ALERUS FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2017, 2016 AND 2015

ALERUS

Consolidated Financial Statements and Notes Table of Contents

Independent Auditors' Report 1

Consolidated Financial Statements

Consolidated Balance Sheet 3
Consolidated Statement of Income 4
Consolidated Statement of Comprehensive Income 5
Consolidated Statement of Changes in Stockholders' Equity 6
Consolidated Statement of Cash Flows 7

Notes to Consolidated Financial Statements

Note 1 – Significant Accounting Policies 9
Note 2 – New Accounting Pronouncements 14
Note 3 – Business Combinations 15
Note 4 – Restrictions on Cash and Due from Banks 15
Note 5 – Investment Securities 16
Note 6 – Loans and Allowance for Loan Losses 18
Note 7 – Premises and Equipment, Net 22
Note 8 – Goodwill and Other Intangible Assets, Net 23
Note 9 – Loan Servicing 24
Note 10 – Other Assets 24
Note 11 – Deposits 25
Note 12 – Short-Term Borrowings 25
Note 13 – Long-Term Debt 25
Note 14 – True-Up Liability 27
Note 15 – Financial Instruments with Off Balance Sheet Risk 27
Note 16 – Legal Contingencies 28
Note 17 – Stock Based Compensation Plans 28
Note 18 – Employee Benefits 30
Note 19 – Other Operating Income and Expenses 30
Note 20 – Income Taxes 31
Note 21 – Related Party Transactions 32
Note 22 – Preferred Stock 32
Note 23 – Derivative Instruments 32
Note 24 – Regulatory Matters 33
Note 25 – Fair Value of Assets and Liabilities 34
Note 26 – Subsequent Events 39

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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, 2017 and 2016, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the years ended December 31, 2017, 2016, and 2015, 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.

A member of Nexia International

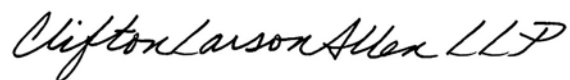
Opinion

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, 2017 and 2016, and the results of their operations and their cash flows for the years ended December 31, 2017, 2016, and 2015 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, 2017, 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 date February 28, 2018, expressed an unqualified opinion on the Company's internal control over financial reporting.



CliftonLarsonAllen LLP

Minneapolis, Minnesota
February 28, 2018

Alerus Financial Corporation and Subsidiaries
Consolidated Balance Sheets

At December 31, *(dollars in thousands, except share and per share amounts)*	2017	2016
Assets		
Cash and cash equivalents	$ 40,336	$ 35,441
Interest-bearing deposits	81,662	171,926
Cash and due from banks	121,998	207,367
Investment securities		
Securities held for trading	1,945	1,959
Securities available for sale	272,466	276,952
Loans held for sale	17,938	35,063
Loans	1,574,474	1,366,952
Less allowance for loan losses	(16,564)	(15,615)
Net loans	1,557,910	1,351,337
Premises and equipment, net	21,229	24,262
Accrued interest receivable	6,817	5,919
Bank-owned life insurance	29,959	29,139
Goodwill	27,329	27,329
Other intangible assets, net	31,797	37,506
Deferred income taxes	9,213	19,521
Other assets	38,457	34,225
Total assets	$ 2,137,058	$ 2,050,579
Liabilities and Stockholders' Equity		
Deposits		
Noninterest-bearing	$ 619,333	$ 554,490
Interest-bearing	1,215,629	1,230,719
Total deposits	1,834,962	1,785,209
Short-term borrowings	30,000	729
Long-term debt	58,819	58,813
Accrued expenses and other liabilities	32,706	37,043
Total liabilities	1,956,487	1,881,794
Stockholders' equity		
Common stock, $1 par value, 30,000,000 shares authorized; 13,699,066 and 13,534,375 issued and outstanding	13,699	13,534
Additional paid-in capital	26,040	23,882
Retained earnings	141,963	133,307
Accumulated other comprehensive income (loss)	(1,131)	(1,938)
Total stockholders' equity	180,571	168,785
Total liabilities and stockholders' equity	$ 2,137,058	$ 2,050,579

Alerus Financial Corporation and Subsidiaries
Consolidated Statements of Income

Year Ended December 31, *(dollars and shares in thousands, except per share data)*	2017	2016	2015
Interest Income			
Loans, including fees	$ 68,799	$ 63,644	$ 51,731
Investment securities			
Taxable	4,773	4,584	3,496
Exempt from federal income taxes	1,356	1,089	808
Other	709	625	293
Total interest income	75,637	69,942	56,328
Interest Expense			
Deposits	3,520	3,385	2,758
Short-term borrowings	942	11	18
Long-term debt	3,505	3,606	682
Total interest expense	7,967	7,002	3,458
Net interest income	67,670	62,940	52,870
Provision for loan losses	3,280	3,060	4,200
Net interest income after provision for loan losses	64,390	59,880	48,670
Noninterest Income			
Retirement and benefit services	62,234	57,804	51,059
Wealth management	14,109	12,640	11,418
Mortgage banking	20,700	28,296	24,630
Service charges on deposit accounts	1,854	1,916	1,611
Net gain (loss) on investment securities	(13)	(24)	(17)
Other	4,575	4,449	4,554
Total noninterest income	103,459	105,081	93,255
Noninterest Expense			
Salaries and incentives	67,576	70,739	59,122
Employee benefits and taxes	16,490	15,975	12,804
Net occupancy	6,266	6,437	5,203
Furniture and equipment	5,568	6,018	5,018
Intangible amortization	5,623	7,005	4,361
Other	33,397	37,618	31,626
Total noninterest expense	134,920	143,792	118,134
Income before income taxes	32,929	21,169	23,791
Income tax expense	17,485	7,138	6,683
Net income	15,444	14,031	17,108
Less preferred stock dividends	-	25	200
Net income applicable to common stock	$ 15,444	$ 14,006	$ 16,908
Earnings per common share	$ 1.13	$ 1.04	$ 1.26
Diluted earnings per common share	$ 1.10	$ 1.00	$ 1.21
Dividends declared per common share	$ 0.48	$ 0.44	$ 0.42
Average common shares outstanding	13,653	13,495	13,413
Diluted average common shares outstanding	14,007	14,000	13,947

See Accompanying Notes to Consolidated Financial Statements

Alerus Financial Corporation and Subsidiaries
Consolidated Statements of Comprehensive Income

Year Ended December 31, *(dollars in thousands)*	2017	2016	2015
Net income	$ 15,444	$ 14,031	$ 17,108
Other Comprehensive Income (Loss), Net of Tax			
Unrealized gains (losses) on available-for-sale securities	1,542	(4,721)	(505)
Reclassification adjustment for losses (gains) realized in income	-	17	-
Total other comprehensive income (loss), before tax	1,542	(4,704)	(505)
Income tax (expense) benefit related to items of other comprehensive income	(735)	1,717	184
Other comprehensive income (loss), net of tax	807	(2,987)	(321)
Total comprehensive income	$ 16,251	$ 11,044	$ 16,787

See Accompanying Notes to Consolidated Financial Statements

Alerus Financial Corporation and Subsidiaries
Consolidated Statements of Changes in Stockholders' Equity
(dollars and shares in thousands, except per share data)

	Preferred Stock	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income/(Loss)	Total
Balance December 31, 2014	$ 20	$ 13,346	$ 41,092	$ 115,258	$ 1,370	$ 171,086
Net income	-	-	-	17,108	-	17,108
Other comprehensive income (loss)	-	-	-	-	(321)	(321)
Common stock repurchased	-	(1)	(26)	-	-	(27)
Common stock issued	-	16	299	-	-	315
Preferred stock dividends	-	-	-	(200)	-	(200)
Common stock dividends	-	-	-	(5,859)	-	(5,859)
Tax benefit equity related items	-	-	606	(606)	-	-
Stock-based compensation expense	-	-	719	-	-	719
Vesting 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 income (loss)	-	-	-	-	(2,987)	(2,987)
Common stock repurchased	-	(18)	(102)	(237)	-	(357)
Common stock issued	-	20	345	-	-	365
Preferred stock dividends	-	-	-	(25)	-	(25)
Common stock dividends	-	-	-	(6,163)	-	(6,163)
Stock-based compensation expense	-	-	1,100	-	-	1,100
Vesting of restricted stock	-	98	(98)	-	-	-
Preferred stock redeemed	(20)	-	(19,980)	-	-	(20,000)
Balance December 31, 2016	-	13,534	23,882	133,307	(1,938)	168,785
Net income	-	-	-	15,444	-	15,444
Other comprehensive income (loss)	-	-	-	172	807	979
Common stock repurchased	-	(16)	(47)	(231)	-	(294)
Common stock issued	-	64	1,384	-	-	1,448
Common stock dividends	-	-	-	(6,729)	-	(6,729)
Stock-based compensation expense	-	17	921	-	-	938
Vesting of restricted stock	-	100	(100)	-	-	-
Balance December 31, 2017	$ -	$ 13,699	$ 26,040	$ 141,963	$ (1,131)	$ 180,571

See Accompanying Notes to Consolidated Financial Statements

Alerus Financial Corporation and Subsidiaries
Consolidated Statements of Cash Flows

Year Ended December 31, *(dollars in thousands)*	2017	2016	2015
Operating Activities			
Net income	$ 15,444	$ 14,031	$ 17,108
Adjustments to reconcile net income to net cash			
Deferred income taxes	9,745	(3,044)	581
Provision for loan losses	3,280	3,060	4,200
Provision for foreclosed asset losses	425	226	53
Depreciation and amortization	9,856	11,385	8,727
Stock-based compensation	938	1,465	1,034
Investment securities premium amortization	2,069	2,364	636
Increase in value of bank-owned life insurance	(820)	(831)	(824)
Realized loss (gain) on forward sale derivatives	97	(81)	(186)
Realized loss (gain) on rate lock commitments	(70)	135	139
Realized loss (gain) on sale of premises and equipment	154	6	-
Realized loss (gain) on sale of foreclosed assets	38	73	540
Realized loss (gain) on sale of investment securities	-	17	-
Realized loss (gain) on servicing rights	(743)	(1,293)	(1,178)
Net change in			
Securities held for trading	14	(12)	13
Loans held for sale	17,125	13,579	(13,600)
Accrued interest receivable	(898)	(1,089)	(56)
Other assets	(2,136)	313	(2,867)
Accrued expenses and other liabilities	(6,628)	(6,315)	10,039
Net cash provided by operating activities	47,890	33,989	24,359
Investing Activities			
Proceeds from sales of investment securities available for sale	325	59,910	-
Proceeds from maturities of investment securities available for sale	42,570	42,806	40,096
Purchases of investment securities available for sale	(38,551)	(82,487)	(27,490)
Net increase in loans	(210,286)	(38,884)	(38,723)
Net cash paid for business combinations	-	(45,441)	(4,314)
Proceeds from bank-owned life insurance	-	5,331	-
Purchases of premises and equipment	(2,946)	(1,684)	(3,906)
Proceeds from sales of premises and equipment	2,390	404	-
Proceeds from sales of foreclosed assets	1,405	636	2,126
Net cash used by investing activities	(205,093)	(59,409)	(32,211)
Financing Activities			
Net increase in deposits	49,754	25,020	195,853
Net increase (decrease) in short-term borrowings	29,271	(6,847)	(10,532)
Repayments of long-term debt	(168)	(25,000)	(125)
Proceeds from issuance of subordinated debt	-	-	49,375
Cash dividends paid on preferred stock	-	(25)	(200)
Cash dividends paid on common stock	(6,729)	(6,163)	(5,859)
Redemption of preferred stock	-	(20,000)	-
Repurchase of common stock	(294)	(357)	(27)
Net cash provided (used) by financing activities	71,834	(33,372)	228,485
Net change in cash and due from banks	(85,369)	(58,792)	220,633
Cash and due from banks at beginning of year	207,367	266,159	45,526
Cash and due from banks	$ 121,998	$ 207,367	$ 266,159

Supplemental Cash Flow Disclosures	2017	2016	2015
Loan collateral transferred to foreclosed assets	$ 433	$ 1,851	$ 684
Unrealized gain (loss) on investment securities available for sale	807	(2,987)	(321)
Interest paid for the period	8,026	7,263	3,381
Income tax payments net of refunds received	13,074	1,612	10,165
Noncash assets acquired	-	335,830	4,572
Liabilities assumed	-	(328,748)	(258)
Net noncash assets acquired	-	7,082	4,314
Cash and due from banks acquired	-	18,748	-

Notes to Consolidated Financial Statements

NOTE 1 Significant Accounting Policies

Alerus Financial Corporation is a financial holding company organized under the laws of Delaware. Alerus Financial Corporation and its subsidiaries (the "Company") is a diversified financial services company that provides commercial banking, mortgage banking, retirement and benefit plan administration, wealth management services. The Company's subsidiary operations also include retail brokerage services.

Alerus Financial, N.A. (the "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 accounts of Alerus Financial Corporation and its subsidiaries in which Alerus Financial Corporation has a controlling interest. Significant intercompany balances and transactions have been eliminated in consolidation. Certain items in prior periods have been reclassified to conform to the current presentation.

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. The Company consolidates 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 investment securities, determination of the allowance for loan losses, 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 clients located within North Dakota, Minnesota and Arizona. At December 31, 2017 and 2016, respectively, 30.5% and 34.4% 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 client. Note 6 discusses the Company's loan portfolio.

The Company invests in a variety of investment securities and does not have any significant concentrations in any one industry or to any one issuer. Note 5 discusses the Company's investment securities portfolio.

Cash and Due from Banks

For purposes of the consolidated statements of cash flows, cash and due from banks include cash and cash equivalents, 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 statements of income. Other marketable securities are classified as available-for-sale and are carried at fair value. Realized gains and losses on investment securities available-for-sale are included in net gain (loss) on investment securities and, when applicable, are reported as a reclassification adjustment, net of tax, in other comprehensive income. Gains and losses on sales of investment 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 investment securities below their cost that are other than temporary, result in write-downs of the individual investment 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 investment 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 by 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.

Loans 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 mortgage banking on the consolidated statements of income.

Loans
Loans are stated at the amount of unpaid principal, reduced by an allowance for loan 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 losses. Loan fees received that are associated with originating or acquiring certain loans are deferred, net of costs, and amortized over the life of the loan as a yield adjustment to interest income.

The accrual of interest on 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.

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 3 and 6. 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 income being recorded only after the carrying value of the loans has been reduced to zero.

Allowance for Loan Losses
The allowance for loan losses (allowance) is an estimate of loan losses inherent in the Company's loan portfolio. The allowance is established through a provision for loan 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; 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 or a 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 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, Agricultural and Other: 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.

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 other 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, Net
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.

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.

Goodwill and Other Intangibles, Net
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, 2017, the Company believes 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 the sale of loans. Servicing rights are recorded at fair value based on assumptions provided by a third-party valuation service. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the servicing cost per loan, the discount rate, the escrow float rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses. Loan servicing income is recorded on the accrual basis and includes servicing fees from investors and certain charges collected from borrowers, such as late payment fees, and is net of fair value adjustments to capitalized mortgage servicing rights. 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.

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 comparing the carrying amount of an asset to the future undiscounted net cash flows expected to be generated by the asset. In the event such an asset is considered impaired, the impairment to be recognized is measured by the amount by which the carrying value of the asset exceeds the fair value of the asset. Assets to be disposed of are reported at the lower of the carrying value or fair value less estimated costs to sell.

Foreclosed Assets
Assets acquired through loan foreclosure are included in other assets and are initially recorded at fair value less estimated selling cost. The fair value of foreclosed assets is evaluated regularly and any decreases value along with holding costs, such as taxes, insurance and utilities, are reported in noninterest expense.

Transfers of Financial Assets and Participating Interests
Transfers of financial assets are accounted for as sales when control over the assets has been surrendered or in the case of a loan participation, a portion of the asset has been surrendered and meets the definition of a "participating

interest". 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. Should the transfer not meet these three criteria, the transaction is treated as a secured financing.

Loans serviced for others are not included in the accompanying consolidated balance sheets. Servicing loans for others generally consists of collecting mortgage payments, maintaining escrow accounts, disbursing payments to investors and collection and foreclosure processing.

Derivatives and Hedging Activities
In the ordinary course of business, the Company enters into derivative transactions to manage various risks and to accommodate the business requirements of its clients. Derivative instruments are reported in other assets or other liabilities at fair value. Changes in a derivative's fair value are recognized currently in earnings unless specific hedge accounting criteria are met.

Retirement Services and Wealth Management Income
Retirement and benefit 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. A valuation allowance would be recognized if it is "more likely than not" that the deferred tax asset will not be realized.

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.

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 of the position. See Note 20, 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 2017, 2016, or 2015.

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 2014.

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 investment 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.

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.

NOTE 2 New Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09 Revenue from Contracts with Clients (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 clients 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 has evaluated the potential impact of ASU 2014-09 on the Company's consolidated financial statements and has determined the update will 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 has evaluated the impact that this new guidance will have on the Company's Consolidated Financial Statements and determined that it will not have a significant impact.

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 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.

In February 2018, the FASB issued Accounting Standard Update ("ASU") No. 2018-02, Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. ASU 2018-02 allows a reclassification from accumulated other comprehensive income to retained earnings and eliminates the stranded tax effects resulting from the Tax Cuts and Jobs Act. The Company adopted the updated guidance effective January 1, 2017. This updated did not have a significant impact on the Company's consolidated financial statements.

NOTE 3 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)	As Recorded by Beacon	Fair Value Adjustments	As Recorded by Alerus
Assets			
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

NOTE 4 Restrictions on Cash and Due from Banks

Banking regulators require bank subsidiaries to maintain minimum average reserve balances, either in the form of vault cash or reserve balances held with central banks or other financial institutions. The amount of required reserve balances were approximately $7.9 million and $3.9 million at December 31, 2017 and 2016, respectively, and represent those required to be held at the Federal Reserve Bank. In addition to vault cash, the Company held balances at the Federal Reserve Bank and other financial institutions of $83.5 million and $173.7 million at December 31, 2017 and 2016, respectively, to meet these requirements. These balances are included in cash and due from banks on the Consolidated Balance Sheets.

NOTE 5 Investment Securities

The amortized cost of investment securities and their approximate fair values, with gross unrealized gains and losses at December 31, 2017 and 2016 are as follows:

	2017				2016			
(dollars in thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Available-for-sale								
U.S. Treasury and agencies	$ 19,086	$ 16	$ (158)	$ 18,944	$ 20,261	$ 1	$ (170)	$ 20,092
Obligations of state and political agencies	74,803	437	(765)	74,475	73,998	225	(2,271)	71,952
Mortgage backed securities								
Residential Agency	149,373	643	(1,386)	148,630	148,560	1,025	(1,553)	148,032
Commercial	14,432	12	(233)	14,211	23,279	79	(247)	23,111
Asset backed securities	530	12	(1)	541	722	18	-	740
Corporate bonds	10,212	19	(11)	10,220	7,319	-	(52)	7,267
Equity securities	5,539	-	(94)	5,445	5,865	-	(107)	5,758
Total available-for-sale	$ 273,975	$ 1,139	$ (2,648)	$ 272,466	$ 280,004	$ 1,348	$ (4,400)	$ 276,952

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

	Securities Available-for-Sale	
(dollars in thousands)	Amortized Cost	Fair Value
Due in one year or less	$ 4,075	$ 4,076
Due after one year through five years	48,955	48,598
Due after five year through ten years	94,102	93,772
Due after 10 years	121,304	120,575
No contractual maturity	5,539	5,445
Total	$ 273,975	$ 272,466

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.

Investment securities with a carrying value of $166.9 million and $191.2 million were pledged at December 31, 2017 and 2016, 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, 2017, 2016, and 2015 were $-0-, $59.9 million and $-0- respectively. Gross losses recognized on these sales were $-0-, $100 thousand, and $-0- for the years ended December 31, 2017, 2016, and 2015, respectively. Gross gains recognized on these sales were $-0-, $83 thousand, and $-0- for the years ended December 31, 2017, 2016, and 2015, respectively.

Proceeds from the sale and maturity of trading securities for the years ended December 31, 2017, 2016, and 2015 were $-0-, $101 thousand, and $240 thousand, respectively. There were no gross losses recognized on these sales for the years ended December 31, 2017, 2016, and 2015. For the years ended December 31, 2017, 2016, and 2015, gross gains recognized on these were $-0-, $1 thousand, and $5 thousand, respectively.

Information pertaining to investment securities with gross unrealized losses that are not deemed to be other-than-temporarily impaired at December 31, 2017 and 2016 aggregated by investment category and length of time that individual investment securities have been in a continuous loss position, follows:

	Less than 12 Months		Over 12 Months		Total	
At December 31, 2017 *(dollars in thousands)*	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value
Available-for-sale						
U.S. Treasury and agencies	$ -	$ -	$ (158)	$ 12,400	$ (158)	$ 12,400
Obligations of state and political agencies	(298)	21,860	(467)	26,643	(765)	48,503
Mortgage backed securities						
Residential Agency	(772)	86,442	(614)	33,691	(1,386)	120,133
Commercial	(26)	1,776	(207)	10,070	(233)	11,846
Asset backed securities	(1)	184	-	-	(1)	184
Corporate bonds	(11)	5,040	-	-	(11)	5,040
Equity securities	-	-	(94)	2,343	(94)	2,343
Total available-for-sale	$ (1,108)	$ 115,302	$ (1,540)	$ 85,147	$ (2,648)	$ 200,449

	Less than 12 Months		Over 12 Months		Total	
At December 31, 2016 *(dollars in thousands)*	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value
Available-for-sale						
U.S. Treasury and agencies	$ (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 backed securities	-	54	-	-	-	54
Corporate bonds	(52)	6,233	-	-	(52)	6,233
Equity securities	-	-	(107)	2,330	(107)	2,330
Total available-for-sale	$ (4,271)	$ 200,247	$ (129)	$ 3,660	$ (4,400)	$ 203,907

At December 31, 2017, all of the available-for-sale debt securities in an unrealized loss position were investment grade. During the year ended December 31, 2017, 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. At December 31, 2017, the Company's evaluation of other investment 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 6 Loans and Allowance for Loan Losses

As discussed in Note 3, 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 at December 31, 2017 and 2016 are as follows:

(dollars in thousands)	2017	2016
Commercial		
Commercial, industrial, and agriculture	$ 476,858	$ 470,179
Real estate construction	22,348	35,174
Real estate mortgage	444,857	391,533
Other	3,737	2,270
Total commercial	947,800	899,156
Consumer		
Real estate 1-4 family first mortgage	348,964	202,217
Real estate 1-4 family junior mortgage	195,103	178,795
Other revolving and installment	82,607	86,784
Total consumer	626,674	467,796
Total Loans	1,574,474	1,366,952
Less: allowance for loan losses	(16,564)	(15,615)
Net loans	$ 1,557,910	$ 1,351,337

Changes in the allowance for years ended December 31, 2017 and 2016 are summarized in the following table:

(dollars in thousands)	2017	2016
Balance - beginning of period	$ 15,615	$ 14,688
Provision for loan losses	3,280	3,060
Commercial loan charge-offs		
Commercial, industrial, and agriculture	(3,032)	(1,556)
Real estate construction	-	(1,655)
Real estate mortgage	-	(43)
Other	(255)	(73)
Total commercial loan charge-offs	(3,287)	(3,327)
Consumer loan charge-offs		
Real estate 1-4 family first mortgage	-	-
Real estate 1-4 family junior mortgage	(1,124)	(829)
Other revolving and installment	(429)	(280)
Total consumer loan charge-offs	(1,553)	(1,109)
Total loan charge-offs	(4,840)	(4,436)
Commercial loan recoveries		
Commercial, industrial, and agriculture	894	1,064
Real estate construction	279	587
Real estate mortgage	73	188
Other	36	20
Total commercial loan recoveries	1,282	1,859
Consumer loans recoveries		
Real estate 1-4 family first mortgage	103	211
Real estate 1-4 family junior mortgage	872	94
Other revolving and installment	252	139
Total consumer loan recoveries	1,227	444
Total loan recoveries	2,509	2,303
Net loan charge-offs	(2,331)	(2,133)
Balance - end of period	$ 16,564	$ 15,615

The following tables summarize the activity in the allowance by commercial and consumer portfolio segments for years ended December 31, 2017 and 2016:

(dollars in thousands)	Commercial	Consumer	Unallocated	Total
Balance at December 31, 2016	$ 11,667	$ 2,432	$ 1,516	$ 15,615
Provision for credit losses	3,180	705	(605)	3,280
Loan charge-offs	(3,287)	(1,553)	-	(4,840)
Loan recoveries	1,282	1,227	-	2,509
Net loan charge-offs	(2,005)	(326)	-	(2,331)
Balance at December 31, 2017	$ 12,842	$ 2,811	$ 911	$ 16,564
Balance at December 31, 2015	$ 11,055	$ 2,956	$ 677	$ 14,688
Provision for credit losses	2,080	141	839	3,060
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 at December 31, 2016	$ 11,667	$ 2,432	$ 1,516	$ 15,615

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

	Allowance for Loan Losses				Recorded Investment in Loans		
(dollars in thousands)	Commercial	Consumer	Unallocated	Total	Commercial	Consumer	Total
December 31, 2017							
Collectively evaluated	$ 12,009	$ 2,702	$ 911	$ 15,622	$ 944,352	$ 624,220	$ 1,568,572
Individually evaluated	833	109	-	942	3,448	2,454	5,902
Purchased credit impaired	-	-	-	-	-	-	-
Total	$ 12,842	$ 2,811	$ 911	$ 16,564	$ 947,800	$ 626,674	$ 1,574,474
December 31, 2016							
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

The tables below provide a breakdown of outstanding commercial loans by risk category at December 31, 2017 and 2016. 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.

(dollars in thousands)	Commercial, Industrial and Ag	Commercial Real Estate	Real Estate Construction	Other	Total
December 31, 2017					
By risk category:					
Pass	$ 452,204	$ 414,621	$ 18,880	$ 3,737	$ 889,442
Criticized	24,654	30,236	3,468	-	58,358
Total commercial loans	$ 476,858	$ 444,857	$ 22,348	$ 3,737	$ 947,800
December 31, 2016					
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

The following tables reflect the past due aging analysis of the loan portfolio at December 31, 2017 and 2016:

(dollars in thousands)	Current	Accruing 30-89 Days Past Due	Accruing 90 Days or More Past Due	Nonperforming	Total Loans
December 31, 2017					
Commercial					
Commercial, industrial, and agriculture	$ 472,725	$ 940	$ -	$ 3,193	$ 476,858
Real estate construction	22,287	-	-	61	22,348
Real estate mortgage	440,412	4,445	-	-	444,857
Other	3,485	252	-	-	3,737
Total commercial	938,909	5,637	-	3,254	947,800
Consumer					
Real estate 1-4 family first mortgage	347,941	361	-	662	348,964
Real estate 1-4 family junior mortgage	191,856	1,374	-	1,873	195,103
Other revolving and installment	82,002	521	-	84	82,607
Total consumer	621,799	2,256	-	2,619	626,674
Total loans	$ 1,560,708	$ 7,893	$ -	$ 5,873	$ 1,574,474
December 31, 2016					
Commercial					
Commercial, industrial, and agriculture	$ 465,769	$ 1,544	$ -	$ 2,866	$ 470,179
Real estate construction	34,423	-	-	751	35,174
Real estate mortgage	391,278	106	-	149	391,533
Other	2,270	-	-	-	2,270
Total commercial	893,740	1,650	-	3,766	899,156
Consumer					
Real estate 1-4 family first mortgage	199,737	1,345	48	1,087	202,217
Real estate 1-4 family junior mortgage	174,741	1,464	-	2,590	178,795
Other revolving and installment	86,179	432	-	173	86,784
Total consumer	460,657	3,241	48	3,850	467,796
Total loans	$ 1,354,397	$ 4,891	$ 48	$ 7,616	$ 1,366,952

Interest income foregone on nonaccrual loans approximated $195 thousand and $728 thousand for the years ended December 31, 2017 and 2016, 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, 2017			December 31, 2016		
(dollars in thousands)	Unpaid Principal	Recorded Investment	Related Allowance	Unpaid Principal	Recorded Investment	Related Allowance
Commercial, industrial, and agriculture	$ 3,423	$ 3,387	$ 833	$ 3,366	$ 3,366	$ 296
Real estate construction	62	61	-	751	530	-
Real estate mortgage	-	-	-	149	146	-
1-4 family first mortgage	591	508	-	1,087	1,087	-
1-4 family junior mortgage	1,969	1,862	41	2,720	2,627	46
Other revolving and installment	84	84	68	75	67	42
Total impaired loans	$ 6,129	$ 5,902	$ 942	$ 8,148	$ 7,823	$ 384

The table below presents the average recorded investment in impaired loans and interest income for years ended December 31, 2017 and 2016 respectively. No interest income on impaired loans was recognized using the cash basis of accounting during the years ended December 31, 2017 and 2016.

	2017		2016	
(dollars in thousands)	Average Recorded Investments	Interest Income	Average Recorded Investments	Interest Income
Commercial				
Commercial, industrial, and agriculture	$ 4,515	$ 246	$ 4,049	$ 195
Real estate mortgage	65	3	752	30
Other	-	-	160	9
Consumer				
1-4 family first mortgage	620	37	1,102	50
1-4 family junior mortgage	2,280	141	2,983	180
Other revolving and installment	89	6	81	6
Total Impaired Loans	$ 7,569	$ 433	$ 9,127	$ 470

Loans with a carrying value of $1.0 billion and $717.9 million were pledged at December 31, 2017 and 2016, respectively, to secure public deposits, repurchase agreements, and for other purposes required or permitted by law.

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, 2017 and 2016.

There was no allowance for loan losses related to the purchased impaired loans at December 31, 2017 and 2016.

Troubled Debt Restructurings

During 2017 there were no loans that were modified as a troubled debt restructuring. During 2016 there was one loan that was modified as a troubled debt restructuring as a result of extending the amortization period. The loan 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. The loan amount is not significant to the consolidated financial statements.

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.

NOTE 7 Premises and Equipment, Net

Components of premises and equipment at December 31, 2017 and 2016 are as follows:

(dollars in thousands)	2017	2016
Land	$ 4,663	$ 4,844
Buildings and improvements	25,888	28,669
Assets under capital lease	2,657	2,657
Furniture, fixtures, and equipment	32,397	30,765
	65,605	66,935
Less accumulated depreciation	(44,376)	(42,673)
Total	$ 21,229	$ 24,262

Depreciation expense for the years ended December 31, 2017, 2016, and 2015 amounted to $3.2 million, $3.3 million, and $2.9 million, respectively.

Total rent expense for the years ended December 31, 2017, 2016, and 2015 amounted to $3.6 million, $3.7 million, and $3.2 million, respectively.

Pursuant to the terms of the noncancelable lease agreements in effect at December 31, 2017, pertaining to banking premises, future minimum rent commitments under various operating leases are as follows:

(dollars in thousands)	Amount
2018	$ 3,506
2019	2,881
2020	2,607
2021	2,162
2022	1,671
Thereafter	4,161
Total	$ 16,988

The annual minimum future rents due to the Company on noncancelable operating leases at December 31, 2017 are as follows:

(dollars in thousands)	Amount
2018	$ 370
2019	297
2020	234
2021	227
2022	212
Thereafter	212
Total	$ 1,552

NOTE 8 Goodwill and Other Intangible Assets, Net

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.

At December 31, 2017 *(dollars in thousands)*	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	(31,333)	24,411
Core deposit intangibles	5 years	Straight Line	7,216	(4,516)	2,700
Servicing rights			4,686	-	4,686
Total			$ 94,975	$ (35,849)	$ 59,126

At December 31, 2016 *(dollars in thousands)*	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

Aggregate amortization expense for the years ended December 31, 2017, 2016, and 2015 was $5.6 million, $7.0 million, and $4.4 million, respectively.

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

(dollars in thousands)	Amount
2018	$ 4,638
2019	4,081
2020	3,961
2021	3,266
2022	3,202
Thereafter	7,963
Total	$ 27,111

NOTE 9 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 $591.8 million, and $625.4 million at December 31, 2017 and 2016, respectively.

The balance of servicing rights included in other intangible assets at December 31, 2017 and 2016 is $4.7 million and $4.8 million, respectively. Servicing rights of $745 thousand, $1.2 million and $1.1 million were capitalized in 2017, 2016, and 2015, respectively. Amortization of servicing rights was $813 thousand, $818 thousand, and $1.4 million in 2017, 2016 and 2015, respectively. Changes in fair value of servicing rights arising from adjustments to valuation allowances are recognized in other noninterest expense and were $14 thousand, $(139) thousand, and $52 thousand in 2017, 2016 and 2015, respectively.

The amount of loan servicing obligations included in other liabilities is $128 thousand and $134 thousand as of December 31, 2017 and 2016, respectively.

The fair value of loan servicing rights and obligations were determined using discount rates averaging 9.50% as of December 31, 2017 and 2016, and prepayment speeds averaging 9.30% and 8.44%, respectively.

NOTE 10 Other Assets

Other assets on the balance sheet consist of the following balances at December 31, 2017 and 2016:

(dollars in thousands)	2017	2016
Federal Reserve Bank stock	$ 2,675	$ 2,675
Foreclosed assets	446	1,721
Prepaid expenses	6,448	2,863
Investments in partnerships	390	458
Trust fees receivable	15,883	18,575
Income tax refund receivable	3,902	-
Federal Home Loan Bank stock	4,281	3,245
Other assets	4,432	4,688
Total	$ 38,457	$ 34,225

Federal Reserve Band 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.

NOTE 11 Deposits

The components of deposits in the consolidated balance sheets at December 31, 2017 and 2016 are as follows:

(dollars in thousands)	2017	2016
Noninterest-bearing deposits	$ 619,333	$ 554,490
Interest-bearing deposits		
Savings accounts	50,794	48,371
Interest-bearing checking accounts	416,991	325,474
Money market savings	543,583	616,341
Certificates of deposit	204,261	240,533
Total interest-bearing deposits	1,215,629	1,230,719
Total deposits	$ 1,834,962	$ 1,785,209

Certificates of deposit in excess of $250 thousand totaled $28.2 million and $30.2 million at December 31, 2017 and 2016, respectively.

At December 31, 2017, the scheduled maturities of certificates of deposit are as follows:

(dollars in thousands)	Amount
2018	$ 155,945
2019	18,690
2020	8,377
2021	9,124
2022	4,416
Thereafter	7,709
Total	$ 204,261

NOTE 12 Short-Term Borrowings

Federal Funds purchased at December 31, 2017 and 2016 were $0. The average interest rate charged on Federal Funds purchased during 2017, 2016 and 2015 was 1.3%, 0.41%, and 0.33%, respectively.

At December 31, 2017, the Company had available $87 million of unsecured lines of credit and no secured lines of credit for Federal Funds outstanding.

At December 31, 2017, the Company had $30 million of short-term borrowings with the Federal Home Loan Bank. The interest rate was 1.42% and the borrowing matures on January 2, 2018.

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 $-0- and $729 thousand at December 31, 2017 and 2016, respectively. Weighted average interest rates were 0.54% and 0.54% as of December 31, 2017 and 2016, respectively.

The securities underlying the agreements at December 31, 2017 and 2016 were under the Company's control in safekeeping at third-party financial institutions.

NOTE 13 Long-Term Debt

Long-term debt at December 31, 2017 and 2016 consisted of the following:

(dollars in thousands)	Rate Type	Interest Rate	2017	2016
Subordinated notes payable	Fixed	5.75%	$ 49,500	$ 49,437
Junior subordinated debentures	Floating	3.39% - 4.77%	8,278	8,166
Obligations under capital lease			1,041	1,210
Total			$ 58,819	$ 58,813

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, 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 $500 thousand and $563 thousand, at December 31, 2017 and 2016, 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, 2017, 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, 2017, 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 Company's 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.

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 4.77% at December 31, 2017) 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 3.39% at December 31, 2017) 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 their 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 $2.0 million at December 31, 2017.

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, 2017 balance of $1.0 million, net of prepaid interest of $194 thousand, is due in monthly installments of $21 thousand including interest through October 31, 2022.

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 $414 million, at December 31, 2017. At December 31, 2017 the Company had the ability to borrow an additional $383.8 million from the FHLB based on the value of pledged loans and investment securities.

At December 31, 2017, the Company had a $10 million letter of credit with the Bank of North Dakota and $150 thousand 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 $296.4 million at December 31, 2017.

The following schedule represents the future minimum lease payments under the capital lease together with the present value of the net minimum lease payments at December 31, 2017:

(dollars in thousands)		Amount
2018	$	251
2019		251
2020		251
2021		251
2022		231
Total minimum lease payments		1,235
Less amount representing interest		(194)
Net minimum lease payments	$	1,041

NOTE 14 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 2.50% and 5.00% as of December 31, 2017 and 2016, respectively.

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 $3.2 million and $2.9 million as of December 31, 2017 and 2016, 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 15 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, 2017 and 2016, the following financial instruments whose contract amount represents credit risk were approximately as follows:

(dollars in thousands)	2017	2016
Commitments to extend credit	$ 509,071	$ 525,416
Standby letters of credit	9,255	8,620
Total	$ 518,326	$ 534,036

Commitments to extend credit are agreements to lend to a client 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 client's creditworthiness on a case by case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation. 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 client 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 clients. 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 clients. 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 client 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 $286 thousand and $3.9 million at December 31, 2017 and 2016, respectively.

NOTE 16 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 17 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.

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 are charged to expense over the period earned. Compensation expense, relating to stock awards under this plan, was $8 thousand in 2017, $10 thousand in 2016, and $10 thousand in 2015.

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 at December 31, 2017, 2016 and 2015.

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 are charged to expense over the period earned. Compensation expense relating to stock awards under this plan was $650 thousand in 2017, $1.1 million in 2016 and $1.1 million in 2015.

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 at December 31, 2017, 2016 and 2015.

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

Activity in the stock plans for the years ended December 31, 2017, 2016 and 2015 is as follows:

	Number of Shares	
	Available for Future Grant	Restricted Stock Awards
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
Restricted units awarded	(5,287)	5,287
Restricted shares awarded	(51,576)	51,576
Shares withheld for taxes	13,273	(13,273)
Awards forfeited	55,134	(55,134)
Balance - December 31, 2017	690,458	2,124,022

The number of unvested shares outstanding was 335,092, 440,511 and 520,054 respectively, at December 31, 2017, 2016 and 2015.

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. Compensation expense relating to stock awards under this plan was $280 thousand in 2017, $330 thousand in 2016 and $280 thousand in 2015.

Activity in the Retainer Plan for the years ended December 31, 2017, 2016 and 2015 is as follows:

	Number of Shares	
(dollars in thousands)	Available for Future Grant	Retainer Stock Awards
Balance - December 31, 2014	82,983	81,345
Retainer shares awarded	(14,512)	14,512
Balance - December 31, 2015	68,471	95,857
Retainer shares awarded	(17,829)	17,829
Balance - December 31, 2016	50,642	113,686
Retainer shares awarded	(14,800)	14,800
Balance - December 31, 2017	35,842	128,486

NOTE 18 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 and for years ending December 31, 2017, and 2016, and as follows:

(dollars in thousands)	2017	2016	2015
Salary reduction plan	$ 2,317	$ 2,290	$ 1,867
ESOP	1,684	1,444	1,347
Total	$ 4,001	$ 3,734	$ 3,214
Total ESOP shares outstanding	1,393,395	1,337,999	1,320,579

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 $31 million, $23 million, and $25 million respectively, for years ended December 31, 2017, 2016 and 2015.

NOTE 19 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, 2017, 2016 and 2015 are as follows:

(dollars in thousands)	2017	2016	2015
Other Operating Income			
Interchange fees	$ 1,997	$ 2,025	$ 1,979
Bank owned life insurance income	820	991	824
Other operating income	1,758	1,433	1,751
Total	$ 4,575	$ 4,449	$ 4,554
Other Operating Expenses			
Marketing, business development, and public relations	$ 3,274	$ 3,239	$ 3,907
Supplies, telephone, and postage	4,504	5,538	4,404
FDIC insurance	1,311	1,458	1,175
Professional fees - legal, audit, and consulting	3,409	3,305	2,512
Correspondent and other outside service fees	11,422	12,860	9,394
Net expenses of OREO and other property including gain or loss on disposal	585	222	821
Other expenses	8,892	10,996	9,413
Total	$ 33,397	$ 37,618	$ 31,626

NOTE 20 Income Taxes

The components of income tax expense (benefit) for the years ended December 31, 2017, 2016, and 2015 are as follows:

(dollars in thousands)	2017	2016	2015
Federal			
Current	$ 6,791	$ 9,090	$ 5,621
Deferred	2,975	(2,659)	926
Federal income tax	9,766	6,431	6,547
State			
Current	949	1,092	481
Deferred	734	(385)	(345)
State income tax	1,683	707	136
Deferred tax impairment and statutory rate change	6,036	-	-
Total income tax provision	$ 17,485	$ 7,138	$ 6,683

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2017 and 2016 are as follows:

(dollars in thousands)	2017	2016
Deferred Tax Assets		
Allowance for loan losses	$ 4,157	$ 5,989
Employee compensation and benefit accruals	2,017	3,855
Expense accruals	1,701	2,356
Identifiable intangible amortization	3,392	4,711
Acquired loans	332	2,924
Net operating loss carry forwards	436	480
Nonaccrual loan interest	193	381
Other	615	2,402
Total	12,843	23,098
Valuation allowance	(150)	(167)
Total deferred tax assets from temporary differences	12,693	22,931
Deferred Tax Liabilities		
Accumulated depreciation	499	1,044
Goodwill and intangible amortization	1,120	1,110
Servicing assets	1,144	1,554
Prepaid expenses	1,051	806
Other	45	10
Total deferred tax liabilities from temporary differences	3,859	4,524
Deferred tax liability from unrealized gain on available-for-sale investment securities	(379)	(1,114)
Total Deferred Liabilities	3,480	3,410
Net Deferred Tax Assets	$ 9,213	$ 19,521

The reconciliation between applicable income taxes and the amount computed at the applicable statutory Federal tax rate for years ending December 31, 2017, and 2016 and 2015 is as follows:

	2017		2016		2015	
(dollars in thousands)	Amount	Percent of Pretax Income	Amount	Percent of Pretax Income	Amount	Percent of Pretax Income
Taxes at statutory federal income tax rate	$ 11,525	35.0%	$ 7,409	35.0%	$ 8,327	35.0%
Tax effect of:						
Tax exempt income	(562)	(1.7)	(736)	(3.4)	(581)	(2.3)
State income taxes, net of federal benefits	1,414	4.3	(602)	(2.8)	6	-
Change in federal statutory tax rate	4,644	14.1	-	-	-	-
Deferred tax asset impairment	1,392	4.2	-	-	-	-
Nondeductible items and other	(928)	(2.8)	1,067	5.0	(1,069)	(1.9)
Applicable income taxes	$ 17,485	53.1%	$ 7,138	33.8%	$ 6,683	30.7%

On December 22, 2017, the U.S. Government enacted "To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018", also known as the Tax Cuts and Jobs Act. This resulted in the corporate income tax rate being reduced from the current 35% level to 21%. The Company is required to adjust the carrying value of the deferred tax assets using the new tax rate, which resulted in a charge to earnings in the fourth quarter of the current period. Impairment expense of $4.6 million was recorded, which is included in Income Tax Expense on the Consolidated Statements of Income.

The Company was unable to recognize certain tax benefits related to some acquired loans and recorded an impairment expense of $1.4 million, which is included in Income Tax Expense on the Consolidated Statements of Income.

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 21 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 related parties totaled $19.9 million at December 31, 2017 and $20.5 million at December 31, 2016. During 2017, new loans total $7.3 million were made and $7.9 million were repaid.

Deposits from related parties held by the Bank at December 31, 2017 and 2016 amounted to $5.8 million and $6.8 million, respectively.

NOTE 22 Preferred Stock

The Company is authorized to issue 2,000,000 shares of preferred stock. The Company redeemed $20 thousand shares of Series A preferred stock in February 2016 that had previously been issued to the Secretary of the Treasury under the Small Business Lending Fund. At December 31, 2017 and 2016, there were no shares that were issued or outstanding.

NOTE 23 Derivative Instruments

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.

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 clients 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 at December 31, 2017 and 2016:

	2017			2016		
		Fair Value			Fair Value	
(dollars in thousands)	Notional Amount	Derivative Assets	Derivative Liabilities	Notional Amount	Derivative Assets	Derivative Liabilities
Free standing derivatives (economic hedges)						
Interest rate contracts	$ 542	$ 9	$ 9	$ 574	$ 22	$ 22
Customer accommodation, trading, and other contracts						
Interest rate contracts	7,877	8	1	13,885	105	72
Total		$ 17	$ 10		$ 127	$ 94

The gain (loss) recognized on derivative instruments for years ended December 31, 2017, 2016, and 2015 was as follows:

Derivatives not designated as hedging instruments	Location of gain or loss recognized in income	Amount of gain or (loss) recognized in income		
		2017	2016	2015
Interest Rate Contracts	Other Income (Expenses)	$ (26)	$ (54)	47

NOTE 24 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 weighted assets (as defined) and of Tier 1 capital (as defined) to average assets (as defined). Management believes at December 31, 2017 and 2016, the Company and the Bank have met all of the capital adequacy requirements to which they are subject.

As of December 31, 2017, 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.

The Company's and the Bank's actual capital amounts and ratios at December 31, 2017 and 2016 are presented in the following table.

At December 31, 2017 *(dollars in thousands)*	Actual		Minimum Capital		Minimum to be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Common equity tier 1 capital to risk weighted assets (CET 1)						
Consolidated	$ 133,149	7.83%	$ 76,522	4.5%	N/A	N/A
Bank	187,115	11.01%	76,478	4.5%	110,468	6.5%
Tier 1 capital to risk weighted assets						
Consolidated	141,037	8.29%	102,077	6.0%	136,103	8.0%
Bank	187,115	11.01%	101,970	6.0%	135,960	8.0%
Total capital to risk weighted assets:						
Consolidated	207,101	12.17%	136,139	8.0%	170,173	10.0%
Bank	203,679	11.99%	135,899	8.0%	169,874	10.0%
Tier 1 capital to average assets:						
Consolidated	141,037	7.07%	79,795	4.0%	N/A	N/A
Bank	187,115	9.40%	79,623	4.0%	99,529	5.0%

At December 31, 2016 *(dollars in thousands)*	Actual		Minimum Capital		Minimum to be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Common equity tier 1 capital to risk weighted assets (CET 1)						
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%

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, 2017, the Company was in compliance with HUD guidelines.

NOTE 25 Fair Value of Assets and Liabilities

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 investment 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 at December 31, 2017 and 2016:

At December 31, 2017 *(dollars in thousands)*	Level 1	Level 2	Level 3	Total
Trading securities				
U.S. treasury and government agencies	$ -	$ 1,945	$ -	$ 1,945
Available-for-sale securities				
U.S. treasury and government agencies	$ -	$ 18,944	$ -	$ 18,944
Obligations of state and political agencies	-	74,475	-	74,475
Mortgage backed securities				
Residential agency	-	148,630	-	148,630
Commercial	-	14,211	-	14,211
Asset backed securities	-	541	-	541
Corporate bonds	-	10,220	-	10,220
Equity securities	5,445	-	-	5,445
Total investment securities	$ 5,445	$ 267,021	$ -	$ 272,466
Other assets				
Derivatives	$ -	$ 17	$ -	$ 17
Other liabilities				
Derivatives	$ -	$ 9	$ 1	$ 10

At December 31, 2016 *(dollars in thousands)*	Level 1	Level 2	Level 3	Total
Trading securities				
U.S. treasury and government agencies	$ -	$ 1,959	$ -	$ 1,959
Available-for-sale securities				
U.S. treasury and government agencies	$ -	$ 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	$ -	$ 127	$ -	$ 127
Other liabilities				
Derivatives	$ -	$ 22	$ 72	$ 94

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 investment securities; such items are classified in Level 1 of the fair value hierarchy. For the Company's investment securities for which quoted prices are not available for identical investment 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.

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, 2017 and 2016 consisted of the following:

	2017				2016			
(dollars in thousands)	Level 2	Level 3	Total	Losses	Level 2	Level 3	Total	Losses
Loans held for sale	$ 17,938	$ -	$ 17,938	$ -	$ 35,063	$ -	$ 35,063	$ -
Impaired loans	5,333	-	5,333	942	7,823	-	7,823	384
Foreclosed assets	318	-	318	425	179	-	179	146
Servicing rights	-	4,686	4,686	-	-	4,777	4,777	-

Loans Held for Sale

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 loans 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 loans 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 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.

Foreclosed Assets

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, 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 for Mortgage Servicing Rights, at December 31, 2017 and 2016, were as follows:

		2017			2016		
Valuation Technique	Unobservable Input	Fair Value	Range	Weighted Average	Fair Value	Range	Weighted Average
Discounted cash flows	Prepayment speed assumptions	4,686	119-239	155	4,777	113 - 253	140.6
	Discount rate		9.5%	9.5%		9.5%	9.5%

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, 2017 and 2016 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

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 the amount due upon surrender of the policy, which is alos the estimated fair value. 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.

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:

At December 31, 2017 *(dollars in thousands)*	Carrying Amount	Estimated Fair Value Level 1	Level 2	Level 3	Total
Financial Assets					
Cash and due from banks	$ 121,998	$ 121,998	$ -	$ -	$ 121,998
Loans	1,557,910	-	-	1,552,399	1,552,399
Accrued interest receivable	6,817	6,817	-	-	6,817
Bank owned life insurance	29,959	-	29,959	-	29,959
Financial Liabilities					
Noninterest-bearing deposits	$ 619,333	$ -	$ 619,333	$ -	$ 619,333
Interest-bearing transaction accounts	1,011,368	-	1,011,368	-	1,011,368
Certificates of deposit	204,261	-	-	202,608	202,608
Short-term borrowings	30,000	30,000	-	-	30,000
Long-term debt	58,819	-	59,337	-	59,337
Accrued interest payable	557	557	-	-	557

At December 31, 2016 *(dollars in thousands)*	Carrying Amount	Estimated Fair Value Level 1	Level 2	Level 3	Total
Financial Assets					
Cash and due from banks	$ 207,367	$ 207,367	$ -	$ -	$ 207,367
Loans	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					
Noninterest-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

NOTE 26 SUBSEQUENT EVENTS

Subsequent events have been evaluated through February 28, 2018, which is the date these financial statements were available to be issued.