINGS

Federal Funds purchased at December 31, 2016 and 2015 were $0. The average interest rate charged on Federal Funds purchased during 2016, 2015 and 2014 was 0.41%, 0.33%, and 0.29%, respectively.

At December 31, 2016, the Company had available $87 million of unsecured lines of credit and no secured lines of credit for Federal Funds outstanding.

The Company enters into agreements to repurchase the same securities that it previously sold. These agreements may have a fixed maturity or be open ended, callable at any time. The aggregate amount of repurchase agreements was $729 thousand and $-0- as of December 31, 2016 and 2015, respectively. Weighted average interest rates were 0.54% and 0.21% as of December 31, 2016 and 2015, respectively.

The securities underlying the agreements as of December 31, 2016 and 2015 were under the Company's control in safekeeping at third-party financial institutions.

*(dollars in thousands, except share and per share amounts)*

## NOTE 11 LONG-TERM DEBT

Long-term debt at December 31, 2016 and 2015 consisted of the following:

| | Rate Type | Interest Rate | 2016 | 2015 |
|---|---|---|---|---|
| Subordinated Notes Payable | Fixed | 5.75% | $ 49,437 | $ 49,375 |
| Junior Subordinated Debentures | Floating | 2.76% - 4.10% | 8,166 | - |
| Federal Home Loan Bank Advances | Fixed | 2.16% | - | 20,000 |
| Obligations Under Capital Lease | | | 1,210 | 1,369 |
| Total | | | $ 58,813 | $ 70,744 |

*Subordinated Notes Payable*. On December 17, 2015, the Company issued $50 million of fixed-to-floating rate subordinated notes that mature on December 30, 2025, through a private placement. The notes, which qualify as Tier 2 capital under capital rules in effect at December 31, 2015, have an interest rate of 5.75% per annum, payable semi-annually on each June 30 and December 30, commencing on June 30, 2016 until December 30, 2020. From December 30, 2020, to the maturity date or date of earlier redemption, the notes will bear interest at a rate per annum equal to three month LIBOR for the related interest period plus 4.12%, payable quarterly on each March 30, June 30, September 30 and December 30.

The notes are subordinated in right of payment to all of the Company's senior indebtedness and effectively subordinated to all existing and future debt and all other liabilities of the Company's subsidiary. The Company may elect to redeem the notes (subject to regulatory approval), in whole or in part, on any early redemption date which is any interest payment date on or after December 30, 2020 at a redemption price equal to 100% of the principal amount plus any accrued and unpaid interest. Other than on an early redemption date, the notes cannot be accelerated except in the event of bankruptcy or the occurrence of certain other events of bankruptcy, insolvency or reorganization.

Unamortized debt issuance costs related to these notes, which are included in Subordinated Notes Payable were $563 thousand and $625 thousand, as of December 31, 2016 and 2015, respectively.

Proceeds from subordinated notes were used, in early 2016, to repay the Small Business Lending Fund (SBLF) preferred stock and fund the acquisitions of Alliance Benefit Group North Central States, Inc and Beacon Bank.

*Junior Subordinated Deferrable Interest Debentures.* At December 31, 2016, the Company had $4.1 million of junior subordinated deferrable interest debentures issued to Excelsior Financial Trust I ("Trust I"), a wholly owned Delaware statutory business trust acquired in connection with the acquisition of Beacon Bank during the first quarter of 2016. At December 31, 2016, the Company also had $6.2 million of junior subordinated deferrable interest debentures issued to Excelsior Financial Trust II ("Trust II"), a wholly owned Delaware statutory business trust acquired in connection with the acquisition of Beacon Bank during the first quarter of 2016. Trust I and Trust II are variable interest entities for which the Company is not the primary beneficiary. As such, the accounts of Trust I and Trust II are not included in the Companys consolidated financial statements. See Note 1 - Summary of Significant Accounting Policies for additional information regarding the consolidation policy. Details of the transactions with the capital trusts are presented below.

## NOTE 11 LONG-TERM DEBT (CONTINUED)

Trust I was formed in 2003 for the purpose of issuing $4 million of floating rate (three-month LIBOR plus a margin of 3.10%) trust preferred securities, which represent beneficial interests in the assets of the trust. The trust preferred securities will mature on June 26, 2033 and are redeemable with the approval of the Federal Reserve Board in whole or in part at our option at any time after June 26, 2008 and in whole at any time upon the occurrence of certain events affecting their tax or regulatory capital treatment. Distributions on the trust preferred securities are payable quarterly in arrears on March 26, June 26, September 26 and December 26 of each year. Trust I also issued $124 thousand of common equity securities. The proceeds of the offering of the trust preferred securities and common equity securities were used to purchase $4.1 million of floating rate (three-month LIBOR plus a margin of 3.10%, which was equal to 4.10% at December 31, 2016) junior subordinated deferrable interest debentures assumed by the Company, which have terms substantially similar to the trust preferred securities.

Trust II was formed in 2006 for the purpose of issuing $6 million of floating rate (three-month LIBOR plus a margin of 1.80%) trust preferred securities, which represent beneficial interests in the assets of the trust. The trust preferred securities will mature on September 15, 2036 and are redeemable with the approval of the Federal Reserve Board in whole or in part at our option at any time after September 15, 2011 and in whole at any time upon the occurrence of certain events affecting their tax or regulatory capital treatment. Distributions on the trust preferred securities are payable quarterly in arrears on March 15, June 15, September 15 and December 15 of each year. Trust I also issued $186 thousand of common equity securities. The proceeds of the offering of the trust preferred securities and common equity securities were used to purchase $6.2 million of floating rate (three-month LIBOR plus a margin of 1.80%, which was equal to 2.76% at December 31, 2016) junior subordinated deferrable interest debentures assumed by the Company, which have terms substantially similar to the trust preferred securities.

The junior subordinated debentures were recorded at there respective fair market values at the time of the acquisition. The discounts are being amortized over the life of the debenture and recorded Long-Term Debt Interest Expense on the Consolidated Statement of Income. Unamortized discounts were $2.1 million as of December 31, 2016.

*Obligations Under Capital Lease.* At November 1, 1999, the Company entered into a capital lease for a portion of a commercial office building in downtown Grand Forks, North Dakota. The depreciable cost of the lease is $2.7 million. The building and the related liability of the capital lease were recorded at the present value of future payments due under the lease provisions and were determined using an 8.0% discount rate.

The related liability under the lease, with a December 31, 2016 balance of $1.2 million, net of prepaid interest of $280 thousand, is due in monthly installments of $21 thousand including interest through October 31, 2022.

The following schedule represents the future minimum lease payments under the capital lease together with the present value of the net minimum lease payments as of December 31, 2016:

***(dollars in thousands, except share and per share amounts)***

## NOTE 11 LONG-TERM DEBT (CONTINUED)

| Year Ending December 31, | | Amount |
|---|---|---|
| 2017 | | 256 |
| 2018 | | 251 |
| 2019 | | 251 |
| 2020 | | 251 |
| 2021 | | 251 |
| Later Years | | 230 |
| Total Minimum Lease Payments | | 1,490 |
| Less: Amount Representing Interest | | (280) |
| Net Minimum Lease Payments | $ | 1,210 |

*Federal Home Loan Bank Advances*. In April of 2016, the Company paid off a $20 million FHLB advance that was scheduled to mature February 2018. The Company incurred a $414 thousand prepayment penalty that was recorded as other non-interest expense on the consolidated statement of income.

FHLB notes payable and standby letters of credit are collateralized by specific loans and investments with a carrying amount of approximately $332 million, at December 31, 2016. At December 31, 2016 the Company had the ability to borrow an additional $317 million from the FHLB based on the value of loans and investment securities pledged to FHLB.

As of December 31, 2016, the Company had no standby letters of credit with the Bank of North Dakota and $10.7 million with the FHLB. Bank of North Dakota letters of credit are collateralized by loans pledged to the Bank of North Dakota in the amount of $197.9 million as of December 31, 2016.

## NOTE 12 TRUE-UP LIABILITY

In connection with the Prosperan Bank acquisition in 2009, the Bank has agreed to pay the FDIC, should the estimated losses on the acquired loan portfolios as well as servicing fees earned on the acquired loan portfolios not meet thresholds as stated in the loss sharing agreements (the “true-up liability”). This contingent consideration is classified as a liability within other liabilities on the Consolidated Balance Sheet and is re-measured at fair value each reporting date until the contingency is resolved. The changes in fair value are recognized in non-interest income or expense.

An expected value methodology is used as a starting point for determining the fair value of the true-up liability based on the contractual terms prescribed in the loss sharing agreements. The resulting values under both calculations are discounted over 10 years (the period defined in the loss sharing agreements) to reflect the uncertainty in the timing and payment of the true-up liability by the Bank to arrive at a net present value. The discount rate used to value the true-up liability was 5.00% as of December 31, 2016 and 2015, respectively.

*(dollars in thousands, except share and per share amounts)*

## NOTE 12 TRUE-UP LIABILITY (CONTINUED)

In accordance with the loss sharing agreements governing the Prosperan Bank acquisition, on January 14, 2020 (the "Prosperan True-Up Measurement Date"), the Bank has agreed to pay to the FDIC half of the amount, if positive, calculated as: (1) 20% of the intrinsic loss estimate of the FDIC (approximately $13.2 million); minus (2) the sum of (A) 25% of the asset discount paid in connection with the Prosperan Bank acquisition (approximately $4.8 million); plus (B) 25% of the cumulative shared-loss payments (as defined below) plus (C) the cumulative servicing amount (as defined below). The fair value of the true-up liability associated with the Prosperan acquisition was $2.9 million and $2.8 million as of December 31, 2016 and 2015, respectively.

For the purposes of the above calculations, cumulative shared-loss payments means: (i) the aggregate of all of the payments made or payable to the Bank under the loss sharing agreements minus (ii) the aggregate of all of the payments made or payable to the FDIC. The cumulative servicing amount means the period servicing amounts (as defined in the loss sharing agreements) for every consecutive twelve-month period prior to and ending on the Prosperan Bank True-Up Measurement Dates. The cumulative loss share payments and cumulative service amounts components of the true-up calculations are estimated each period end based on the expected amount and timing of cash flows of the acquired loan portfolios.

## NOTE 13 FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK

In the normal course of business, the Bank has outstanding commitments and contingent liabilities, such as commitments to extend credit and standby letters of credit, which are not included in the accompanying consolidated financial statements. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual or notional amount of those instruments. The Bank uses the same credit policies in making such commitments as it does for instruments that are included in the statements of financial condition.

At December 31, 2016 and 2015, the following financial instruments whose contract amount represents credit risk were approximately as follows:

| | 2016 | 2015 |
|---|---|---|
| Commitments to Extend Credit | $ 525,416 | $ 434,666 |
| Standby Letters of Credit | 8,620 | 7,806 |
| | $ 534,036 | $ 442,472 |

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

## NOTE 13 FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK (CONTINUED)

collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include accounts receivable, inventory, property and equipment, and income producing commercial properties.

Standby letters-of-credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Standby letters-of-credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank's policy for obtaining collateral, and the nature of such collateral, is essentially the same as that involved in making commitments to extend credit.

The Bank was not required to perform on any financial guarantees and did not incur any losses on its commitments during the past two years.

The Mortgage Partnership Finance (MPF) Program, which is available through most Federal Home Loan Banks (FHLBs), provides member financial institutions an alternative method for funding home mortgages for their customers. Under the MPF Program, the lender effectively originates loans for, or sells loans to, the respective FHLB. The lender retains some or all of the credit risk and customer relationship (through servicing) inherent in the loan, and shifts the interest rate risk and prepayment risk to the FHLB. The lender receives a credit enhancement fee from the FHLB in exchange for managing the credit risk of the loan. Total commitments under the program amounted to $3.9 million and $3.9 million at December 31, 2016 and 2015, respectively.

## NOTE 14 LEGAL CONTINGENCIES

The Company may be subject to claims and lawsuits which may arise primarily in the ordinary course of business. It is the opinion of management, if such claims are made, that the disposition or ultimate resolution of the claims and lawsuits will not have a material adverse effect on the financial position of the Company.

## NOTE 15 STOCK BASED COMPENSATION PLANS

In April 1991, the stockholders approved the adoption of the Alerus Financial Corporation 1991 Stock Award Plan (the 1991 Plan) providing for the grant of up to 1.8 million shares of its common stock to certain key employees in the form of restricted stock awards, and incentive and nonqualified stock options. The 1991 Plan is administered by a committee elected by the Board and consists of three or more directors, none of whom may be a participant in the 1991 Plan. The Committee has sole discretion, subject to the terms of the Plan, to adopt and revise rules of the 1991 Plan and to determine those key employees who may participate along with the timing, amounts and other terms and conditions of awards.

## NOTE 15 STOCK BASED COMPENSATION PLANS (CONTINUED)

The 1991 Plan provides for the granting of restricted stock at no cost to certain key employees. Shares of stock are issued to each employee immediately upon the grant of the award and the employee becomes entitled to all rights of a shareholder, unless such shares are forfeited under the plan. The restricted stock is subject to full or partial forfeiture, as defined, if the employee terminates employment with the Company within prescribed time periods or violates any restrictions under their agreement. Restricted stock awards generally vest over a five- to ten-year period, but vesting may be accelerated or immediate due to death or disability of the employee or the occurrence of certain events relating primarily to significant changes in directors or ownership of the Company. Restricted stock awards are considered to represent an element of employee compensation and is charged to expense over the period earned. Compensation expense, relating to stock awards under this plan, was $10 thousand in 2016 $10 thousand in 2015, and $39 thousand in 2014.

In addition, the 1991 Plan provides the ability to grant incentive and nonqualified stock options with terms fixed by the Committee at the time of grant. There were no options outstanding as December 31, 2016, 2015 and 2014.

Effective May 2009, the Company adopted the Alerus Financial Corporation 2009 Stock Award Plan (the 2009 Plan) providing for the grant of up to 1.4 million shares of its common stock to employees, officers, and directors pursuant to awards of non-qualified options, restricted stock, or other stock-based employee benefits.

The 2009 Plan provides for the granting of restricted stock at no cost to certain key employees. Shares of stock are issued to each employee immediately upon the grant of the award and the employee becomes entitled to all rights of a shareholder, unless such shares are forfeited under the plan. The restricted stock is subject to full or partial forfeiture, as defined, if the employee terminates employment with the Company within prescribed time periods (generally five to ten years) or violates any restrictions under their agreement. Restricted stock awards generally vest over a five- to ten-year period, but vesting may be accelerated or immediate due to death or disability of the employee or the occurrence of certain events relating primarily to significant changes in directors or ownership of the Company. Restricted stock awards are considered to represent an element of employee compensation and is charged to expense over the period earned. Compensation expense relating to stock awards under this plan was $1.1 million in 2016, $1.1 million in 2015 and $1.0 million in 2014.

In addition, the 2009 Plan provides the ability to grant nonqualified stock options with terms fixed by the Committee at the time of grant. There were no options outstanding as December 31, 2016, 2015 and 2014.

Amounts granted under the 1991 and 2009 plan have been retroactively adjusted for all stock splits effected in the form of dividends.

*(dollars in thousands, except share and per share amounts)*

## NOTE 15 STOCK BASED COMPENSATION PLANS (CONTINUED)

Activity in the stock plans for the years ended December 31, 2016, 2015 and 2014 is as follows:

| | Number of Shares | |
|---|---|---|
| | Available for Future Grant | Restricted Stock Awards |
| Balance - December 31, 2013 | 810,315 | 2,004,165 |
| Restricted Units Awarded | (2,682) | 2,682 |
| Restricted Shares Awarded | (91,305) | 91,305 |
| Balance - December 31, 2014 | 716,328 | 2,098,152 |
| Restricted Units Awarded | (2,316) | 2,316 |
| Restricted Shares Awarded | (114,826) | 114,826 |
| Shares Withheld for Taxes | 1,411 | (1,411) |
| Awards Forfeited | 96,085 | (96,085) |
| Balance - December 31, 2015 | 696,682 | 2,117,798 |
| Restricted Units Awarded | (2,558) | 2,558 |
| Restricted Shares Awarded | (52,050) | 52,050 |
| Shares Withheld for Taxes | 5,557 | (5,557) |
| Awards Forfeited | 31,283 | (31,283) |
| Balance - December 31, 2016 | 678,914 | 2,135,566 |

The number of unvested shares outstanding was 440,511, 520,054 and 575,667 respectively, as of December 31, 2016, 2015 and 2014.

Effective May 2009, the Company also adopted the Alerus Financial Corporation Stock Grant Plan for Non-Employee Directors (the Retainer Plan) providing for the issuance of up to 180 thousand shares of its common stock to non-employee directors. The purpose of the Retainer Plan is to provide for payment of the annual retainer to directors in shares of Company common stock. The number of shares to be issued is based on the retainer divided by the fair market value per share as of the applicable date, as defined. Upon the issuance of shares under this plan, the then current value of the shares is charged to expense.

Activity in the Retainer Plan for the years ended December 31, 2016, 2015 and 2014 is as follows:

| | Number of Shares | |
|---|---|---|
| | Available for Future Grant | Retainer Stock Awards |
| Balance - December 31, 2013 | 98,655 | 81,345 |
| Retainer Shares Awarded | (15,672) | 15,672 |
| Balance - December 31, 2014 | 82,983 | 97,017 |
| Retainer Shares Awarded | (14,512) | 14,512 |
| Balance - December 31, 2015 | 68,471 | 111,529 |
| Retainer Shares Awarded | (17,829) | 17,829 |
| Balance - December 31, 2016 | 50,642 | 129,358 |

***(dollars in thousands, except share and per share amounts)***

## NOTE 16 EMPLOYEE BENEFITS

**Retirement Plans**

The Company maintains two employee retirement plans including a defined benefit employee stock ownership plan (ESOP) and a defined contribution salary reduction profit sharing plan. The plans cover substantially all full-time employees upon satisfying prescribed eligibility requirements for age and length of service. Contributions to the non-contributory profit sharing plan and the ESOP are determined annually by the Board of Directors at their discretion and allocated to participants based on a percentage of annual compensation. Under the salary reduction profit sharing plan, the Company contributes 100% of amounts deferred by employees up to 3% of eligible compensation and 50% of amounts deferred by employees between 3% and 6% of eligible compensation. Under the ESOP, corporate stock is transferred to the plan at market value on date of transfer. The Company treats these as outstanding shares, accordingly, dividends on these shares are charged to retained earnings.

Retirement plan contributions are reflected under employee benefits in the income statement as follows:

| | 2016 | 2015 | 2014 |
|---|---|---|---|
| Salary Reduction Plan | $ 2,290 | $ 1,867 | $ 1,604 |
| ESOP | 1,444 | 1,347 | 1,149 |
| Total | $ 3,734 | $ 3,214 | $ 2,753 |
| Total ESOP Shares Outstanding | 1,337,999 | 1,320,579 | 1,312,827 |

Under Federal income tax regulations, the employer stock that is held by the plan and its participants is not readily tradable on an established market, or is subject to trading limitations and includes a put option. The put option is a right to demand that the Company buy any shares of its stock distributed to participants for which there is no market. The put price is representative of the fair market value of the stock. The Company's ESOP repurchase obligation was $23 million, $25 million, and $25 million respectively, for years ended December 31, 2016, 2015 and 2014.

***(dollars in thousands, except share and per share amounts)***

## NOTE 17 OTHER OPERATING INCOME AND EXPENSES

The components of other operating income and other operating expenses including those which exceed 1% of the aggregate of total interest income and other income for the years ended December 31, 2016, 2015 and 2014 are as follows:

| | 2016 | 2015 | 2014 |
|---|---|---|---|
| Other Operating Income | | | |
| Interchange Fees | $ 2,025 | $ 1,979 | $ 1,704 |
| Bank Owned Life Insurance Income | 991 | 824 | 821 |
| Other Operating Income | 1,433 | 1,751 | 1,464 |
| Total Other Operating Income | $ 4,449 | $ 4,554 | $ 3,989 |
| Other Operating Expenses | | | |
| Marketing, Business Development and Public Relations | $ 3,239 | $ 3,907 | $ 2,745 |
| Supplies, Telephone and Postage | 5,538 | 4,404 | 3,838 |
| FDIC Insurance | 1,458 | 1,175 | 1,040 |
| Professional Fees - Legal, Audit and Consulting | 3,305 | 2,512 | 2,667 |
| Correspondent and Other Outside Service Fees | 12,860 | 9,394 | 6,981 |
| Net Expenses of OREO and Other Property Including Gain or Loss on Disposal | 222 | 821 | 678 |
| Other Expenses | 10,996 | 9,413 | 8,469 |
| Total Other Operating Expenses | $ 37,618 | $ 31,626 | $ 26,418 |

*(dollars in thousands, except share and per share amounts)*

## NOTE 18 INCOME TAXES

The components of income tax expense (benefit) for the years ended December 31, 2016, 2015, and 2014 are as follows:

| | 2016 | 2015 | 2014 |
|---|---|---|---|
| Current: | | | |
| Federal | $ 9,090 | $ 5,621 | $ 9,982 |
| State | 1,092 | 481 | 76 |
| Total | 10,182 | 6,102 | 10,058 |
| Deferred: | | | |
| Federal | (2,659) | 926 | (918) |
| State | (385) | (345) | (141) |
| Total | (3,044) | 581 | (1,059) |
| Total Current and Deferred: | | | |
| Federal | 6,431 | 6,547 | 9,064 |
| State | 707 | 136 | (65) |
| Total Current and Deferred: | $ 7,138 | $ 6,683 | $ 8,999 |

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2016 and 2015 are as follows:

| | 2016 | 2015 |
|---|---|---|
| Deferred Tax Assets | | |
| Allowance for Loan Losses | $ 5,989 | $ 5,593 |
| Employee Compensation and Benefit Accruals | 3,855 | 2,324 |
| Identifiable Intangible Amortization | 4,711 | 3,576 |
| Acquired Loans | 2,992 | 2,453 |
| Net Operating Loss Carry Forwards | 480 | 835 |
| Nonaccrual Loan Interest | 381 | 293 |
| Other | 4,758 | 2,913 |
| | 23,166 | 17,987 |
| Valuation Allowance | (167) | (167) |
| Total Deferred Tax Assets from Temporary Differences | 22,999 | 17,820 |
| Deferred Tax Liabilities | | |
| Accumulated Depreciation | 1,044 | 595 |
| Goodwill and Intangible Amortization | 1,110 | 519 |
| Servicing Assets | 1,554 | 1,553 |
| Acquired Loans | 68 | 122 |
| Prepaid Expenses | 806 | 638 |
| Other | 10 | 10 |
| Total Deferred Tax Liabilities from Temporary Differences | 4,592 | 3,437 |
| Deferred Tax Liability from Unrealized Gain on Available-for-Sale Investment Securities | (1,114) | 603 |
| Total Deferred Liabilities | 3,478 | 4,040 |
| Net Deferred Tax Assets | $ 19,521 | $ 13,780 |

***(dollars in thousands, except share and per share amounts)***

## NOTE 18 INCOME TAXES (CONTINUED)

The reconciliation between applicable income taxes and the amount computed at the applicable statutory Federal tax rate is as follows:

| | 2016 | | 2015 | | 2014 | |
|---|---|---|---|---|---|---|
| | Amount | Percent of Pretax Income | Amount | Percent of Pretax Income | Amount | Percent of Pretax Income |
| Taxes at Statutory Federal Income Tax Rate | $ 7,409 | 35.0% | $ 8,327 | 35.0% | $ 10,419 | 35.0% |
| Increase (Decrease) in Taxes (Benefit) Resulting from: | | | | | | |
| Tax Exempt Income, Net of Disallowed Interest Expense | (736) | (3.4) | (581) | (2.3) | (589) | (1.9) |
| State Income Taxes, Net of Federal Benefits | (602) | (2.8) | 6 | - | 154 | 0.5 |
| Nondeductible Items and Other | 1,067 | 5.0 | (1,069) | (1.9) | (985) | (1.5) |
| Applicable Income Taxes | $ 7,138 | 33.8% | $ 6,683 | 30.7% | $ 8,999 | 32.1% |

During the fourth quarter of 2014, the Company completed an analysis of revenue apportionment for state income tax purposes. As a result of that analysis, the Company determined the use of an alternative method of allocating revenue was permitted. During 2014, the Company filed amended state tax returns for 2011 through 2013 to claim appropriate refunds. As a result, the Company increased its current income taxes receivable and recognized a current tax benefit of $1.1 million. These state amended tax returns are subject to review by the various jurisdictions.

The federal income tax returns of the Company are subject to examination by the IRS, generally three years after they were filed. All of the tax filings of the Company are current.

It is the opinion of management that the Company has no significant uncertain tax positions that would be subject to change upon examination.

## NOTE 19 RELATED PARTY TRANSACTIONS

In the ordinary course of business, the Bank has granted loans to executive officers, directors, and their affiliates (related parties). These loans are made on substantially the same terms and conditions as those prevailing at the time for comparable transactions with outsiders and are not considered to involve more than the normal risk of collectability. Loans outstanding both direct and indirect to directors and executive officers totaled $20.5 million at December 31, 2016 and $7.5 million at December 31, 2015. During 2016, new loans totaling $25.2 million were made and $12.2 million were repaid.

Deposits from related parties held by the Bank at December 31, 2016 and 2015 amounted to $6.8 million and $6.6 million, respectively.

## NOTE 20 PREFERRED STOCK

On August 18, 2011, the Company completed the sale of $20 million of Series A preferred stock to the Secretary of the Treasury under the Small Business Lending Fund (SBLF). The fund was established under the Small Business Jobs Act of 2010 that was created to encourage lending to small businesses by providing capital to qualified community banks

## NOTE 20 PREFERRED STOCK (CONTINUED)

with assets less than $10 billion. Under the terms of the stock purchase agreement, the Treasury received 20,000 shares of noncumulative perpetual preferred stock with a liquidation value of $1,000 per share, in exchange for $20 million.

The Series A preferred stock qualified as Tier 1 capital. The dividend rate, as a percentage of the liquidation amount, fluctuated on a quarterly basis during the first 10 quarters during which the Series A preferred stock was outstanding, based upon changes in the level of "Qualified Small Business Lending" or "QSBL". The dividend rate for the initial dividend period (which ended September 30, 2011) was 1.0%. Based upon the increase in level of QSBL over the baseline level calculated under the terms of the related purchase agreement, the dividend rate for the second dividend period ending on December 31, 2011, was 1.0%. For the third through tenth calendar quarters, the dividend rate may be adjusted to between 1.0% and 5.0% per annum based upon the increase in QSBL as compared to the baseline. For the eleventh calendar quarter through four and one half years after issuance, the dividend rate will be fixed at between 1.0% and 7.0% based upon the level of QSBL compared to the baseline. After four and one half years from the issuance, the dividend rate will increase to 9.0% (including a quarterly lending incentive fee of 0.5%).

Subject to regulatory approval, the Company is generally permitted to redeem the Series A preferred shares at par plus unpaid dividends. The Company redeemed the shares in February 2016.

## NOTE 21 DERIVATIVES

The Company maintains an overall interest-rate risk-management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest-rate volatility. The Company's goal is to manage interest-rate sensitivity by modifying the repricing or maturity characteristics of certain balance sheet assets and liabilities so that the net-interest margin is not, on a material basis, adversely affected by movements in interest rates. As a result of interest-rate fluctuations, hedged assets and liabilities will appreciate or depreciate in market value. The effect of this unrealized appreciation or depreciation will generally be offset by income or loss on the derivative instruments that are linked to the hedged assets and liabilities. The Company views this strategy as a prudent management of interest-rate sensitivity, such that earnings are not exposed to undue risk presented by changes in interest rates.

Derivative instruments that are used as part of the Company's interest-rate risk-management strategy include interest-rate swaps, futures contracts, and options contracts with indices that relate to the pricing of specific balance-sheet assets and liabilities. Interest-rate swaps generally involve the exchange of fixed- and variable-rate interest payments between two parties, based on a common notional principal amount and maturity date.

Interest-rate options represent contracts that allow the holder of the option to (1) receive cash or (2) purchase, sell or enter into a financial instrument at a specified price within a specified period of time. Certain of these contracts also provide the Company with the right to enter into interest-rate swaps and cap and floor agreements with the writer of the option.

***(dollars in thousands, except share and per share amounts)***

## NOTE 21 DERIVATIVES (CONTINUED)

By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair-value gain in a derivative. When the fair value of a derivative contract is positive, this generally indicates that the counterparty owes the Company and therefore, creates a repayment risk for the Company. When the fair value of a derivative contract is negative, the Company owes the counterparty and, therefore, it has no repayment risk. The Company minimizes the credit (or repayment) risk in derivative instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company's credit committee. The Company also maintains a policy of requiring that all derivative contracts be governed by an International Swaps and Derivatives Association Master Agreement. Various derivatives, including interest rate, commodity, equity, credit and foreign exchange contracts, are offered to customers but usually offset the exposure from such contracts by purchasing other financial contracts. The customer accommodations and any offsetting financial contracts are treated as freestanding derivatives. Free-standing derivatives also include derivatives entered into for risk management that do not otherwise qualify for hedge accounting, including economic hedge derivatives.

The following table presents the total notional or contractual amounts and fair values for derivatives not designated as hedging instruments that are recorded on the balance sheet in other assets or other liabilities. Customer accommodation, trading and other free-standing derivatives are recorded on the balance sheet at fair value in trading assets or other liabilities as of December 31, 2016 and 2015:

| | Balance at December 31, 2016 | | |
|---|---|---|---|
| | | Fair Value | |
| December 31, 2016 | Notional Amount | Derivative Assets | Derivative Liabilities |
| Derivatives not Designed as Qualifying Hedging Instruments: | | | |
| Free Standing Derivatives (Economic Hedges) | | | |
| Interest Rate Contracts | $ 574 | $ 22 | $ 22 |
| Customer Accommodation, Trading, and other Contracts | | | |
| Interest Rate Contracts | 13,885 | 105 | 72 |
| Total Derivatives Not Designated as Qualifying Hedging Instruments | | $ 127 | $ 94 |

| | Balance at December 31, 2015 | | |
|---|---|---|---|
| | | Fair Value | |
| December 31, 2015 | Notional Amount | Derivative Assets | Derivative Liabilities |
| Derivatives not Designed as Qualifying Hedging Instruments: | | | |
| Free Standing Derivatives (Economic Hedges) | | | |
| Interest Rate Contracts | $ 604 | $ 33 | $ 33 |
| Customer Accommodation, Trading, and other Contracts | | | |
| Interest Rate Contracts | 13,771 | 87 | - |
| Total Derivatives Not Designated as Qualifying Hedging Instruments | | $ 120 | $ 33 |

***(dollars in thousands, except share and per share amounts)***

## NOTE 21 DERIVATIVES (CONTINUED)

The gain (loss) recognized on derivative instruments for years ended December 31, 2016, 2015, and 2014 was as follows:

| Derivatives Not Designated as Hedging Instruments | Recognized in Income Derivative | Amount of Gain or (Loss) Recognized in Income on Derivative | | |
|---|---|---|---|---|
| | | 2016 | 2015 | 2014 |
| Interest Rate Contracts | Other Income (Expenses) | $ (54) | $ 47 | $ 13 |

## NOTE 22 REGULATORY MATTERS

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and the Bank's consolidated financial statements. These capital requirements were modified in 2013 with the Basel III capital rules, which establish a new comprehensive capital framework for U.S. banking organizations. The Company and Bank became subject to the new rules on January 1, 2015, with a phase-in period for many of the new provisions.

Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measure of their assets, liabilities, and certain off balance sheet items as calculated under regulatory accounting practices. The capital amounts and the classifications are also subject to qualitative judgment by the regulator in regards to components, risk weighting and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of Common Equity Tier 1, Tier 1 and total capital (as defined in the regulations) to risk weighed assets (as defined) and of Tier 1 capital (as defined) to average assets (as defined). Management believes as of December 31, 2016 and 2015, the Company and the Bank meet all of the capital adequacy requirements to which they are subject.

As of December 31, 2016, the most recent notification from the Federal Deposit Insurance Corporation, categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since the notification that management believe have changed the Bank's category.

*(dollars in thousands, except share and per share amounts)*

## NOTE 22 REGULATORY MATTERS (CONTINUED)

The Company's and the Bank's actual capital amounts and ratios as of December 31, 2016 and 2015 are presented in the following table.

| | Actual | | Minimum Capital | | Minimum to be Well | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| **As of December 31, 2016** | | | | | | |
| Common Equity Tier 1 Capital to Risk Weighted Assets (CET1): | | | | | | |
| Consolidated | $ 124,093 | 7.74% | $ 72,147 | 4.5% | N/A | N/A |
| Bank | 177,662 | 11.10% | 72,025 | 4.5% | 104,036 | 6.5% |
| Tier 1 Capital to Risk Weighted Assets: | | | | | | |
| Consolidated | 131,822 | 8.23% | 96,104 | 6.0% | 128,138 | 8.0% |
| Bank | 177,662 | 11.10% | 96,034 | 6.0% | 128,045 | 8.0% |
| Total Capital to Risk Weighted Assets: | | | | | | |
| Consolidated | 196,875 | 12.29% | 128,153 | 8.0% | 160,191 | 10.0% |
| Bank | 193,276 | 12.07% | 128,103 | 8.0% | 160,129 | 10.0% |
| Tier 1 Capital to Average Assets: | | | | | | |
| Consolidated | 131,822 | 6.85% | 76,976 | 4.0% | N/A | N/A |
| Bank | 177,662 | 9.25% | 76,827 | 4.0% | 96,034 | 5.0% |

| | Actual | | Minimum Capital | | Minimum to be Well | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| **As of December 31, 2015** | | | | | | |
| Common Equity Tier 1 Capital to Risk Weighted Assets (CET1): | | | | | | |
| Consolidated | $ 150,873 | 10.92% | $ 62,173 | 4.5% | N/A | N/A |
| Bank | 197,716 | 14.37% | 61,915 | 4.5% | 89,433 | 6.5% |
| Tier 1 Capital to Risk Weighted Assets: | | | | | | |
| Consolidated | 170,472 | 12.33% | 82,955 | 6.0% | 110,606 | 8.0% |
| Bank | 197,716 | 14.37% | 82,554 | 6.0% | 110,072 | 8.0% |
| Total Capital to Risk Weighted Assets: | | | | | | |
| Consolidated | 235,160 | 17.01% | 110,598 | 8.0% | 138,248 | 10.0% |
| Bank | 212,403 | 15.44% | 110,053 | 8.0% | 137,567 | 10.0% |
| Tier 1 Capital to Average Assets: | | | | | | |
| Consolidated | 170,472 | 10.85% | 62,847 | 4.0% | N/A | N/A |
| Bank | 197,716 | 12.64% | 62,568 | 4.0% | 78,210 | 5.0% |

The Bank is subject to certain restrictions on the amount of dividends that it may pay without prior regulatory approval. The Bank normally restricts dividends to a lesser amount.

In addition, the Company must adhere to various U.S. Department of Housing and Urban Development (HUD) regulatory guidelines including required minimum capital and liquidity to maintain their Federal Housing Administration approved status. Failure to comply with the HUD guidelines could result in withdrawal of this certification. As of December 31, 2016, the Company was in compliance with HUD guidelines.

## NOTE 23 FAIR VALUE MEASUREMENTS

The Company categorizes its assets and liabilities measured at fair value into a three-level hierarchy based on the priority of the inputs to the valuation technique used to determine fair value. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used in the determination of the fair value measurement fall within different levels of the hierarchy, the categorization is based on the lowest level input that is significant to the fair value measurement. Assets and liabilities valued at fair value are categorized based on the inputs to the valuation techniques as follows:

*Level 1* – Inputs that utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that an entity has the ability to access.

*Level 2* – Inputs that include quoted prices for similar assets and liabilities in active markets and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument. Fair values for these instruments are estimated using pricing models, quoted prices of securities with similar characteristics, or discounted cash flows.

*Level 3* – Inputs that are unobservable inputs for the asset or liability, which are typically based on an entity's own assumptions, as there is little, if any, related market activity.

Subsequent to initial recognition, the Company may re-measure the carrying value of assets and liabilities measured on a nonrecurring basis to fair value. Adjustments to fair value usually result when certain assets are impaired. Such assets are written down from their carrying amounts to their fair value.

Professional standards allow entities the irrevocable option to elect to measure certain financial instruments and other items at fair value for the initial and subsequent measurement on an instrument-by-instrument basis. The Company adopted the policy to value certain financial instruments at fair value. The Company has not elected to measure any existing financial instruments at fair value; however, it may elect to measure newly acquired financial instruments at fair value in the future.

### Recurring Basis

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. For additional information on how the Company measures fair value refer to Note 1 – Summary of Significant Accounting Principles to the Consolidated Financial Statements. The following table presents the balances of the assets and liabilities measured at fair value on a recurring basis as of December 31, 2016 and 2015:

***(dollars in thousands, except share and per share amounts)***

## NOTE 23 FAIR VALUE MEASUREMENTS (CONTINUED)

### Recurring Basis (Continued)

| December 31, 2016 | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Trading Securities: | | | | |
| U.S. Treasury and Government Agency Securities | $ - | $ 1,959 | $ - | $ 1,959 |
| Available-for-Sale Securities: | | | | |
| U.S. Treasury and Government Agency Securities | $ - | $ 20,092 | $ - | $ 20,092 |
| Obligations of State and Political Agencies | - | 71,952 | - | 71,952 |
| Mortgage Backed Securities: | | | | |
| Residential Agency | - | 148,032 | - | 148,032 |
| Commercial | - | 23,111 | - | 23,111 |
| Asset Backed Securities | - | 740 | - | 740 |
| Corporate Bonds | - | 7,267 | - | 7,267 |
| Equity Securities | 5,758 | - | - | 5,758 |
| Total Investment Securities | $ 5,758 | $ 271,194 | $ - | $ 276,952 |
| Other Assets | | | | |
| Derivatives | $ - | $ 105 | $ - | $ 105 |
| Total Other Assets | $ - | $ 105 | $ - | $ 105 |
| Derivatives | | | $ 72 | $ 72 |
| Total Other Liabilities | | | $ 72 | $ 72 |

| December 31, 2015 | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Trading Securities: | | | | |
| U.S. Treasury and Government Agency Securities | $ - | $ 1,947 | $ - | $ 1,947 |
| Available-for-Sale Securities: | | | | |
| U.S. Treasury and Government Agency Securities | $ - | $ 69,283 | $ - | $ 69,283 |
| Obligations of State and Political Agencies | - | 24,104 | - | 24,104 |
| Mortgage Backed Securities: | | | | |
| Residential Agency | - | 90,822 | - | 90,822 |
| Commercial | - | 736 | 240 | 976 |
| Equity Securities | 5,211 | - | - | 5,211 |
| Total Investment Securities | $ 5,211 | $ 184,945 | $ 240 | $ 190,396 |
| Other Assets | | | | |
| Derivatives | $ - | $ 87 | $ - | $ 87 |
| Total Other Assets | $ - | $ 87 | $ - | $ 87 |
| Derivatives | | $ - | | $ - |
| Total Other Liabilities | | $ - | | $ - |

*(dollars in thousands, except share and per share amounts)*

## NOTE 23 FAIR VALUE MEASUREMENTS (CONTINUED)

### Recurring Basis (Continued)

The following table presents the changes in Level 3 financial instruments for the years ended December 31, 2016 and 2015.

| Balance at December 31, 2016 | Commercial Mortgage Backed Securities |
|---|---|
| Beginning Balance | $ 240 |
| Transfers In and/or Out of Level 3 | (240) |
| Ending Balance | $ - |

| Balance at December 31, 2015 | |
|---|---|
| Beginning Balance | $ 264 |
| Included in Other Comprehensive Income | (24) |
| Ending Balance | $ 240 |

The following is a description of the valuation methodologies used for instruments measured at fair value on a recurring basis, as well as the general classification of such instruments pursuant to the valuation hierarchy.

### Investment Securities

When available, the Company uses quoted market prices to determine the fair value of securities; such items are classified in Level 1 of the fair value hierarchy. For the Company's securities for which quoted prices are not available for identical securities in an active market, the Company determines fair value utilizing vendors who apply matrix pricing for similar bonds for which no price is observable or may compile prices from various sources. These models are primarily industry-standard models that consider various assumptions, including time value, yield curve, volatility factors, prepayment speeds, default rates, loss severity, current market, and contractual prices for the underlying financial instruments, as well as other relevant economic measures. Substantially all of these assumptions are observable in the marketplace, can be derived from observable data, or are supported by observable levels at which transactions are executed in the marketplace. Fair values from these models are verified, where possible, against quoted market prices for recent trading activity of assets with similar characteristics to the security being valued. Such methods are generally classified as Level 2. However, when prices from independent sources vary, cannot be obtained, or cannot be corroborated, a security is generally classified as Level 3.

*(dollars in thousands, except share and per share amounts)*

## NOTE 23 FAIR VALUE MEASUREMENTS (CONTINUED)

### Derivatives

All of the Companies derivatives are traded in over-the-counter markets where quoted market prices are not readily available. For these derivatives, fair value is measured using internally developed models that use primarily market observable inputs, such as yield curves and option volatilities, and, accordingly, classify as Level 2. Examples of Level 2 derivatives are basic interest rate swaps and forward contracts. Any remaining derivative fair value measurements using significant assumptions that are unobservable are classified as Level 3. Level 3 derivatives include interest rate lock commitments written for residential mortgage loans that are held for sale.

### Nonrecurring Basis

Certain assets are measured at fair value on a nonrecurring basis. These assets are not measured at fair value on an ongoing basis; however, they are subject to fair value adjustments in certain circumstances, such as when there is evidence of impairment or a change in the amount of previously recognized impairment.

Net impairment losses related to nonrecurring fair value measurements of certain assets for the years ended December 31, 2016 and 2015 consisted of the following:

| 2016 | Level 2 | Level 3 | Total | Total Losses |
|---|---|---|---|---|
| Mortgages Held for Sale | $ 35,063 | $ - | $ 35,063 | $ - |
| Impaired Loans | 7,823 | - | 7,823 | 384 |
| Foreclosed Assets | 179 | - | 179 | 146 |
| Mortgage Servicing Rights | - | 4,777 | 4,777 | - |

| 2015 | Level 2 | Level 3 | Total | Total Losses |
|---|---|---|---|---|
| Mortgages Held for Sale | $ 48,642 | $ - | $ 48,642 | $ - |
| Impaired Loans | 5,562 | - | 5,562 | 180 |
| Foreclosed Assets | 295 | - | 295 | 15 |
| Mortgage Servicing Rights | - | 4,145 | 4,145 | 110 |

### Mortgages Held for Sale

Mortgage loans originated and held for sale are carried at the lower of cost or estimated fair value. The Company obtains quotes or bids on these loans directly from purchasing financial institutions. Typically these quotes include a premium on the sale and thus these quotes indicate fair value of the held for sale loans is greater than cost.

Impairment losses for mortgages held for sale that are carried at the lower of cost or fair value represent additional net write-downs during the period to record these loans at the lower of cost or estimated fair value subsequent to their initial classification as mortgages held for sale.

### Impaired Loans

In accordance with the provisions of the loan impairment guidance, impairment was measured for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement. The fair value of impaired

## NOTE 23 FAIR VALUE MEASUREMENTS (CONTINUED)

**Impaired Loans (Continued)**
loans is estimated using one of several methods, including collateral value, market value of similar debt, or discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceeds the recorded investments in such loans. Impaired loans for which an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. Collateral values are estimated using Level 2 inputs based on customized discounting criteria.

Impairment amounts on impaired loans represent specific valuation allowance and write-downs during the period presented on impaired loans that were individually evaluated for impairment based on the estimated fair value of the collateral less estimated selling costs, excluding impaired loans fully charged-off.

**Other Real Estate**
Foreclosed assets are recorded at fair value based on property appraisals, less estimated selling costs, at the date of the transfer with any impairment amount charged to the allowance for loan losses. Subsequent to the transfer, foreclosed assets are carried at the lower of cost or fair value, less estimated selling costs with changes in fair value or any impairment amount recorded in other non-interest expense. Values are estimated using Level 2 inputs based on customized discounting criteria. The carrying value of foreclosed assets is not re-measured to fair value on a recurring basis but is subject to fair value adjustments when the carrying value exceeds the fair value, less estimated selling costs.

**Servicing Rights**
Servicing rights do not trade in an active market with readily observable prices. Accordingly, the fair value of servicing rights is determined using a valuation model that calculates the present value of estimated future net servicing income. The model incorporates assumptions that market participants use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, the cost to service, escrow account earnings, contractual servicing fee income, ancillary income and late fees. Servicing rights are carried at lower of cost or market value, and therefore can be subject to fair value measurements on a nonrecurring basis. Fair value measurements of servicing rights use significant unobservable inputs and, accordingly, are classified as Level 3. The Company obtains the fair value of servicing rights from an independent third party pricing service and records the unadjusted fair values in the financial statements.

The valuation techniques and significant unobservable inputs used to measure Level 3 fair value measurements at December 31, 2016 and 2015, were as follows:

*(dollars in thousands, except share and per share amounts)*

## NOTE 23 FAIR VALUE MEASUREMENTS (CONTINUED)

### Servicing Rights (Continued)

Quantitative Information About Level 3 Fair Value Measurements as of December 31, 2016

| Financial Instrument | Fair Value | Valuation Technique | Unobservable Input | Range | Weighted Average |
|---|---|---|---|---|---|
| Mortgage Servicing Rights | 4,777 | Discounted Cash Flows | Prepayment Speed Assumptions | 113 - 253 | 140.6 |
| | | | Discount Rate | 9.5% | 9.5% |

Quantitative Information About Level 3 Fair Value Measurements as of December 31, 2015

| Financial Instrument | Fair Value | Valuation Technique | Unobservable Input | Range | Weighted Average |
|---|---|---|---|---|---|
| Mortgage Servicing Rights | 4,145 | Discounted Cash Flows | Prepayment Speed Assumptions | 125-285 | 164.7 |
| | | | Discount Rate | 9.8% | 9.8% |

Disclosure of fair value information about financial instruments, for which it is practicable to estimate that value, is required whether or not recognized in the consolidated balance sheets. In cases in which 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 estimate of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases could not be realized in immediate settlement of the instruments. Certain financial instruments with a fair value that is not practicable to estimate and all non-financial instruments are excluded from the disclosure requirements. Accordingly, the aggregate fair value amounts presented do not necessarily represent the underlying value of the Company.

The following disclosures represent financial instruments in which the ending balances at December 31, 2016 and 2015 are not carried at fair value in their entirety on the consolidated balance sheets.

### Cash and Due From Banks and Accrued Interest

The carrying amounts reported in the consolidated balance sheets approximate those assets' and liabilities' fair values.

### Loans and Leases

For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair values of other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality.

### Bank Owned Life Insurance

Bank owned life insurance is carried at fair value which was determined based on the amount due upon surrender of the policy. This amount was provided by the insurance companies based on the terms of the underlying insurance contract.

### Deposits

The fair values of demand deposits are, by definition, equal to the amount payable on demand at the consolidated balance sheet date. The fair values of fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies current incremental interest rates being offered on certificates of deposit to a schedule of aggregated expected monthly maturities of the outstanding certificates of deposit.

*(dollars in thousands, except share and per share amounts)*

## NOTE 23 FAIR VALUE MEASUREMENTS (CONTINUED)

**Short-Term Borrowings and Long-Term Debt**

For variable-rate borrowings that reprice frequently, fair values are based on carrying values. The fair value of fixed-rate borrowings are estimated using discounted cash flow analysis, based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

**Off Balance Sheet Credit-Related Commitments**

Off balance sheet credit related commitments are generally of a short-term nature. The contract amount of such commitments approximates their fair value since the commitments are comprised primarily of unfunded loan commitments which are generally priced at market at the time of funding.

The estimated fair values, and related carrying or notional amounts, of the Company's financial instruments are as follows:

| | December 31, 2016 | | | | |
|---|---|---|---|---|---|
| | Carrying | Estimated Fair Value | | | |
| Financial Assets | Amount | Level 1 | Level 2 | Level 3 | Total |
| Cash and Due From Banks | $ 207,367 | $ 207,367 | $ - | $ - | $ 207,367 |
| Loans and Leases, Net | 1,351,337 | - | - | 1,342,792 | 1,342,792 |
| Accrued Interest Receivable | 5,919 | 5,919 | - | - | 5,919 |
| Bank Owned Life Insurance | 29,139 | - | 29,139 | - | 29,139 |
| Financial Liabilities | | | | | |
| Non Interest Bearing Deposits | $ 554,490 | $ - | $ 554,490 | $ - | $ 554,490 |
| Interest Bearing Transaction Accounts | 990,186 | - | 990,186 | - | 990,186 |
| Certificates of Deposit | 240,533 | - | - | 240,416 | 240,416 |
| Short-Term Borrowings | 729 | 729 | - | - | 729 |
| Long-Term Debt | 58,813 | - | 59,193 | - | 59,193 |
| Accrued Interest Payable | 616 | 616 | - | - | 616 |

| | December 31, 2015 | | | | |
|---|---|---|---|---|---|
| | Carrying | Estimated Fair Value | | | |
| Financial Assets | Amount | Level 1 | Level 2 | Level 3 | Total |
| Cash and Due From Banks | $ 266,159 | $ 266,159 | $ - | $ - | $ 266,159 |
| Loans and Leases, Net | 1,112,233 | - | - | 1,191,792 | 1,191,792 |
| Accrued Interest Receivable | 4,830 | 4,830 | - | - | 4,830 |
| Bank Owned Life Insurance | 28,308 | - | 28,308 | - | 28,308 |
| Financial Liabilities | | | | | |
| Non Interest Bearing Deposits | $ 425,608 | $ - | $ 425,608 | $ - | $ 425,608 |
| Interest Bearing Transaction Accounts | 815,958 | - | 815,958 | - | 815,958 |
| Certificates of Deposit | 216,455 | - | - | 220,817 | 220,817 |
| Long-Term Debt | 70,744 | - | 71,943 | - | 71,943 |
| Accrued Interest Payable | 711 | 711 | - | - | 711 |

## NOTE 24 SUBSEQUENT EVENTS

On January 11, 2017, the Company sold its Maplewood branch location for $1.8 million. The Company recognized a loss of $1.1 million in 2016, when the asset was taken out of service.

Subsequent events have been evaluated through March 03, 2017, which is the date these financial statements were available to be issued.