MACKINAC FINANCIAL CORP /MI/
Form 10-Q
November 13, 2013
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

**x QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended September 30, 2013**

**OR**

**o TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from <> to <>**

**Commission file number: 0-20167**

# MACKINAC FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **MICHIGAN**<br>(State or other jurisdiction of<br>incorporation or organization) | **38-2062816**<br>(I.R.S. Employer Identification No.) |
| **130 SOUTH CEDAR STREET, MANISTIQUE, MI**<br>(Address of principal executive offices) | **49854**<br>(Zip Code) |

Registrant s telephone number, including area code: **(888) 343-8147**

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

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

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

| | |
|---|---|
| Large Accelerated Filer o | Accelerated Filer o |
| Non-accelerated Filer o | Smaller reporting company x |

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

As of September 30, 2013, there were outstanding 5,581,339 shares of the registrant s common stock, no par value.

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MACKINAC FINANCIAL CORPORATION

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands)

| | September 30, 2013 (Unaudited) | December 31, 2012 | September 30, 2012 (Unaudited) |
|---|---|---|---|
| **ASSETS** | | | |
| | | | |
| Cash and due from banks | **$ 22,791** | $ 26,958 | $ 31,403 |
| Federal funds sold | **3** | 3 | 16,002 |
| Cash and cash equivalents | **22,794** | 26,961 | 47,405 |
| | | | |
| Interest-bearing deposits in other financial institutions | **10** | 10 | 10 |
| Securities available for sale | **48,096** | 43,799 | 42,476 |
| Federal Home Loan Bank stock | **3,060** | 3,060 | 3,060 |
| | | | |
| Loans: | | | |
| Commercial | **353,526** | 342,841 | 329,891 |
| Mortgage | **104,504** | 95,413 | 93,446 |
| Consumer | **14,465** | 10,923 | 10,621 |
| Total Loans | **472,495** | 449,177 | 433,958 |
| Allowance for loan losses | **(4,959)** | (5,218) | (5,186) |
| Net loans | **467,536** | 443,959 | 428,772 |
| | | | |
| Premises and equipment | **10,484** | 10,633 | 10,744 |
| Other real estate held for sale | **2,568** | 3,212 | 3,511 |
| Deferred tax asset | **7,953** | 9,131 | 9,670 |
| Other assets | **5,416** | 5,215 | 5,469 |
| | | | |
| **TOTAL ASSETS** | **$ 567,917** | $ 545,980 | $ 551,117 |
| | | | |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | | |
| | | | |
| LIABILITIES: | | | |
| Deposits: | | | |
| Noninterest bearing deposits | **$ 70,063** | $ 67,652 | $ 62,306 |
| NOW, money market, interest checking | **158,588** | 155,465 | 152,286 |
| Savings | **12,694** | 13,829 | 15,783 |
| CDs<$100,000 | **133,821** | 135,550 | 142,125 |
| CDs>$100,000 | **23,816** | 24,355 | 25,390 |
| Brokered | **62,706** | 37,706 | 41,473 |
| Total deposits | **461,688** | 434,557 | 439,363 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Borrowings | | **35,852** | | 35,925 | | 35,925 |
| Other liabilities | | **3,332** | | 3,050 | | 2,884 |
| Total liabilities | | **500,872** | | 473,532 | | 478,172 |
| | | | | | | |
| SHAREHOLDERS EQUITY: | | | | | | |
| Preferred stock - No par value: | | | | | | |
| Authorized - 500,000 shares | | **4,000** | | 11,000 | | 11,000 |
| Issued and outstanding - **4,000,** 11,000 and 11,000 respectively | | | | | | |
| Common stock and additional paid in capital - No par value | | | | | | |
| Authorized - 18,000,000 shares | | | | | | |
| Issued and outstanding - **5,581,339**, 5,559,859 and 5,559,914 respectively | | **53,915** | | 53,797 | | 55,047 |
| Retained earnings | | **8,780** | | 6,727 | | 6,028 |
| Accumulated other comprehensive income | | **350** | | 924 | | 870 |
| | | | | | | |
| Total shareholders equity | | **67,045** | | 72,448 | | 72,945 |
| | | | | | | |
| **TOTAL LIABILITIES AND SHAREHOLDERS EQUITY** | **$** | **567,917** | $ | 545,980 | $ | 551,117 |

See accompanying notes to condensed consolidated financial statements.

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MACKINAC FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in Thousands, Except per Share Data)

| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 |
|---|---|---|---|---|
| | (Unaudited) | | (Unaudited) | |
| **INTEREST INCOME:** | | | | |
| Interest and fees on loans: | | | | |
| Taxable | **$ 6,077** | $ 5,803 | **$ 17,980** | $ 17,256 |
| Tax-exempt | **26** | 28 | **81** | 90 |
| Interest on securities: | | | | |
| Taxable | **245** | 226 | **726** | 728 |
| Tax-exempt | **9** | 6 | **22** | 20 |
| Other interest income | **33** | 41 | **96** | 96 |
| Total interest income | **6,390** | 6,104 | **18,905** | 18,190 |
| **INTEREST EXPENSE:** | | | | |
| Deposits | **879** | 1,011 | **2,642** | 2,986 |
| Borrowings | **163** | 163 | **490** | 492 |
| Total interest expense | **1,042** | 1,174 | **3,132** | 3,478 |
| Net interest income | **5,348** | 4,930 | **15,773** | 14,712 |
| Provision for loan losses | **375** | 150 | **850** | 795 |
| Net interest income after provision for loan losses | **4,973** | 4,780 | **14,923** | 13,917 |
| **OTHER INCOME:** | | | | |
| Deposit service fees | **158** | 155 | **495** | 538 |
| Income from loans sold in the secondary market | **203** | 320 | **781** | 844 |
| SBA/USDA loan sale gains | **135** | 506 | **798** | 1,126 |
| Mortgage servicing income | **128** | 92 | **413** | 292 |
| Other | **114** | 76 | **260** | 260 |
| Total other income | **738** | 1,149 | **2,747** | 3,060 |
| **OTHER EXPENSE:** | | | | |
| Salaries and employee benefits | **2,226** | 2,063 | **6,907** | 6,041 |
| Occupancy | **362** | 370 | **1,107** | 1,050 |
| Furniture and equipment | **274** | 213 | **799** | 660 |
| Data processing | **269** | 253 | **802** | 739 |
| Professional service fees | **161** | 210 | **706** | 700 |
| Loan and deposit | **55** | 195 | **173** | 674 |
| Writedowns and losses on other real estate held for sale | **57** | 265 | **146** | 450 |
| FDIC insurance assessment | **100** | 36 | **300** | 354 |
| Telephone | **84** | 56 | **229** | 168 |
| Advertising | **119** | 96 | **334** | 292 |
| Other | **652** | 610 | **1,690** | 1,280 |
| Total other expenses | **4,359** | 4,367 | **13,193** | 12,408 |
| Income before provision for income taxes | **1,352** | 1,562 | **4,477** | 4,569 |
| Provision for (benefit of) income taxes | **456** | 528 | **1,508** | (1,458) |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **NET INCOME** | | **896** | | 1,034 | | **2,969** | | 6,027 |
| **Preferred dividend and accretion of discount** | | **50** | | 137 | | **250** | | 491 |
| **NET INCOME AVAILABLE TO COMMON SHAREHOLDERS** | **$** | **846** | $ | 897 | **$** | **2,719** | $ | 5,536 |
| **INCOME PER COMMON SHARE*:** | | | | | | | | |
| Basic | **$** | **.15** | $ | .21 | **$** | **.49** | $ | 1.30 |
| Diluted | **$** | **.15** | $ | .20 | **$** | **.49** | $ | 1.25 |

*Earnings per share data for 2012 restated for common stock issuance

See accompanying notes to condensed consolidated financial statements.

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MACKINAC FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS COMPREHENSIVE INCOME

(Dollars in Thousands)

(Unaudited)

| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 |
|---|---|---|---|---|
| Net income | **$ 896** | $ 1,034 | **$ 2,969** | $ 6,027 |
| Net change in net unrealized gains and losses on securities available for sale: | | | | |
| Unrealized gains (losses) arising during the period | **(136)** | 264 | **(899)** | 827 |
| Less: reclassification adjustment for gains included in net income | **14** | | **29** | |
| Net securities gain (loss) during the period | **(122)** | 264 | **(870)** | 827 |
| Tax effect | **42** | (90) | **296** | (282) |
| Net of tax | **(80)** | 174 | **(574)** | 545 |
| | | | | |
| Comprehensive income | **$ 816** | $ 1,208 | **$ 2,395** | $ 6,572 |

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(Dollars in Thousands)

(Unaudited)

| | Three Months Ended September 30, 2013 Preferred Stock | 2013 Common Shareholders Equity | 2013 Total Shareholders Equity | 2012 Preferred Stock | 2012 Common Shareholders Equity | 2012 Total Shareholders Equity |
|---|---|---|---|---|---|---|
| Balance, beginning of period | **$ 4,000** | **$ 62,520** | **$ 66,520** | $ 11,000 | $ 49,352 | $ 60,352 |
| Net income for period | | **896** | **896** | | 1,034 | 1,034 |
| Net unrealized gain (loss) on securities available for sale | | **(80)** | **(80)** | | 174 | 174 |
| Total comprehensive income (loss) | | **816** | **816** | | 1,208 | 1,208 |
| Issuance of common stock | | | | | 11,506 | 11,506 |
| Stock compensation | | **75** | **75** | | 16 | 16 |
| Dividend on common stock | | **(222)** | **(222)** | | | |
| Repurchase of common stock | | **(94)** | **(94)** | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Dividend on preferred stock | | **(50)** | **(50)** | | (137) | (137) |
| Balance, end of period | **$ 4,000** | **$ 63,045** | **$ 67,045** | $ 11,000 | $ 61,945 | $ 72,945 |

| | **Nine Months Ended September 30,** | | | | | |
|---|---|---|---|---|---|---|
| | | **2013** | | | **2012** | |
| | **Preferred Stock** | **Common Shareholders Equity** | **Total Shareholders Equity** | **Preferred Stock** | **Common Shareholders Equity** | **Total Shareholders Equity** |
| Balance, beginning of period | **$ 11,000** | **$ 61,448** | **$ 72,448** | $ 10,921 | $ 44,342 | $ 55,263 |
| Net income for period | | **2,969** | **2,969** | | 6,027 | 6,027 |
| Net unrealized gain (loss) on securities available for sale | | **(574)** | **(574)** | | 545 | 545 |
| Total comprehensive income (loss) | | **2,395** | **2,395** | | 6,572 | 6,572 |
| Issuance of common stock | | | | | 11,506 | 11,506 |
| Stock compensation | | **258** | **258** | | 16 | 16 |
| Dividend on common stock | | **(666)** | **(666)** | | | |
| Repurchase of common stock | | **(140)** | **(140)** | | | |
| Redemption of Preferred Series A stock | **(7,000)** | | **(7,000)** | | | |
| Dividend on preferred stock | | **(250)** | **(250)** | | (412) | (412) |
| Accretion of preferred stock discount | | | | 79 | (79) | |
| Balance, end of period | **$ 4,000** | **$ 63,045** | **$ 67,045** | $ 11,000 | $ 61,945 | $ 72,945 |

See accompanying notes to condensed consolidated financial statements.

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MACKINAC FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in Thousands)

(Unaudited)

| | Nine Months Ended September 30, 2013 | 2012 |
|---|---|---|
| **Cash Flows from Operating Activities:** | | |
| Net income | **$ 2,969** | $ 6,027 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | **1,264** | 1,152 |
| Provision for loan losses | **850** | 795 |
| Deferred income taxes | **1,508** | (1,458) |
| (Gain) on sales/calls of securities | **(29)** | |
| (Gain) on sale of secondary market loans | **(609)** | (641) |
| Origination of loans held for sale in secondary market | **(44,568)** | (45,605) |
| Proceeds from loans held for sale in secondary market | **45,177** | 46,246 |
| Loss on sale of premises, equipment, and other real estate held for sale | **13** | 12 |
| Writedown of other real estate held for sale | **134** | 474 |
| Stock compensation | **258** | 16 |
| Change in other assets | **(201)** | (315) |
| Change in other liabilities | **283** | 622 |
| Net cash provided by operating activities | **7,049** | 7,325 |
| | | |
| **Cash Flows from Investing Activities:** | | |
| Net increase in loans | **(25,393)** | (34,652) |
| Purchase of securities available for sale | **(7,875)** | (11,031) |
| Proceeds from maturities, sales, calls or paydowns of securities available for sale | **2,378** | 7,848 |
| Capital expenditures | **(757)** | (1,929) |
| Proceeds from sale of premises, equipment, and other real estate | **1,429** | 178 |
| Net cash (used in) investing activities | **(30,218)** | (39,586) |
| | | |
| **Cash Flows from Financing Activities:** | | |
| Net increase in deposits | **27,131** | 34,574 |
| Net proceeds from stock issuance | | 11,506 |
| Repurchase of common stock | **(140)** | |
| Dividend on common stock | **(666)** | |
| Redemption of Preferred Series A | **(7,000)** | |
| Principal payments on borrowings | **(73)** | (72) |
| Dividend on preferred stock | **(250)** | (412) |
| Net cash provided by financing activities | **19,002** | 45,596 |
| | | |
| Net increase (decrease) in cash and cash equivalents | **(4,167)** | 13,335 |
| Cash and cash equivalents at beginning of period | **26,961** | 34,070 |
| | | |
| Cash and cash equivalents at end of period | **$ 22,794** | $ 47,405 |

| | | | | |
|---|---|---|---|---|
| **Supplemental Cash Flow Information:** | | | | |
| Cash paid during the year for: | | | | |
| Interest | **$** | **2,721** | $ | 3,020 |
| Income taxes | | **124** | | 75 |
| | | | | |
| **Noncash Investing and Financing Activities:** | | | | |
| Transfers of Foreclosures from Loans to Other Real Estate Held for Sale (net of adjustments made through the allowance for loan losses) | | **932** | | 1,013 |

See accompanying notes to condensed consolidated financial statements.

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

***Basis of Presentation***

The unaudited condensed consolidated financial statements of Mackinac Financial Corporation (the Corporation ) have been prepared in accordance with generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine-month period ended September 30, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013. The unaudited consolidated financial statements and footnotes thereto should be read in conjunction with the audited consolidated financial statements and footnotes thereto included in the Corporation s Annual Report on Form 10-K for the year ended December 31, 2012.

In order to properly reflect some categories of other income and other expenses, reclassifications of expense and income items have been made to prior period numbers. The net other income and other expenses was not changed due to these reclassifications.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 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 relate to the determination of the allowance for loan losses, and the valuation of deferred tax assets, mortgage servicing rights and other real estate held for sale.

***Allowance for Loan Losses***

The allowance for loan losses includes specific allowances related to commercial loans, when they have been judged to be impaired. A loan is impaired when, based on current information, it is probable that the Corporation will not collect all amounts due in accordance with the contractual terms of the loan agreement. These specific allowances are based on discounted cash flows of expected future payments using the loan s initial effective interest rate or the fair value of the collateral if the loan is collateral dependent.

The Corporation continues to maintain a general allowance for loan losses for loans not considered impaired. The allowance for loan losses is maintained at a level which management believes is adequate to provide for possible loan losses. Management periodically evaluates the adequacy of the allowance using the Corporation s past loan loss experience, known and inherent risks in the portfolio, composition of the portfolio, current economic conditions, and other factors. The allowance does not include the effects of expected losses related to future events or future changes in economic conditions. This evaluation is inherently subjective since it requires material estimates that may be susceptible to significant change. Loans are charged against the allowance for loan losses when management believes the collectability of the principal is unlikely. In addition, various regulatory agencies periodically review the allowance for loan losses. These agencies may require additions to the allowance for loan losses based on their judgments of collectability.

In management s opinion, the allowance for loan losses is adequate to cover probable losses relating to specifically identified loans, as well as probable losses inherent in the balance of the loan portfolio as of the balance sheet date.

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

***Stock Compensation Plans***

The Corporation has three stock compensation plans, which are now expired. One plan was approved during 2000 and applies to officers, employees, and nonemployee directors. This plan was amended as a part of the December 2004 stock offering and recapitalization. The amendment, approved by shareholders, increased the shares available under this plan by 428,587 shares from the original 25,000 (adjusted for the 1:20 reverse stock split), to a total authorized share balance of 453,587. The other two plans, one for officers and employees and the other for nonemployee directors, were approved in 1997. A total of 30,000 shares (adjusted for the 1:20 split), were made available for grant under these plans. Options under all of the plans were granted at the discretion of a committee of the Corporation s Board of Directors. Options to purchase shares of the Corporation s stock were granted at a price equal to the market price of the stock at the date of grant. The committee determined the vesting of the options when they were granted as established under the plan.

On May 22, 2012, the Corporation s shareholders approved the Mackinac Financial Corporation 2012 Incentive Compensation Plan, under which current and prospective employees, non-employee directors and consultants may be awarded incentive stock options, non-statutory stock options, shares of restricted stock units ( RSUs ), or stock appreciation rights. The aggregate number of shares of the Corporation s common stock issuable under the plan is 757,848.

On August 31, 2012, the Corporation granted 148,500 RSUs to certain members of management and all outside directors at the market value of the stock, which was $7.91. The RSUs were awarded at no cost to the employee and vest ratably over a four-year period. Compensation cost to be recognized over the four-year vesting period is $1.175 million. As of September 30, 2013, 37,125 of the RSUs were vested and issued. The unrecognized compensation expense was $.851 million as of September 30, 2013.

**2. EARNINGS PER SHARE**

Diluted earnings per share, which reflects the potential dilution that could occur if outstanding stock options and warrants were exercised and stock awards were fully vested and resulted in the issuance of common stock that then shared in our earnings, is computed by dividing net income by the weighted average number of common shares outstanding and common stock equivalents, after giving effect for dilutive shares issued.

The following shows the computation of basic and diluted earnings per share for the three and nine months ended September 30, 2013 and 2012 (dollars in thousands, except per share data):

| | Three Months Ended September 30, 2013 | Three Months Ended September 30, 2012 | Nine Months Ended September 30, 2013 | Nine Months Ended September 30, 2012 |
|---|---|---|---|---|
| **(Numerator):** | | | | |
| Net income | **$ 896** | $ 1,034 | **$ 2,969** | $ 6,027 |
| Preferred stock dividends and accretion of discount | **50** | 137 | **250** | 491 |
| Net income available to common shareholders | **$ 846** | $ 897 | **$ 2,719** | $ 5,536 |
| **(Denominator):** | | | | |
| Weighted average shares outstanding - basic | **5,562,835** | 4,722,029 | **5,559,108** | 3,857,002 |
| Dilutive effect of common stock warrants | | 136,186 | | 119,850 |
| Weighted average shares outstanding - diluted | **5,562,835** | 4,858,215 | **5,559,108** | 3,976,852 |
| Income per common share*: | | | | |
| Basic | **$ .15** | $ .21 | **$ .49** | $ 1.30 |
| Diluted | **$ .15** | $ .20 | **$ .49** | $ 1.25 |

*Earnings per share data for 2012 restated for common stock issuance

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**3. INVESTMENT SECURITIES**

The amortized cost and estimated fair value of investment securities available for sale as of September 30, 2013, December 31, 2012 and September 30, 2012 are as follows (dollars in thousands):

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| ***September 30, 2013*** | | | | |
| **US Agencies - MBS** | **$ 7,236** | **$ 315** | **$** | **$ 7,551** |
| **US Agencies** | **16,003** | **66** | **(336)** | **15,733** |
| **Corporate Bonds** | **18,451** | **192** | **(4)** | **18,639** |
| **Obligations of states and political subdivisions** | **5,876** | **297** | | **6,173** |
| **Total securities available for sale** | **$ 47,566** | **$ 870** | **$ (340)** | **$ 48,096** |
| *December 31, 2012* | | | | |
| US Agencies - MBS | $ 7,962 | $ 412 | $ | $ 8,374 |
| US Agencies | 10,267 | 137 | | 10,404 |
| Corporate Bonds | 18,763 | 237 | (23) | 18,977 |
| Obligations of states and political subdivisions | 5,407 | 637 | | 6,044 |
| Total securities available for sale | $ 42,399 | $ 1,423 | $ (23) | $ 43,799 |
| *September 30, 2012* | | | | |
| US Agencies - MBS | $ 8,282 | $ 388 | $ | $ 8,670 |
| US Agencies | 10,303 | 154 | | 10,457 |
| Corporate Bonds | 17,180 | 232 | (9) | 17,403 |
| Obligations of states and political subdivisions | 5,391 | 557 | (2) | 5,946 |
| Total securities available for sale | $ 41,156 | $ 1,331 | $ (11) | $ 42,476 |

The Corporation has evaluated gross unrealized losses that exist within the portfolio and considers them temporary in nature. The Corporation has both the ability and the intent to hold the investment securities until their respective maturities and therefore does not anticipate the realization of the temporary losses.

The amortized cost and estimated fair value of investment securities pledged to secure FHLB borrowings and customer relationships were $8.499 million and $8.729 million, respectively, at September 30, 2013.

## 4. LOANS

The composition of loans is as follows (dollars in thousands):

| | September 30, 2013 | December 31, 2012 | September 30, 2012 |
|---|---|---|---|
| Commercial real estate | **$ 257,961** | $ 244,966 | $ 224,061 |
| Commercial, financial, and agricultural | **79,511** | 80,646 | 84,073 |
| One to four family residential real estate | **98,770** | 87,948 | 86,643 |
| Construction : | | | |
| Consumer | **5,734** | 7,465 | 6,803 |
| Commerical | **16,054** | 17,229 | 21,757 |
| Consumer | **14,465** | 10,923 | 10,621 |
| Total loans | **$ 472,495** | $ 449,177 | $ 433,958 |

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**4. LOANS** (Continued)

An analysis of the allowance for loan losses for nine months ended September 30, 2013, the year ended December 31, 2012 and the nine months ended September 30, 2012 is as follows (dollars in thousands):

| | September 30, 2013 | December 31, 2012 | September 30, 2012 |
|---|---|---|---|
| Balance at beginning of period | **$ 5,218** | $ 5,251 | $ 5,251 |
| Recoveries on loans previously charged off | **154** | 278 | 231 |
| Loans charged off | **(1,263)** | (1,256) | (1,091) |
| Provision | **850** | 945 | 795 |
| Balance at end of period | **$ 4,959** | $ 5,218 | $ 5,186 |

In the first nine months of 2013, net charge off activity was $1.109 million, or .32% of average loans outstanding compared to net charge-offs of $.860 million, or .28% of average loans, in the same period in 2012. In the first nine months of 2013, the Corporation recorded a provision for loan loss of $.850 million compared to $.795 million in the first nine months of 2012. The Corporation s allowance for loan loss reserve policy calls for a measurement of the adequacy of the reserve at each quarter end. This process includes an analysis of the loan portfolio to take into account increases in loans outstanding and portfolio composition, historical loss rates, and specific reserve requirements of nonperforming loans.

A breakdown of the allowance for loan losses and recorded balances in loans at September 30, 2013 is as follows (dollars in thousands):

| | Commercial real estate | Commercial, financial and agricultural | Commercial construction | One to four family residential real estate | Consumer construction | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| ***Three Months Ended September 30, 2013*** | | | | | | | | |
| ***Allowance for loan loss reserve:*** | | | | | | | | |
| **Beginning balance ALLR** | **$ 2,661** | **$ 1,090** | **$ 97** | **$ 877** | **$** | **$ 13** | **$ 439** | **$ 5,177** |
| **Charge-offs** | **(132)** | **(476)** | | **(25)** | | **(14)** | | **(647)** |
| **Recoveries** | **23** | **20** | | **6** | **1** | **4** | | **54** |
| **Provision** | **3** | **522** | **(16)** | **44** | **(1)** | **15** | **(192)** | **375** |
| **Ending balance ALLR** | **$ 2,555** | **$ 1,156** | **$ 81** | **$ 902** | **$** | **$ 18** | **$ 247** | **$ 4,959** |
| ***Nine Months Ended September 30, 2013*** | | | | | | | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| ***Allowance for loan loss reserve:*** | | | | | | | | |
| **Beginning balance ALLR** | **$ 3,267** | **$ 692** | **$ 125** | **$ 980** | **$** | **$** | **$ 154** | **$ 5,218** |
| **Charge-offs** | **(588)** | **(552)** | | **(38)** | | **(85)** | | **(1,263)** |
| **Recoveries** | **64** | **53** | **2** | **17** | **1** | **17** | | **154** |
| **Provision** | **(188)** | **963** | **(46)** | **(57)** | **(1)** | **86** | **93** | **850** |
| **Ending balance ALLR** | **$ 2,555** | **$ 1,156** | **$ 81** | **$ 902** | **$** | **$ 18** | **$ 247** | **$ 4,959** |
| | | | | | | | | |
| ***At September 30,2013*** | | | | | | | | |
| ***Loans:*** | | | | | | | | |
| **Ending balance** | **$ 257,961** | **$ 79,511** | **$ 16,054** | **$ 98,770** | **$ 5,734** | **$ 14,465** | **$** | **$ 472,495** |
| **Ending balance ALLR** | **(2,555)** | **(1,156)** | **(81)** | **(902)** | | **(18)** | **(247)** | **(4,959)** |
| **Net loans** | **$ 255,406** | **$ 78,355** | **$ 15,973** | **$ 97,868** | **$ 5,734** | **$ 14,447** | **$ (247)** | **$ 467,536** |
| | | | | | | | | |
| ***Ending balance ALLR:*** | | | | | | | | |
| **Individually evaluated** | **$ 1,407** | **$ 802** | **$ 6** | **$ 246** | **$** | **$ 18** | **$** | **$ 2,479** |
| **Collectively evaluated** | **1,148** | **354** | **75** | **656** | | | **247** | **2,480** |
| **Total** | **$ 2,555** | **$ 1,156** | **$ 81** | **$ 902** | **$** | **$ 18** | **$ 247** | **$ 4,959** |
| | | | | | | | | |
| ***Ending balance Loans:*** | | | | | | | | |
| **Individually evaluated** | **$ 13,475** | **$ 7,638** | **$ 798** | **$ 450** | **$** | **$ 35** | **$** | **$ 22,396** |
| **Collectively evaluated** | **244,486** | **71,873** | **15,256** | **98,320** | **5,734** | **14,430** | | **450,099** |
| **Total** | **$ 257,961** | **$ 79,511** | **$ 16,054** | **$ 98,770** | **$ 5,734** | **$ 14,465** | **$** | **$ 472,495** |

*Impaired loans, by definition, are individually evaluated.*

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**4. LOANS** (Continued)

A breakdown of the allowance for loan losses and recorded balances in loans at December 31, 2012 is as follows (dollars in thousands):

| | Commercial real estate | Commercial, financial and agricultural | Commercial construction | One to four family residential real estate | Consumer construction | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| ***Allowance for loan loss reserve:*** | | | | | | | | |
| Beginning balance ALLR | $ 2,823 | $ 1,079 | $ 207 | $ 1,114 | $ | $ | $ 28 | $ 5,251 |
| Charge-offs | (729) | (40) | (6) | (399) | | (82) | | (1,256) |
| Recoveries | 52 | 201 | | 7 | | 18 | | 278 |
| Provision | 1,121 | (548) | (76) | 258 | | 64 | 126 | 945 |
| Ending balance ALLR | $ 3,267 | $ 692 | $ 125 | $ 980 | $ | $ | $ 154 | $ 5,218 |
| | | | | | | | | |
| ***Loans:*** | | | | | | | | |
| Ending balance | $ 244,966 | $ 80,646 | $ 17,229 | $ 87,948 | $ 7,465 | $ 10,923 | $ | $ 449,177 |
| Ending balance ALLR | (3,267) | (692) | (125) | (980) | | | (154) | (5,218) |
| Net loans | $ 241,699 | $ 79,954 | $ 17,104 | $ 86,968 | $ 7,465 | $ 10,923 | $ (154) | $ 443,959 |
| | | | | | | | | |
| ***Ending balance ALLR:*** | | | | | | | | |
| Individually evaluated | $ 1,662 | $ 155 | $ 10 | $ 112 | $ | $ | $ | $ 1,939 |
| Collectively evaluated | 1,605 | 537 | 115 | 868 | | | 154 | 3,279 |
| Total | $ 3,267 | $ 692 | $ 125 | $ 980 | $ | $ | $ 154 | $ 5,218 |
| | | | | | | | | |
| ***Ending balance Loans:*** | | | | | | | | |
| Individually evaluated | $ 22,910 | $ 6,070 | $ 858 | $ 796 | $ | $ | $ | $ 30,634 |
| Collectively evaluated | 222,056 | 74,576 | 16,371 | 87,152 | 7,465 | 10,923 | | 418,543 |
| Total | $ 244,966 | $ 80,646 | $ 17,229 | $ 87,948 | $ 7,465 | $ 10,923 | $ | $ 449,177 |

A breakdown of the allowance for loan losses and recorded balances in loans at September 30, 2012 is as follows (dollars in thousands):

| | Commercial real estate | Commercial, financial and agricultural | Commercial construction | One to four family residential real estate | Consumer construction | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| *Three Months Ended September 30, 2012* | | | | | | | | |
| ***Allowance for loan loss reserve:*** | | | | | | | | |
| Beginning balance ALLR | $ 2,784 | $ 888 | $ 218 | $ 1,083 | $ | $ | $ 110 | $ 5,083 |
| Charge-offs | (36) | | | (23) | | (1) | | (60) |
| Recoveries | 10 | 1 | | | | 2 | | 13 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Provision | 90 | (114) | (33) | 177 | | (1) | 31 | 150 |
| Ending balance ALLR | $ 2,848 | $ 775 | $ 185 | $ 1,237 | $ | $ | $ 141 | $ 5,186 |
| | | | | | | | | |
| *Nine Months Ended September 30, 2012* | | | | | | | | |
| ***Allowance for loan loss reserve:*** | | | | | | | | |
| Beginning balance ALLR | $ 2,823 | $ 1,079 | $ 207 | $ 1,114 | $ | $ | $ 28 | $ 5,251 |
| Charge-offs | (726) | (24) | (6) | (319) | | (16) | | (1,091) |
| Recoveries | 27 | 188 | | 5 | | 11 | | 231 |
| Provision | 724 | (468) | (16) | 437 | | 5 | 113 | 795 |
| Ending balance ALLR | $ 2,848 | $ 775 | $ 185 | $ 1,237 | $ | $ | $ 141 | $ 5,186 |
| | | | | | | | | |
| *At September 30, 2012* | | | | | | | | |
| ***Loans:*** | | | | | | | | |
| Ending balance | $ 224,061 | $ 84,073 | $ 21,757 | $ 86,643 | $ 6,803 | $ 10,621 | $ | $ 433,958 |
| Ending balance ALLR | (2,848) | (775) | (185) | (1,237) | | | (141) | (5,186) |
| Net loans | $ 221,213 | $ 83,298 | $ 21,572 | $ 85,406 | $ 6,803 | $ 10,621 | $ (141) | $ 428,772 |
| | | | | | | | | |
| ***Ending balance ALLR:*** | | | | | | | | |
| Individually evaluated | $ 1,198 | $ 145 | $ 11 | $ 277 | $ | $ | $ | $ 1,631 |
| Collectively evaluated | 1,650 | 630 | 174 | 960 | | | 141 | 3,555 |
| Total | $ 2,848 | $ 775 | $ 185 | $ 1,237 | $ | $ | $ 141 | $ 5,186 |
| | | | | | | | | |
| ***Ending balance Loans:*** | | | | | | | | |
| Individually evaluated | $ 22,571 | $ 5,997 | $ 858 | $ 1,248 | $ | $ 10 | $ | $ 30,684 |
| Collectively evaluated | 201,490 | 78,076 | 20,899 | 85,395 | 6,803 | 10,611 | | 403,274 |
| Total | $ 224,061 | $ 84,073 | $ 21,757 | $ 86,643 | $ 6,803 | $ 10,621 | $ | $ 433,958 |

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**4.** **LOANS** (Continued)

As part of the management of the loan portfolio, risk ratings are assigned to all commercial loans. Through the loan review process, ratings are modified as believed to be appropriate to reflect changes in the credit. Our ability to manage credit risk depends in large part on our ability to properly identify and manage problem loans. To do so, we operate a credit risk rating system under which our credit management personnel assign a credit risk rating to each loan at the time of origination and review loans on a regular basis to determine each loan s credit risk rating on a scale of 1 through 8, with higher scores indicating higher risk. The credit risk rating structure used is shown below.

In the context of the credit risk rating structure, the term Classified is defined as a problem loan which may or may not be in a nonaccrual status, dependent upon current payment status and collectability.

***Excellent (1)***

Borrower is not vulnerable to sudden economic or technological changes and is in a non-seasonal business or industry. These loans generally would be characterized by having good experienced management and a strong liquidity position with minimal leverage.

***Good (2)***

Borrower shows limited vulnerability to sudden economic change with modest seasonal effect. Borrower has above average financial statements and an acceptable repayment history with minimal leverage and a profitability that exceeds peers.

***Average (3)***

Generally, a borrower rated as average may be susceptible to unfavorable changes in the economy and somewhat affected by seasonal factors. Some product lines may be affected by technological change. Borrowers in this category exhibit stable earnings, with a satisfactory payment history.

***Acceptable (4)***

The loan is an otherwise acceptable credit that warrants a higher level of administration due to various underlying weaknesses. These weaknesses, however, have not and may never deteriorate to the point of a Special Mention rating or Classified status. This rating category may include new businesses not yet having established a firm performance record.

***Special Mention (5)***

The loan is not considered as a Classified status, however may exhibit material weaknesses that, if not corrected, may cause future problems. Borrowers in this category warrant special attention but have not yet reached the point of concern for loss. The borrower may have deteriorated to the point that they would have difficulty refinancing elsewhere. Similarly, purchasers of these businesses would not be eligible for bank financing unless they represent a significantly lessened credit risk.

***Substandard (6)***

The loan is Classified and exhibits a number of well-defined weaknesses that jeopardize normal repayment. The assets are no longer adequately protected due to declining net worth, lack of earning capacity or insufficient collateral offering the distinct possibility of the loss of a portion of the loan principal. Loans within this category clearly represent troubled and deteriorating credit situations requiring constant supervision and an action plan must be developed and approved by the appropriate officers to mitigate the risk.

***Doubtful (7)***

Loans in this category exhibit the same weaknesses used to describe the substandard credit; however, the traits are more pronounced. Loans are frozen with collection improbable. Such loans are not yet rated as Charge-off because certain actions may yet occur which would salvage the loan.

***Charge-off/Loss (8)***

Loans in this category are largely uncollectible and should be charged against the loan loss reserve immediately.

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**4. LOANS** (Continued)

***General Reserves:***

For loans with a credit risk rating of 5 or better and any loans with a risk rating of 6 or 7 with no specific reserve, reserves are established based on the type of loan collateral, if any, and the assigned credit risk rating. Determination of the allowance is inherently subjective as it requires significant estimates, including the amounts and timing of expected future cash flows on impaired loans, estimated losses on pools of homogenous loans based on historical loss experience, and consideration of current environmental factors and economic trends, all of which may be susceptible to significant change.

Using a historical average loss by loan type as a base, each loan graded as higher risk is assigned a specific percentage. Within the commercial loan portfolio, the historical loss rates are used for specific industries such as hospitality, gaming, petroleum, and forestry. The residential real estate and consumer loan portfolios are assigned a loss percentage as a homogenous group. If, however, on an individual loan the projected loss based on collateral value and payment histories are in excess of the computed allowance, the allocation is increased for the higher anticipated loss. These computations provide the basis for the allowance for loan losses as recorded by the Corporation.

Commercial construction loans in the amount of $2.773 million, $3.468 million and $3.882 million for the periods ended September 30, 2013 and December 31, 2012, and September 30, 2012, respectively did not receive a specific risk rating. These amounts represent loans made for land development and unimproved land purchases. Below is a breakdown of loans by risk category as of September 30, 2013 (dollars in thousands):

| | (1) Excellent | (2) Good | (3) Average | (4) Acceptable | (5) Sp. Mention | (6) Substandard | (7) Doubtful | Rating Unassigned | Total |
|---|---|---|---|---|---|---|---|---|---|
| **Commercial real estate** | **$ 2,240** | **$ 23,675** | **$ 88,105** | **$ 123,373** | **$ 16,117** | **$ 4,451** | **$** | **$** | **$ 257,961** |
| **Commercial, financial and agricultural** | **4,260** | **5,108** | **22,263** | **41,851** | **3,746** | **2,094** | **189** | | **79,511** |
| **Commercial construction** | | **676** | **5,283** | **6,167** | **753** | **402** | | **2,773** | **16,054** |
| **One to four family residential real estate** | | **1,951** | **2,186** | **4,522** | | **6** | | **90,105** | **98,770** |
| **Consumer construction** | | | | | | | | **5,734** | **5,734** |
| **Consumer** | | **102** | **34** | **632** | | | | **13,697** | **14,465** |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **Total loans** | **$ 6,500** | **$ 31,512** | **$ 117,871** | **$ 176,545** | **$ 20,616** | **$ 6,953** | **$ 189** | **$ 112,309** | **$ 472,495** |

Below is a breakdown of loans by risk category as of December 31, 2012 (dollars in thousands):

| | **(1) Excellent** | **(2) Good** | **(3) Average** | **(4) Acceptable** | **(5) Sp. Mention** | **(6) Substandard** | **(7) Doubtful** | **Rating Unassigned** | **Total** |
|---|---|---|---|---|---|---|---|---|---|
| Commercial real estate | $ 4,807 | $ 20,491 | $ 84,164 | $ 113,379 | $ 16,754 | $ 5,189 | $ 182 | $ | $ 244,966 |
| Commercial, financial and agricultural | 5,026 | 3,936 | 23,821 | 41,785 | 4,296 | 1,782 | | | 80,646 |
| Commercial construction | | 1,038 | 5,103 | 5,784 | 759 | 1,077 | | 3,468 | 17,229 |
| One-to-four family residential real estate | | 1,969 | 3,635 | 4,791 | | 646 | | 76,907 | 87,948 |
| Consumer construction | | | | | | | | 7,465 | 7,465 |
| Consumer | | 359 | 71 | 257 | | 6 | | 10,230 | 10,923 |
| Total loans | $ 9,833 | $ 27,793 | $ 116,794 | $ 165,996 | $ 21,809 | $ 8,700 | $ 182 | $ 98,070 | $ 449,177 |

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**4. LOANS** (Continued)

Below is a breakdown of loans by risk category as of September 30, 2012 (dollars in thousands):

| | (1) Excellent | (2) Good | (3) Average | (4) Acceptable | (5) Sp. Mention | (6) Substandard | (7) Doubtful | Rating Unassigned | Total |
|---|---|---|---|---|---|---|---|---|---|
| Commercial real estate | $ 3,372 | $ 19,939 | $ 72,647 | $ 105,736 | $ 16,784 | $ 5,374 | $ 209 | $ | $ 224,061 |
| Commercial, financial and agricultural | 4,306 | 5,517 | 25,932 | 42,097 | 4,320 | 1,901 | | | 84,073 |
| Commercial construction | | 988 | 5,039 | 9,995 | 761 | 1,092 | | 3,882 | 21,757 |
| One to four family residential real estate | | 1,979 | 3,586 | 4,703 | | 709 | | 75,666 | 86,643 |
| Consumer construction | | | | | | | | 6,803 | 6,803 |
| Consumer | | 362 | 71 | 233 | | 3 | | 9,952 | 10,621 |
| Total loans | $ 7,678 | $ 28,785 | $ 107,275 | $ 162,764 | $ 21,865 | $ 9,079 | $ 209 | $ 96,303 | $ 433,958 |

***Impaired Loans***

Nonperforming loans are those which are contractually past due 90 days or more as to interest or principal payments, on nonaccrual status, or loans, the terms of which have been renegotiated to provide a reduction or deferral on interest or principal.  There was no interest income recorded during impairment and that which would have been recognized was $.060 million for the three months ended September 30, 2013, and no interest income recorded during impairment and that which would have been recognized of $.177 million for the nine months ended September 30, 2013.  For the three months ended September 30, 2012, the amounts were $.017 million and $.072 million and for the nine month period in 2012, the amounts were $.054 million and $.246 million.

The accrual of interest on loans is discontinued when, in management s opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions.  When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due.  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 are considered impaired when, based on current information and events, it is probable the Corporation will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loans basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan s existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**4. LOANS** (Continued)

The following is a summary of impaired loans and their effect on interest income (dollars in thousands):

| | | | | | | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|---|---|---|---|---|
| | Nonaccrual Basis | Accrual Basis | QTD Average Investment | YTD Average Investment | Related Valuation Reserve | Interest Income Recognized During Impairment | Interest Income on Accrual Basis | Interest Income Recognized During Impairment | Interest Income on Accrual Basis |
| ***September 30, 2013*** | | | | | | | | | |
| ***With no valuation reserve:*** | | | | | | | | | |
| **Commercial real estate** | **$ 238** | **$** | **$ 412** | **$ 501** | **$** | **$** | **$** | **$** | **$ 26** |
| **Commercial, financial and agricultural** | | | **147** | **243** | | | **3** | | **9** |
| **Commercial construction** | | | | **193** | | | | | **3** |
| **One to four family residential real estate** | **67** | | **86** | **140** | | | **2** | | **7** |
| **Consumer construction** | | | | | | | | | |
| **Consumer** | **10** | | **9** | **4** | | | | | |
| ***With a valuation reserve:*** | | | | | | | | | |
| **Commercial real estate** | **$ 2,589** | **$** | **$ 2,581** | **$ 2,557** | **$ 1,272** | **$** | **$ 42** | **$** | **$ 102** |
| **Commercial, financial and agricultural** | **767** | | **741** | **373** | **33** | | **5** | | **11** |
| **Commercial construction** | | | | | | | | | |
| **One to four family residential real estate** | **642** | | **560** | **396** | **250** | | **8** | | **19** |
| **Consumer construction** | | | | | | | | | |
| **Consumer** | | | | | | | | | |
| ***Total:*** | | | | | | | | | |
| **Commercial real estate** | **$ 2,827** | **$** | **$ 2,993** | **$ 3,058** | **$ 1,272** | **$** | **$ 42** | **$** | **$ 128** |
| **Commercial, financial and agricultural** | **767** | | **888** | **616** | **33** | | **8** | | **20** |
| **Commercial construction** | | | | **193** | | | | | **3** |
| **One to four family residential real estate** | **709** | | **646** | **536** | **250** | | **10** | | **26** |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **Consumer construction** | | | | | | | | | |
| **Consumer** | **10** | | **9** | **4** | | | | | |
| **Total** | **$ 4,313** | **$** | **$ 4,536** | **$ 4,407** | **$ 1,555** | **$** | **$ 60** | **$** | **$ 177** |

| **For the Year Ended: December 31, 2012** | **Nonaccrual Basis** | **Accrual Basis** | **Average Investment** | **Related Valuation Reserve** | **Interest Income Recognized During Impairment** | **Interest Income on Accrual Basis** |
|---|---|---|---|---|---|---|
| *With no valuation reserve:* | | | | | | |
| Commercial real estate | $ 132 | $ | $ 1,550 | $ | $ | $ 37 |
| Commercial, financial and agricultural | | | 1,063 | | | 19 |
| Commercial construction | 675 | | 675 | | | 15 |
| One to four family residential real estate | 230 | | 1,074 | | | 41 |
| Consumer construction | | | 16 | | | 1 |
| Consumer | | | 3 | | | |
| | | | | | | |
| *With a valuation reserve:* | | | | | | |
| Commercial real estate | $ 2,939 | $ | $ 3,173 | $ 1,315 | $ 54 | $ 177 |
| Commercial, financial and agricultural | 436 | | 504 | 109 | | 17 |
| Commercial construction | | | | | | |
| One to four family residential real estate | 275 | | 281 | 95 | | 6 |
| Consumer construction | | | | | | |
| Consumer | | | | | | |
| | | | | | | |
| *Total:* | | | | | | |
| Commercial real estate | $ 3,071 | $ | $ 4,723 | $ 1,315 | $ 54 | $ 214 |
| Commercial, financial and agricultural | 436 | | 1,567 | 109 | | 36 |
| Commercial construction | 675 | | 675 | | | 15 |
| One to four family residential real estate | 505 | | 1,355 | 95 | | 47 |
| Consumer construction | | | 16 | | | 1 |
| Consumer | | | 3 | | | |
| Total | $ 4,687 | $ | $ 8,339 | $ 1,519 | $ 54 | $ 313 |

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**4. LOANS** (Continued)

| | Nonaccrual Basis | Accrual Basis | QTD Average Investment | YTD Average Investment | Related Valuation Reserve | Three Months Ended Interest Income Recognized During Impairment | Three Months Ended Interest Income on Accrual Basis | Nine Months Ended Interest Income Recognized During Impairment | Nine Months Ended Interest Income on Accrual Basis |
|---|---|---|---|---|---|---|---|---|---|
| *September 30, 2012* | | | | | | | | | |
| *With no valuation reserve:* | | | | | | | | | |
| Commercial real estate | $ 530 | $ | $ 533 | $ 1,135 | $ | $ | $ 9 | $ | $ 32 |
| Commercial, financial and agricultural | | | | 1,063 | | | | | 18 |
| Commercial construction | 676 | | 676 | 676 | | | 5 | | 9 |
| One to four family residential real estate | 156 | | 384 | 818 | | | 4 | | 28 |
| Consumer construction | 15 | | 15 | 16 | | | | | 1 |
| Consumer | | | | | | | | | |
| *With a valuation reserve:* | | | | | | | | | |
| Commercial real estate | $ 3,161 | $ | $ 3,177 | $ 3,663 | $ 937 | $ 17 | $ 42 | $ 54 | $ 136 |
| Commercial, financial and agricultural | 287 | | 281 | 398 | 90 | | 4 | | 12 |
| Commercial construction | | | | | | | | | |
| One to four family residential real estate | 462 | | 267 | 463 | 188 | | 8 | | 10 |
| Consumer construction | | | | | | | | | |
| Consumer | 3 | | 1 | 3 | 3 | | | | |
| *Total:* | | | | | | | | | |
| Commercial real estate | $ 3,691 | $ | $ 3,710 | $ 4,798 | $ 937 | $ 17 | $ 51 | $ 54 | $ 168 |
| Commercial, financial and agricultural | 287 | | 281 | 1,461 | 90 | | 4 | | 30 |
| Commercial construction | 676 | | 676 | 676 | | | 5 | | 9 |
| One to four family residential real estate | 618 | | 651 | 1,281 | 188 | | 12 | | 38 |
| Consumer construction | 15 | | 15 | 16 | | | | | 1 |
| Consumer | 3 | | 1 | 3 | 3 | | | | |
| Total | $ 5,290 | $ | $ 5,334 | $ 8,235 | $ 1,218 | $ 17 | $ 72 | $ 54 | $ 246 |

A summary of past due loans at September 30, 2013, December 31, 2012 and September 30, 2012 is as follows (dollars in thousands):

| | September 30, 2013 30-89 days Past Due (accruing) | September 30, 2013 90+ days Past Due/ Nonaccrual | Total | December 31, 2012 30-89 days Past Due (accruing) | December 31, 2012 90+ days Past Due/ Nonaccrual | Total | September 30, 2012 30-89 days Past Due (accruing) | September 30, 2012 90+ days Past Due/ Nonaccrual | Total |
|---|---|---|---|---|---|---|---|---|---|
| Commercial real estate | **$** | **$ 2,827** | **$ 2,827** | $ 575 | $ 3,071 | $ 3,646 | $ 427 | $ 3,691 | $ 4,118 |
| Commercial, financial and agricultural | **100** | **767** | **867** | 71 | 436 | 507 | 64 | 287 | 351 |
| Commercial construction | | | | | 675 | 675 | 47 | 676 | 723 |
| One to four family residential real estate | **186** | **709** | **895** | 291 | 505 | 796 | 582 | 618 | 1,200 |
| Consumer construction | | | | | | | | 15 | 15 |
| Consumer | **31** | **10** | **41** | 14 | | 14 | 99 | 3 | 102 |
| Total past due loans | **$ 317** | **$ 4,313** | **$ 4,630** | $ 951 | $ 4,687 | $ 5,638 | $ 1,219 | $ 5,290 | $ 6,509 |

A roll-forward of nonaccrual activity for the three months ended September 30, 2013 (dollars in thousands):

| | For the Three Months Ended September 30, 2013 | | | | | | |
|---|---|---|---|---|---|---|---|
| | **Commercial Real Estate** | **Commercial, Financial and Agricultural** | **Commercial Construction** | **One to four family residential real estate** | **Consumer Construction** | **Consumer** | **Total** |
| **NONACCRUAL** | | | | | | | |
| **Beginning balance** | **$ 3,057** | **$ 517** | **$** | **$ 400** | **$** | **$ 9** | **$ 3,983** |
| **Principal payments** | **(26)** | **(224)** | | **(12)** | | **(1)** | **(263)** |
| **Charge-offs** | **(23)** | **(476)** | | **(24)** | | | **(523)** |
| **Advances** | | | | | | | |
| **Class transfers** | | | | | | | |
| **Transfers to OREO** | **(208)** | **(37)** | | | | | **(245)** |
| **Transfers to accruing** | | | | | | | |
| **Transfers from accruing** | | **966** | | **344** | | **2** | **1,312** |
| **Other** | **27** | **21** | | **1** | | | **49** |
| **Ending balance** | **$ 2,827** | **$ 767** | **$** | **$ 709** | **$** | **$ 10** | **$ 4,313** |

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(Unaudited)

**4. LOANS** (Continued)

A roll-forward of nonaccrual activity for the three months ended September 30, 2012 (dollars in thousands):

| | For the Three Months Ended September 30, 2012 | | | | | | |
|---|---|---|---|---|---|---|---|
| | **Commercial Real Estate** | **Commercial, Financial and Agricultural** | **Commercial Construction** | **One to four family residential real estate** | **Consumer Construction** | **Consumer** | **Total** |
| NONACCRUAL | | | | | | | |
| Beginning balance | $ 3,749 | $ 278 | $ 676 | $ 657 | $ 15 | $ | $ 5,375 |
| Principal payments | (89) | (1) | | (2) | | | (92) |
| Charge-offs | | | | (14) | | | (14) |
| Advances | | | | | | | |
| Class transfers | | | | (329) | | | (329) |
| Transfers to OREO | | | | | | | |
| Transfers to accruing | | | | | | | |
| Transfers from accruing | | 7 | | 304 | | 3 | 314 |
| Other | 31 | 3 | | 2 | | | 36 |
| Ending balance | $ 3,691 | $ 287 | $ 676 | $ 618 | $ 15 | $ 3 | $ 5,290 |

A roll-forward of nonaccrual activity for the nine months ended September 30, 2013 (dollars in thousands):

| | For the Nine Months Ended September 30, 2013 | | | | | | |
|---|---|---|---|---|---|---|---|
| | **Commercial Real Estate** | **Commercial, Financial and Agricultural** | **Commercial Construction** | **One to four family residential real estate** | **Consumer Construction** | **Consumer** | **Total** |
| **NONACCRUAL** | | | | | | | |
| **Beginning balance** | **$ 3,071** | **$ 436** | **$ 675** | **$ 505** | **$** | **$** | **$ 4,687** |
| **Principal payments** | **(174)** | **(292)** | **(100)** | **(77)** | | **(1)** | **(644)** |
| **Charge-offs** | **(352)** | **(548)** | | **(37)** | | **(4)** | **(941)** |
| **Advances** | | | | | | | |
| **Class transfers** | | | | | | | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Transfers to OREO** | **(208)** | **(37)** | **(580)** | **(107)** | | | **(932)** |
| **Transfers to accruing** | | | | | | | |
| **Transfers from accruing** | **443** | **1,207** | | **420** | | **15** | **2,085** |
| **Other** | **47** | **1** | **5** | **5** | | | **58** |
| | | | | | | | |
| **Ending balance** | **$ 2,827** | **$ 767** | **$** | **$ 709** | **$** | **$ 10** | **$ 4,313** |

A roll-forward of nonaccrual activity for the nine months ended September 30, 2012 (dollars in thousands):

| | For the Nine Months Ended September 30, 2012 | | | | | | |
|---|---|---|---|---|---|---|---|
| | **Commercial Real Estate** | **Commercial, Financial and Agricultural** | **Commercial Construction** | **One to four family residential real estate** | **Consumer Construction** | **Consumer** | **Total** |
| NONACCRUAL | | | | | | | |
| | | | | | | | |
| Beginning balance | $ 2,362 | $ 1,111 | $ | $ 1,997 | $ 20 | $ | $ 5,490 |
| | | | | | | | |
| Principal payments | (1,101) | (1,383) | | (1,054) | | | (3,538) |
| Charge-offs | (463) | | | (307) | (5) | | (775) |
| Advances | | | | | | | |
| Class transfers | | | | | | | |
| Transfers to OREO | (465) | | | (548) | | | (1,013) |
| Transfers to accruing | | | | | | | |
| Transfers from accruing | 3,288 | 566 | 676 | 524 | | 3 | 5,057 |
| Other | 70 | (7) | | 6 | | | 69 |
| | | | | | | | |
| Ending balance | $ 3,691 | $ 287 | $ 676 | $ 618 | $ 15 | $ 3 | $ 5,290 |

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(Unaudited)

**4. LOANS** (Continued)

A roll-forward of nonaccrual activity during the year ended December 31, 2012 (dollars in thousands):

| | Commercial Real Estate | Commercial, Financial and Agricultural | Commercial Construction | One to four family residential real estate | Consumer Construction | Consumer | Total |
|---|---|---|---|---|---|---|---|
| NONACCRUAL | | | | | | | |
| Beginning balance | $ 2,362 | $ 1,111 | $ | $ 1,997 | $ 20 | $ | $ 5,490 |
| Principal payments | (1,569) | (1,385) | | (1,068) | | | (4,022) |
| Charge-offs | (463) | | | (387) | (5) | (3) | (858) |
| Advances | | | | | | | |
| Class transfers | | | | | | | |
| Transfers to OREO | (675) | | | (662) | (15) | | (1,352) |
| Transfers to accruing | | | | | | | |
| Transfers from accruing | 3,377 | 716 | 675 | 617 | | 3 | 5,388 |
| Other | 39 | (6) | | 8 | | | 41 |
| Ending balance | $ 3,071 | $ 436 | $ 675 | $ 505 | $ | $ | $ 4,687 |

***Troubled Debt Restructuring***

Troubled debt restructurings ( TDR ) are determined on a loan-by-loan basis. Generally restructurings are related to interest rate reductions, loan term extensions and short term payment forbearance as means to maximize collectability of troubled credits. If a portion of the TDR loan is uncollectible (including forgiveness of principal), the uncollectible amount will be charged off against the allowance at the time of the restructuring. In general, a borrower must make at least six consecutive timely payments before the Corporation would consider a return of a restructured loan to accruing status in accordance with FDIC guidelines regarding restoration of credits to accrual status.

The Corporation has, in accordance with generally accepted accounting principles and per recently enacted accounting standard updates, evaluated all loan modifications to determine the fair value impact of the underlying asset. The carrying amount of the loan is compared to the expected payments to be received, discounted at the loan s original rate, or for collateral dependent loans, to the fair value of the collateral.

A summary of troubled debt restructurings for the periods indicated is as follows (dollars in thousands):

| | **September 30, 2013** | | | **December 31, 2012** | | | **September 30, 2012** | | |
|---|---|---|---|---|---|---|---|---|---|
| | **Number of Modifications** | | **Recorded Investment** | **Number of Modifications** | | **Recorded Investment** | **Number of Modifications** | | **Recorded Investment** |
| Commercial real estate | | **$** | | 3 | $ | 4,614 | 4 | $ | 5,799 |
| Commercial, financial and agricultural | **1** | | **528** | 1 | | 1,221 | 1 | | 1,221 |
| Commercial construction | | | | 3 | | 860 | 3 | | 858 |
| One to four family residential real estate | | | | 1 | | 102 | 1 | | 102 |
| Consumer construction | | | | | | | | | |
| Consumer | | | | | | | | | |
| Total troubled debt restructurings | **1** | **$** | **528** | 8 | $ | 6,797 | 9 | $ | 7,980 |

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(Unaudited)

**4. LOANS** (Continued)

A roll-forward of troubled debt restructuring during the three months ended September 30, 2013 (dollars in thousands):

| | Commercial Real Estate | Commercial, Financial and Agricultural | Commercial Construction | One to four family residential real estate | Consumer and Consumer Construction | Total |
|---|---|---|---|---|---|---|
| **ACCRUING** | | | | | | |
| **Beginning balance** | $ 3,563 | $ 2,174 | $ 858 | $ 100 | $ | $ 6,695 |
| **Principal payments** | (20) | (25) | | (1) | | (46) |
| **Charge-offs** | | (400) | | | | (400) |
| **Advances** | | | | | | |
| **New restructured** | | | | | | |
| **Transferred out of TDR** | | | | | | |
| **Transfers to nonaccrual** | | (528) | | | | (528) |
| **Ending Balance** | $ 3,543 | $ 1,221 | $ 858 | $ 99 | $ | $ 5,721 |
| **NONACCRUAL** | | | | | | |
| **Beginning balance** | $ 2,169 | $ | $ | $ 106 | $ | $ 2,275 |
| **Principal payments** | (87) | | | (14) | | (101) |
| **Charge-offs** | | | | | | |
| **Advances** | | | | | | |
| **New restructured** | | | | | | |
| **Transfers to foreclosed properties** | | | | | | |
| **Transfers from accruing** | | 528 | | | | 528 |
| **Ending Balance** | $ 2,082 | $ 528 | $ | $ 92 | $ | $ 2,702 |
| **TOTALS** | | | | | | |
| **Beginning balance** | $ 5,732 | $ 2,174 | $ 858 | $ 206 | $ | $ 8,970 |
| **Principal payments** | (107) | (25) | | (15) | | (147) |
| **Charge-offs** | | (400) | | | | (400) |
| **Advances** | | | | | | |
| **New restructured** | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| **Transfers out of TDRs** | | | | | | |
| **Tansfers to nonaccrual** | | **(528)** | | | | **(528)** |
| **Transfers to foreclosed properties** | | | | | | |
| **Transfers from accruing** | | **528** | | | | **528** |
| | | | | | | |
| **Ending Balance** | **$ 5,625** | **$ 1,749** | **$ 858** | **$ 191** | **$** | **$ 8,423** |

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(Unaudited)

**4. LOANS** (Continued)

A roll-forward of troubled debt restructuring during the three months ended September 30, 2012 (dollars in thousands):

| | Commercial Real Estate | Commercial, Financial and Agricultural | Commercial Construction | One to four family residential real estate | Consumer and Consumer Construction | Total |
|---|---|---|---|---|---|---|
| ACCRUING | | | | | | |
| Beginning balance | $ 3,645 | $ 1,221 | $ 858 | $ 102 | $ | $ 5,826 |
| Principal payments | (14) | | | | | (14) |
| Charge-offs | | | | | | |
| Advances | | | | | | |
| New restructured | | | | | | |
| Transferred out of TDRs | | | | | | |
| Transfers to nonaccrual | | | | | | |
| Ending Balance | $ 3,631 | $ 1,221 | $ 858 | $ 102 | $ | $ 5,812 |
| NONACCRUAL | | | | | | |
| Beginning balance | $ 2,188 | $ | $ | $ | $ | $ 2,188 |
| Principal payments | (47) | | | | | (47) |
| Charge-offs | | | | | | |
| Advances | 27 | | | | | 27 |
| New restructured | | | | | | |
| Transfers to foreclosed properties | | | | | | |
| Transfers from accruing | | | | | | |
| Ending Balance | $ 2,168 | $ | $ | $ | $ | $ 2,168 |
| TOTALS | | | | | | |
| Beginning balance | $ 5,833 | $ 1,221 | $ 858 | $ 102 | $ | $ 8,014 |
| Principal payments | (61) | | | | | (61) |
| Charge-offs | | | | | | |
| Advances | 27 | | | | | 27 |
| New restructured | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Transfers out of TDRs | | | | | | |
| Tansfers to nonaccrual | | | | | | |
| Transfers to foreclosed properties | | | | | | |
| Transfers from accruing | | | | | | |
| | | | | | | |
| Ending Balance | $ 5,799 | $ 1,221 | $ 858 | $ 102 | $ | $ 7,980 |

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**4. LOANS** (Continued)

A roll-forward of troubled debt restructuring during the nine months ended September 30, 2013 (dollars in thousands):

| | Commercial Real Estate | Commercial, Financial and Agricultural | Commercial Construction | One to four family residential real estate | Consumer and Consumer Construction | Total |
|---|---|---|---|---|---|---|
| **ACCRUING** | | | | | | |
| **Beginning balance** | $ 3,611 | $ 1,221 | $ 858 | $ 102 | $ | $ 5,792 |
| **Principal payments** | (68) | (25) | | (3) | | (96) |
| **Charge-offs** | | (400) | | | | (400) |
| **Advances** | | | | | | |
| **New restructured** | | 953 | | | | 953 |
| **Transferred out of TDRs** | | | | | | |
| **Transfers to nonaccrual** | | (528) | | | | (528) |
| **Ending Balance** | $ 3,543 | $ 1,221 | $ 858 | $ 99 | $ | $ 5,721 |
| **NONACCRUAL** | | | | | | |
| **Beginning balance** | $ 2,162 | $ | $ | $ 102 | $ | $ 2,264 |
| **Principal payments** | (87) | | | (14) | | (101) |
| **Charge-offs** | | | | | | |
| **Advances** | | | | | | |
| **New restructured** | 7 | | | 4 | | 11 |
| **Transfers to foreclosed properties** | | | | | | |
| **Transfers from accruing** | | 528 | | | | 528 |
| **Ending Balance** | $ 2,082 | $ 528 | $ | $ 92 | $ | $ 2,702 |
| **TOTALS** | | | | | | |
| **Beginning balance** | $ 5,773 | $ 1,221 | $ 858 | $ 204 | $ | $ 8,056 |
| **Principal payments** | (155) | (25) | | (17) | | (197) |
| **Charge-offs** | | (400) | | | | (400) |
| **Advances** | | | | | | |
| **New restructured** | 7 | 953 | | 4 | | 964 |

| | | | | | | |
|---|---|---|---|---|---|---|
| **Transfers out of TDR** | | | | | | |
| **Transfers to nonaccrual** | | **(528)** | | | | **(528)** |
| **Transfers to foreclosed properties** | | **528** | | | | **528** |
| **Transfer from accruing** | | | | | | |
| | | | | | | |
| **Ending Balance** | **$ 5,625** | **$ 1,749** | **$ 858** | **$ 191** | **$** | **$ 8,423** |

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. **LOANS** (Continued)

A roll-forward of troubled debt restructuring during the nine months ended September 30, 2012 (dollars in thousands):

| | Commercial Real Estate | Commercial, Financial and Agricultural | Commercial Construction | One to four family residential real estate | Consumer and Consumer Construction | Total |
|---|---|---|---|---|---|---|
| ACCRUING | | | | | | |
| Beginning balance | $ 2,400 | $ | $ | $ 103 | $ | $ 2,503 |
| Principal payments | (64) | | (2) | (1) | | (67) |
| Charge-offs | | | | | | |
| Advances | | | | | | |
| New restructured | 3,695 | 1,221 | 860 | | | 5,776 |
| Transferred out of TDRs | | | | | | |
| Transfers to nonaccrual | (2,400) | | | | | (2,400) |
| Ending Balance | $ 3,631 | $ 1,221 | $ 858 | $ 102 | $ | $ 5,812 |
| NONACCRUAL | | | | | | |
| Beginning balance | $ | $ | $ | $ | $ | $ |
| Principal payments | (426) | | | | | (426) |
| Charge-offs | (772) | | | | | (772) |
| Advances | 47 | | | | | 47 |
| New restructured | 919 | | | | | 919 |
| Transfers to foreclosed properties | | | | | | |
| Transfers from accruing | 2,400 | | | | | 2,400 |
| Ending Balance | $ 2,168 | $ | $ | $ | $ | $ 2,168 |
| TOTALS | | | | | | |
| Beginning balance | $ 2,400 | $ | $ | $ 103 | $ | $ 2,503 |
| Principal payments | (490) | | (2) | (1) | | (493) |
| Charge-offs | (772) | | | | | (772) |
| Advances | 47 | | | | | 47 |
| New restructured | 4,614 | 1,221 | 860 | | | 6,695 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Transfers out of TDRs | | | | | | |
| Transfers to nonaccrual | (2,400) | | | | | (2,400) |
| Transfers to foreclosed properties | | | | | | |
| Transfers from accruing | 2,400 | | | | | 2,400 |
| | | | | | | |
| Ending Balance | $ 5,799 | $ 1,221 | $ 858 | $ 102 | $ | $ 7,980 |

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**4. LOANS** (Continued)

A roll-forward of troubled debt restructuring during the year ended December 31, 2012 (dollars in thousands):

| | Commercial Real Estate | Commercial, Financial and Agricultural | Commercial Construction | One to four family residential real estate | Consumer and Consumer Construction | Total |
|---|---|---|---|---|---|---|
| ACCRUING | | | | | | |
| Beginning balance | $ 2,400 | $ | $ | $ 103 | $ | $ 2,503 |
| Principal payments | (84) | | (2) | (1) | | (87) |
| Charge-offs | | | | | | |
| Advances | | | | | | |
| New restructured | 3,695 | 1,221 | 860 | | | 5,776 |
| Transferred out of TDRs | | | | | | |
| Transfers to nonaccrual | (2,400) | | | | | (2,400) |
| Ending Balance | $ 3,611 | $ 1,221 | $ 858 | $ 102 | $ | $ 5,792 |
| NONACCRUAL | | | | | | |
| Beginning balance | $ | $ | $ | $ | $ | $ |
| Principal payments | (432) | | | | | (432) |
| Charge-offs | (772) | | | | | (772) |
| Advances | 47 | | | | | 47 |
| New restructured | 919 | | | 102 | | 1,021 |
| Transfers to foreclosed properties | | | | | | |
| Transfers from accruing | 2,400 | | | | | 2,400 |
| Ending Balance | $ 2,162 | $ | $ | $ 102 | $ | $ 2,264 |
| TOTALS | | | | | | |
| Beginning balance | $ 2,400 | $ | $ | $ 103 | $ | $ 2,503 |
| Principal payments | (516) | | (2) | (1) | | (519) |
| Charge-offs | (772) | | | | | (772) |
| Advances | 47 | | | | | 47 |
| New restructured | 4,614 | 1,221 | 860 | 102 | | 6,797 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Transfers out of TDRs | | | | | | |
| Transfers to nonaccrual | (2,400) | | | | | (2,400) |
| Transfers to foreclosed properties | | | | | | |
| Transfers from accruing | 2,400 | | | | | 2,400 |
| | | | | | | |
| Ending Balance | $ 5,773 | $ 1,221 | $ 858 | $ 204 | $ | $ 8,056 |

***Insider Loans***

The Bank, in the ordinary course of business, grants loans to the Corporation s executive officers and directors, including their families and firms in which they are principal owners. Activity in such loans is summarized below (dollars in thousands):

| | **September 30, 2013** | **December 31, 2012** | **September 30, 2012** |
|---|---|---|---|
| Loans outstanding, beginning of period | **$ 11,297** | $ 8,827 | $ 8,827 |
| New loans | **496** | 3,911 | 3,401 |
| Net activity on revolving lines of credit | **(263)** | 233 | 17 |
| Principal payments | **(1,442)** | (1,674) | (1,490) |
| | | | |
| Loans outstanding, end of period | **$ 10,088** | $ 11,297 | $ 10,755 |

There were no loans to related parties classified substandard as of September 30, 2013, December 31, 2012 or September 30, 2012. In addition to the outstanding balances above, there were unfunded commitments of $5,000 to related parties at September 30, 2013.

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(Unaudited)

## 5. MORTGAGE SERVICING RIGHTS

Mortgage servicing rights ( MSRs ) are recorded when loans are sold in the secondary market with servicing retained. As of September 30, 2013, the Corporation had obligations to service approximately $126 million of residential first mortgage loans. The valuation is based upon the net present value of the projected revenues over the expected life of the loans being serviced, as reduced by estimated internal costs to service these loans. The fair value of the capitalized servicing rights approximates the carrying value. The key economic assumptions used in determining the fair value of the mortgage servicing rights include an annual constant prepayment speed of 15.90 and a discount rate of 7.50% for September 30, 2013.

The following summarizes mortgage servicing rights capitalized and amortized, along with the aggregate activity in related valuation allowances (dollars in thousands):

| | Nine months ended September 30, 2013 | Year ended December 31, 2012 | Nine months ended September 30, 2012 |
|---|---|---|---|
| Balance at beginning of period | **$ 638** | $ 400 | $ 400 |
| Additions from loans sold with servicing retained | **325** | 344 | 245 |
| Amortization | **(129)** | (106) | (74) |
| Estimated Valuation of MSRs at end of period | **$ 834** | $ 638 | $ 571 |

## 6. BORROWINGS

Borrowings consist of the following at September 30, 2013, December 31, 2012 and September 30, 2012 (dollars in thousands):

| | September 30, 2013 | December 31, 2012 | September 30, 2012 |
|---|---|---|---|
| Federal Home Loan Bank fixed rate advances at September 30, 2013 with a weighted average rate of 1.79% maturing in 2014, 2016 and 2018 | **$ 35,000** | $ 35,000 | $ 35,000 |
| | **852** | 925 | 925 |

| | | | | | | |
|---|---|---|---|---|---|---|
| USDA Rural Development, fixed-rate note payable, maturing August 24, 2024, interest payable at 1% | | | | | | |
| | **$** | **35,852** | $ | 35,925 | $ | 35,925 |

The Federal Home Loan Bank borrowings are collateralized at September 30, 2013 by the following:  a collateral agreement on the Corporation s one to four family residential real estate loans with a book value of approximately $41.769 million; mortgage related and municipal securities with an amortized cost and estimated fair value of $8.424 million and $8.654 million, respectively; and Federal Home Loan Bank stock owned by the Bank totaling $3.060 million.  Prepayment of the advances is subject to the provisions and conditions of the credit policy of the Federal Home Loan Bank of Indianapolis in effect as of September 30, 2013.

The USDA Rural Development borrowing is collateralized by loans totaling $.130 million originated and held by the Corporation s wholly owned subsidiary, First Rural Relending, and an assignment of a demand deposit account in the amount of $.790 million, and guaranteed by the Corporation.

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(Unaudited)

## 7. STOCK COMPENSATION PLANS

A summary of stock option transactions for the nine months ended September 30, 2013 and 2012, and the year ended December 31, 2012, is as follows:

| | September 30, 2013 | December 31, 2012 | September 30, 2012 |
|---|---|---|---|
| Outstanding shares at beginning of year | **242,152** | 392,152 | 392,152 |
| Granted during the period | | | |
| Exercised during the period | | | |
| Expired / forfeited during the period | **(5,000)** | | |
| Surrendered/Echanged for restricted stock | | (150,000) | (150,000) |
| Outstanding shares at end of period | **237,152** | 242,152 | 242,152 |
| Exercisable shares at end of period | **125,861** | 126,361 | 107,561 |
| Weighted average exercise price per share at end of period | **$ 9.88** | $ 9.88 | $ 9.88 |
| Shares available for grant at end of period | | | |

There were no options granted in the first nine months of 2013 and 2012.

Following is a summary of the options outstanding and exercisable at September 30, 2013:

| Exercise Price | Number Outstanding | Exercisable | Unvested Options | Weighted Average Remaining Contractual Life-Years |
|---|---|---|---|---|
| $ 9.75 | 217,152 | 120,861 | 96,291 | 1.21 |
| $ 10.65 | 10,000 | 2,500 | 7,500 | 3.21 |
| $ 12.00 | 10,000 | 2,500 | 7,500 | 1.79 |
| | 237,152 | 125,861 | 111,291 | 1.32 |

The Corporation, in August 2012, granted 148,500 Restricted Stock Units ( RSU s ) to outside members of the Board of Directors and Management. These RSU s were granted at a market value of $7.91 and will vest equally over a four year term.

**8. INCOME TAXES**

A valuation allowance is provided against deferred tax assets when it is more likely than not that some or all of the deferred tax asset will not be realized. The Corporation, as of September 30, 2013 had a net operating loss and tax credit carryforwards for tax purposes of approximately $19.2 million, and $2.1 million, respectively. The net operating loss carryforwards expire twenty years from the date they originated. These carryforwards, if not utilized, will begin to expire in the year 2023. A portion of the NOL, approximately $14.2 million, and all of the credit carryforwards are subject to the limitations for utilization as set forth in Section 382 of the Internal Revenue Code. The annual limitation is $1.400 million for the NOL and the equivalent value of tax credits, which is approximately $.476 million. These limitations for use were established in conjunction with the recapitalization of the Corporation in December 2004.

The Corporation has reported deferred tax assets of $7.953 million at September 30, 2013, which is net of a valuation allowance of $3.0 million. Management evaluated the deferred tax valuation allowance as of September 30, 2013 and determined that no adjustment to the valuation was warranted. The Corporation will continue to evaluate the future benefits from these carryforwards and at such time as it becomes more likely than not that they would be utilized prior to expiration will recognize the additional benefits as an adjustment to the valuation allowance.

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**9. FAIR VALUE MEASUREMENTS**

Fair value estimates, methods, and assumptions are set forth below for the Corporation s financial instruments:

***Cash, cash equivalents, and interest-bearing deposits*** - The carrying values approximate the fair values for these assets.

***Securities*** - Fair values are based on quoted market prices where available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities and other inputs such as interest rates and yield curves that are observable at commonly quoted intervals.

***Federal Home Loan Bank stock*** Federal Home Loan Bank stock is carried at cost, which is its redeemable value and approximates its fair value, since the market for this stock is limited.

***Loans*** - Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, residential mortgage, and other consumer. The fair value of loans is calculated by discounting scheduled cash flows using discount rates reflecting the credit and interest rate risk inherent in the loan.

The methodology in determining fair value of nonaccrual loans is to average them into the blended interest rate at 0% interest. This has the effect of decreasing the carrying amount below the risk-free rate amount and, therefore, discounts the estimated fair value.

Impaired loans are measured at the estimated fair value of the expected future cash flows at the loan s effective interest rate or the fair value of the collateral for loans which are collateral dependent. Therefore, the carrying values of impaired loans approximate the estimated fair values for these assets.

***Deposits*** - The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits and savings, is equal to the amount payable on demand at the reporting date. The fair value of time deposits is based on the discounted value of contractual cash flows applying interest rates currently being offered on similar time deposits.

***Borrowings*** - Rates currently available for debt with similar terms and remaining maturities are used to estimate the fair value of existing debt. The fair value of borrowed funds due on demand is the amount payable at the reporting date.

***Accrued interest*** - The carrying amount of accrued interest approximates fair value.

***Off-balance-sheet instruments*** - The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements, the current interest rates, and the present creditworthiness of the counterparties. Since the differences in the current fees and those reflected to the off-balance-sheet instruments at year-end are immaterial, no amounts for fair value are presented.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**9. FAIR VALUE MEASUREMENTS** (Continued)

The following table presents information for financial instruments at September 30, 2013, December 31, 2012 and September 30, 2012 (dollars in thousands):

| | Level in Fair Value Hierarchy | **September 30, 2013** Carrying Amount | Estimated Fair Value | **December 31, 2012** Carrying Amount | Estimated Fair Value | **September 30, 2012** Carrying Amount | Estimated Fair Value |
|---|---|---|---|---|---|---|---|
| Financial assets: | | | | | | | |
| Cash and cash equivalents | Level 1 | **$ 22,794** | **$ 22,794** | $ 26,961 | $ 26,961 | $ 47,405 | $ 47,405 |
| Interest-bearing deposits | Level 2 | **10** | **10** | 10 | 10 | 10 | 10 |
| Securities available for sale | Level 2 | **48,096** | **48,096** | 43,799 | 43,799 | 42,476 | 42,476 |
| Federal Home Loan Bank stock | Level 2 | **3,060** | **3,060** | 3,060 | 3,060 | 3,060 | 3,060 |
| Net loans | Level 3 | **467,536** | **460,009** | 443,959 | 439,239 | 428,772 | 425,406 |
| Accrued interest receivable | Level 3 | **1,536** | **1,536** | 1,319 | 1,319 | 1,574 | 1,574 |
| Total financial assets | | **$ 543,032** | **$ 535,505** | $ 519,108 | $ 514,388 | $ 523,297 | $ 519,931 |
| Financial liabilities: | | | | | | | |
| Deposits | Level 2 | **$ 461,688** | **$ 459,862** | $ 434,557 | $ 434,227 | $ 439,363 | $ 439,139 |
| Borrowings | Level 2 | **35,852** | **35,548** | 35,925 | 35,729 | 35,925 | 35,681 |
| Accrued interest payable | Level 2 | **200** | **200** | 214 | 214 | 238 | 238 |
| Total financial liabilties | | **$ 497,740** | **$ 495,610** | $ 470,696 | $ 470,170 | $ 475,526 | $ 475,058 |

***Limitations -*** Fair value estimates are made at a specific point in time based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation s entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Corporation s financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates. Fair value estimates are based on existing on-and off-balance-sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial assets or liabilities include premises and equipment, other assets, and other liabilities. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

The following is information about the Corporation s assets and liabilities measured at fair value on a recurring basis at September 30, 2013, and the valuation techniques used by the Corporation to determine those fair values.

**Level 1:** In general, fair values determined by Level 1 inputs use quoted prices in active markets for identical assets or liabilities that the Corporation has the ability to access.

**Level 2:** Fair values determined by Level 2 inputs use other inputs that are observable, either directly or indirectly. These Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and other inputs such as interest rates and yield curves that are observable at commonly quoted intervals.

**Level 3:** Level 3 inputs are unobservable inputs, including inputs available in situations where there is little, if any, market activity for the related asset or liability.

The fair value of all investment securities at September 30, 2013 and September 30, 2012 were based on level 2 inputs. There are no other assets or liabilities measured on a recurring basis at fair value. For additional information regarding investment securities, please refer to Note 3 Investment Securities.

The Corporation had no Level 3 assets or liabilities on a recurring basis as of September 30, 2013, December 31, 2012 or September 30, 2012.

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

9. **FAIR VALUE MEASUREMENTS** (Continued)

In instances where inputs used to measure fair value fall into different levels in the above fair value hierarchy, fair value measurements in their entirety are categorized based on the lowest level input that is significant to the valuation. The Corporation s assessment of the significance of particular inputs to these fair value measurements requires judgment and considers factors specific to each asset or liability.

The Corporation also has assets that under certain conditions are subject to measurement at fair value on a non-recurring basis. These assets include loans and other real estate owned. The Corporation has estimated the fair values of these assets using Level 3 inputs, specifically discounted cash flow projections.

**Assets Measured at Fair Value on a Nonrecurring Basis at September 30, 2013**

| (dollars in thousands) | Balance at September 30, 2013 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Losses for Three Months Ended September 30, 2013 | Total Losses for Nine Months Ended September 30, 2013 |
|---|---|---|---|---|---|---|
| **Assets** | | | | | | |
| **Impaired loans** | **$ 4,313** | **$** | **$** | **$ 4,313** | **$ 531** | **$ 949** |
| **Other real estate owned** | **2,568** | | | **2,568** | **57** | **146** |
| | | | | | **$ 588** | **$ 1,095** |

**Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2012**

| (dollars in thousands) | Balance at December 31, 2012 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Losses for Year Ended December 31, 2012 |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Impaired loans | $ 4,687 | $ | $ | $ 4,687 | $ 1,151 |
| Other real estate owned | 3,212 | | | 3,212 | 489 |
| | | | | | $ 1,640 |

**Assets Measured at Fair Value on a Nonrecurring Basis at September 30, 2012**

| (dollars in thousands) | Balance at September 30, 2012 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total Losses for Three Months Ended September 30, 2012 | Total Losses for Nine Months Ended September 30, 2012 |
|---|---|---|---|---|---|---|
| **Assets** | | | | | | |
| Impaired loans | $ 5,290 | $ | $ | $ 5,290 | $ 53 | $ 1,065 |
| Other real estate owned | 3,511 | | | 3,511 | 265 | 450 |
| | | | | | $ 318 | $ 1,515 |

The Corporation had no investments subject to fair value measurement on a nonrecurring basis.

Impaired loans categorized as Level 3 assets consist of non-homogeneous loans that are considered impaired. The Corporation estimates the fair value of the loans based on the present value of expected future cash flows using management s best estimate of key assumptions. These assumptions include future payment ability, timing of payment streams, and estimated realizable values of available collateral (typically based on outside appraisals).

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**10. SHAREHOLDER S EQUITY**

***Participation in the TARP Capital Purchase Program***

On April 24, 2009, the Corporation entered into and closed a Letter Agreement, including the Securities Purchase Agreement-Standard Terms (collectively, the Securities Purchase Agreement ), related to the TARP Capital Purchase Program ( CPP ). Pursuant to the Securities Purchase Agreement, the Corporation issued and sold to the Treasury (i) 11,000 shares of the Corporation s Series A Preferred Shares, and (ii) the Warrant to purchase 379,310 shares of the Corporation s Common Shares, at an exercise price of $4.35 per share (subject to certain anti-dilution and other adjustments), for an aggregate purchase price of $11.000 million in cash.

Amounts recorded for Preferred Stock and Warrant Common Stock were estimated based on an allocation of the total proceeds from the issuance on the relative fair values of both instruments. Fair value of the Preferred Stock was determined based on assumptions regarding the discount rate (market rate) on the Preferred Stock (estimated 12%). Fair value of the Warrant Common Stock is based on the value of the underlying Preferred Stock based on an estimate for a three year term. The allocation of the proceeds received resulted in the recording of a discount on the Preferred Stock and a premium on the Warrant Common Stock. The discount on the preferred was accreted on an effective yield basis over a three-year term. The allocated carrying value of the Preferred Stock and Warrant Common Stock on the date of issuance (based on their relative fair values) was $10.382 million and $.618 million, respectively. Cumulative dividends on the Preferred Stock are payable at 5% annum for the first five years and at a rate of 9% per annum thereafter on the liquidation preference of $1,000 per share. The Corporation is prohibited from paying any dividend with respect to shares of common stock unless all accrued and unpaid dividends are paid in full on the Preferred Stock for all past dividend periods. The Preferred Stock is non-voting, other than class voting rights on matters that could adversely affect the Preferred Stock. The Preferred Stock may be redeemed at any time with regulatory approval. The preferred stock qualifies as Tier 1 Capital for regulatory purposes at the holding company. The preferred stock was auctioned by the Treasury in 2012 and is now held by various investors. The warrants were purchased from the Treasury in December 2012 at a cost of $1.300 million.

In the 2013 second quarter, the Corporation redeemed $7.0 million of the $11.0 million outstanding preferred stock at par.

**11. COMMITMENTS, CONTINGENCIES AND CREDIT RISK**

***Financial Instruments With Off-Balance-Sheet Risk***

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

The Corporation s exposure to credit loss, in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit, is represented by the contractual amount of those instruments. The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. These commitments are as follows (dollars in thousands):

| | September 30, 2013 | December 31, 2012 | September 30, 2012 |
|---|---|---|---|
| Commitments to extend credit: | | | |
| Variable rate | **$ 32,061** | $ 39,782 | $ 38,068 |
| Fixed rate | **24,536** | 18,427 | 21,247 |
| Standby letters of credit - Variable rate | **4,741** | 2,879 | 3,816 |
| Credit card commitments - Fixed rate | **3,162** | 3,060 | 3,161 |
| | **$ 64,500** | $ 64,148 | $ 66,292 |

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**11. COMMITMENTS, CONTINGENCIES AND CREDIT RISK** (Continued)

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

Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The commitments are structured to allow for 100% collateralization on all standby letters of credit.

Credit card commitments are commitments on credit cards issued by the Corporation s subsidiary and serviced by other companies. These commitments are unsecured.

***Legal Proceedings and Contingencies***

In the normal course of business, the Corporation is involved in various legal proceedings. For expanded discussion on the Corporation s legal proceedings, see Part II, Item 1, Legal Proceedings in this report.

***Concentration of Credit Risk***

The Bank grants commercial, residential, agricultural, and consumer loans throughout Michigan. The Bank s most prominent concentration in the loan portfolio relates to commercial real estate loans to operators of nonresidential buildings. This concentration at September 30, 2013 represents $101.406 million, or 28.68%, compared to $88.505 million, or 26.83%, of the commercial loan portfolio on September 30, 2012. The remainder of the commercial loan portfolio is diversified in such categories as hospitality and tourism, real estate agents and managers, new car dealers, gaming, petroleum, forestry, agriculture and construction. Due to the diversity of the Bank s locations, the ability of debtors of residential and consumer loans to honor their obligations is not tied to any particular economic sector.

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**Forward Looking Statements/Risk Factors**

*FORWARD LOOKING STATEMENTS*

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The Corporation intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 and is including this statement for purposes of these safe harbor provisions. Forward-looking statements which are based on certain assumptions and describe future plans, strategies, or expectations of the Corporation, are generally identifiable by use of the words believe , expect , intend , anticipate , estimate project , or similar expressions. The Corporation s ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors that could cause actual results to differ from the results in forward-looking statements include, but are not limited to:

*RISK FACTORS*

**Risks Related to our Lending and Credit Activities**

- *Our business may be adversely affected by conditions in the financial markets and economic conditions generally, as our borrowers ability to repay loans and the value of the collateral securing our loans decline.*

- *Weakness in the markets for residential or commercial real estate, including the secondary residential mortgage loan markets, could reduce our net income and profitability.*

- *Our allowance for loan losses may be insufficient.*

Continuing deterioration in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans, and other factors, both within and outside of our control, may require an increase in our allowance for loan losses.

**Risks Related to Our Operations**

- *We are subject to interest rate risk.*

Our earnings and cash flows are largely dependent upon our net interest income, which is the difference between interest income on interest-earning assets such as loans and securities and interest expense paid on interest-bearing liabilities such as deposits and borrowed funds. There are many factors which influence interest rates that are beyond our control, including but not limited to general economic conditions and governmental policy, in particular, the policies of the FRB.

- *Changes in our accounting policies or in accounting standards could materially affect how we report our financial results and condition.*

- *Our controls and procedures may fail or be circumvented.*

- *Impairment of deferred income tax assets could require charges to earnings, which could result in an adverse impact on our results of operations.*

In assessing the realizability of deferred income tax assets, management considers whether it is more likely than not that some allowance requires management to evaluate all available evidence, both negative and positive. Positive evidence necessary to overcome the negative evidence includes whether future taxable income in sufficient amounts and character within the carry back and carry forward periods is available under the tax law, including the use of tax planning strategies. When negative evidence (e.g. cumulative losses in recent years, history of operating loss or tax credit carry forwards expiring unused) exists, more positive evidence than negative evidence will be necessary. At September 30, 2013, net deferred tax assets are approximately $8.0 million. If an additional valuation allowance becomes necessary with respect to such balance, it could have a material adverse effect on our business, results of operations and financial condition.

- *Our information systems may experience an interruption or breach in security.*

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**Risks Related to Legal and Regulatory Compliance**

- *We operate in a highly regulated environment, which could increase our cost structure or have other negative impacts on our operations.*

- *The full impact of the recently enacted Dodd-Frank Act is currently unknown given that many of the details and substance of the new laws will be implemented through agency rulemaking.*

Among the many requirements if the Dodd-Frank Act for new banking regulations is a requirement for new capital regulations to be adopted within 15 months.  These regulations must be at least as stringent as, and may call for higher levels of capital than, current regulations.

**Strategic Risks**

- *Maintaining or increasing our market share may depend on lowering prices and market acceptance of new products and services.*
- *Future growth or operating results may require us to raise additional capital but that capital may not be available.*

**Reputation Risks**

- *Unauthorized disclosure of sensitive or confidential client or customer information, whether through a breach of our computer system or otherwise, could severely harm our business.*

**Liquidity Risks**

- *We could experience an unexpected inability to obtain needed liquidity.*

The ability of a financial institution to meet its current financial obligations is a function of its balance sheet structure, its ability to liquidate assets and its access to alternative sources of funds.  We seek to ensure our funding needs are met by maintaining an appropriate level of liquidity through asset/liability management.

**Risks Related to an Investment in Our Common Stock**

- *Limited trading activity for shares of our common stock may contribute to price volatility.*
- *Our securities are not an insured deposit.*
- *You may not receive dividends on your investment in common stock.*

Our ability to pay dividends is dependent upon our receipt of dividends from the Bank, which is subject to regulatory restrictions. Such restrictions, which govern state-chartered banks, generally limit the payment of dividends on bank stock to the bank s undivided profits after all payments of all necessary expenses, provided that the bank s surplus equals or exceeds its capital.

These risks and uncertainties should be considered in evaluating forward-looking statements. Further information concerning the Corporation and its business, including additional factors that could materially affect the Corporation s financial results, is included in the Corporation s filings with the Securities and Exchange Commission. All forward-looking statements contained in this report are based upon information presently available and the Corporation assumes no obligation to update any forward-looking statements.

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MACKINAC FINANCIAL CORPORATION

ITEM 2 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS

OF OPERATIONS (Continued)

The following discussion will cover results of operations, asset quality, financial position, liquidity, interest rate sensitivity, and capital resources for the periods indicated. The information included in this discussion is intended to assist readers in their analysis of, and should be read in conjunction with, the consolidated financial statements and related notes and other supplemental information presented elsewhere in this report. This discussion should be read in conjunction with the consolidated financial statements and footnotes contained in the Corporation s Annual Report and Form 10-K for the year-ended December 31, 2012. Throughout this discussion, the term Bank refers to mBank, the principal banking subsidiary of the Corporation.

*FINANCIAL OVERVIEW*

The Corporation recorded third quarter 2013 net income available to common shareholders of $.846 million or $.15 per share compared to net income of $.897 million, or $.21 per share for the third quarter of 2012. Income for the nine months ended September 30, 2013 totaled $2.719 million, or $.49 per share, compared to $5.536 million, or $1.30 per share for the same period in 2012. Operating results for the nine month period in 2012 included a valuation adjustment to the deferred tax asset of $3.000 million.

Weighted average shares totaled 5,559,108 shares for the nine month period in 2013 and 5,562,835 shares in the 2013 third quarter compared to 3,857,002 shares and 4,722,029 shares in 2012. The increase in outstanding shares for 2013 reflects the issuance of 2.138 million shares of common stock in August of 2012. Quarterly and nine month per share earnings for 2012 have been adjusted for the common stock issuance.

The net interest margin for the third quarter of 2013 increased to $5.348 million, or 4.12%, compared to $4.930 million, of 4.10% in the third quarter of 2012. The nine month margin in 2013 was $15.773 million, or 4.15% compared to $14.712 million, or 4.19%.

Total assets of the Corporation at September 30, 2013 were $567.917 million, up by $16.800 million, or 3.05% from the $551.117 million in total assets reported at September 30, 2012 and up by $21.937 million, or 4.02%, from total assets of $545.980 million at year-end 2012. The loan portfolio increased $23.318 million, or 5.19%, from December 31, 2012 balances of $449.177 million. Deposits totaled $461.688 million at September 30, 2013, an increase of $27.131 million from the $434.557 million at December 31, 2012.

*FINANCIAL CONDITION*

**Cash and Cash Equivalents**

Cash and cash equivalents as of September 30, 2013 totaled $22.794 million, a decrease of $4.167 million during the first nine months of 2013. See further discussion of the change in cash and cash equivalents in the Liquidity section.

**Investment Securities**

Securities available for sale increased $4.297 million from December 31, 2012 to September 30, 2013, with the balance on September 30, 2013, totaling $48.096 million. The Corporation purchased $7.875 million of investments during the 2013 first nine months mainly to replace maturities and paydowns of investments. Investment securities are utilized in an effort to manage interest rate risk and liquidity. As of September 30, 2013, investment securities with an estimated fair value of $8.729 million were pledged.

**Loans**

Through the first nine months of 2013, loan balances increased by $23.318 million, or 5.19%, from December 31, 2012 balances of $449.177 million. During the first nine months of 2013, the Bank had total loan production of $139 million, which included $45 million of secondary market loan production. This loan production, however, was offset by loan principal runoff, paydowns and amortization, and also SBA/USDA loan sales of $6.133 million, and nonperforming loans transferred to other real estate owned ( OREO ) amounting to $.932 million.

Management continues to actively manage the loan portfolio, seeking to identify and resolve problem assets at an early stage. Management believes a properly positioned loan portfolio provides the most attractive earning asset yield available to the Corporation and, with a diligent loan approval process and exception reporting, management can effectively manage the risk in the loan portfolio. Management intends to continue loan growth within its

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markets for mortgage, consumer, and commercial loan products while concentrating on loan quality, industry concentration issues, and competitive pricing.

Following is a summary of the loan portfolio at September 30, 2013, December 31, 2012 and September 30, 2012 (dollars in thousands):

| | September 30, 2013 | Percent of Total | December 31, 2012 | Percent of Total | September 30, 2012 | Percent of Total |
|---|---|---|---|---|---|---|
| Commercial real estate | $ **257,961** | **54.60**% | $ 244,966 | 54.54% | $ 224,061 | 51.63% |
| Commercial, financial, and agricultural | **79,511** | **16.83** | 80,646 | 17.95 | 84,073 | 19.37 |
| One to four family residential real estate | **98,770** | **20.90** | 87,948 | 19.58 | 86,643 | 19.97 |
| Construction: | | | | | | |
| Consumer | **5,734** | **1.21** | 7,465 | 1.66 | 6,803 | 1.57 |
| Commercial | **16,054** | **3.40** | 17,229 | 3.84 | 21,757 | 5.01 |
| Consumer | **14,465** | **3.06** | 10,923 | 2.43 | 10,621 | 2.45 |
| Total loans | $ **472,495** | **100.00**% | $ 449,177 | 100.00% | $ 433,958 | 100.00% |

Following is a table showing the significant industry types in the commercial loan portfolio as of September 30, 2013, December 31, 2012 and September 30, 2012 (dollars in thousands):

| | September 30, 2013 | | | December 31, 2012 | | | September 30, 2012 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Outstanding Balance | Percent of Loans | Percent of Capital | Outstanding Balance | Percent of Loans | Percent of Capital | Outstanding Balance | Percent of Loans | Percent of Capital |
| Real estate - operators of nonres bldgs | $ **101,406** | **28.68%** | **151.25%** | $ 95,151 | 27.75% | 131.34% | $ 88,505 | 26.83% | 121.33% |
| Hospitality and tourism | **41,473** | **11.73** | **61.86** | 40,787 | 11.90 | 56.30 | 36,950 | 11.20 | 50.65 |
| Commercial construction | **16,054** | **4.54** | **23.95** | 17,229 | 5.03 | 23.78 | 21,757 | 6.59 | 29.83 |
| Lessors of nonresidential buildings | **14,573** | **4.12** | **21.74** | 12,672 | 3.70 | 17.49 | 12,326 | 3.74 | 16.90 |
| Real estate agents and managers | **10,975** | **3.11** | **16.37** | 10,597 | 3.09 | 14.63 | 12,336 | 3.74 | 16.91 |
| Gasoline stations and convenience stores | **10,897** | **3.08** | **16.25** | 11,393 | 3.32 | 15.73 | 12,394 | 3.76 | 16.99 |
| Other | **158,148** | **44.74** | **235.88** | 155,012 | 45.21 | 213.96 | 145,623 | 44.14 | 199.63 |
| Total Commercial Loans | $ **353,526** | **100.00%** | | $ 342,841 | 100.00% | | $ 329,891 | 100.00% | |

Management recognizes the additional risk presented by the concentration in certain segments of the portfolio. On a historical basis, the Corporation s highest concentration of credit risk was the hospitality and tourism industry. Management does not consider the current loan concentrations in hospitality and tourism to be problematic, and has no intention of further reducing loans to this industry segment. Management does not believe that its current portfolio composition has increased exposure related to any specific industry concentration as of September 30, 2013. The current concentration of real estate related loans represents a broad customer base composed of a high percentage of owner occupied developments.

Our residential real estate portfolio predominantly includes one to four family adjustable rate mortgages that have repricing terms generally from one to three years, construction loans to individuals and bridge financing loans for qualifying customers. As of September 30, 2013, our residential loan portfolio totaled $104.504 million, or 22.12% of our total outstanding loans.

The Corporation has also extended credit to governmental units, including Native American organizations. Tax-exempt loans and leases decreased from $4.436 million at the end of December 31, 2012 to $1.525 million at September 30, 2013. The Corporation has elected to reduce its tax-exempt portfolio, since it provides no current tax benefit, due to tax net operating loss carryforwards.

Due to the seasonal nature of many of the Corporation s commercial loan customers, loan payment terms provide flexibility by structuring payments to coincide with the customer s business cycle. The lending staff evaluates the collectability of the past due loans based on documented collateral values and payment history. The Corporation discontinues the accrual of interest on loans when, in the opinion of management, there is an indication that the borrower may be unable to meet the payments as they become due. Upon such discontinuance, all unpaid accrued interest is reversed. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

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**Credit Quality**

Management analyzes the allowance for loan losses in detail on a monthly basis to determine whether the losses inherent in the portfolio are properly reserved for. Net charge-offs for the nine months ended September 30, 2013 amounted to $1.109 million, or .32% annualized, of average loans outstanding, compared to $.860 million, or .28% annualized, of average loans outstanding, for the same period in 2012. The current reserve balance is representative of the relevant risk inherent within the Corporation s loan portfolio. Additions or reductions to the reserve in future periods will be dependent upon a combination of future loan growth, nonperforming loan balances and charge-off activity.

The table below shows period end balances of nonperforming assets (dollars in thousands):

| | September 30, 2013 | December 31, 2012 | September 30, 2012 |
|---|---|---|---|
| **Nonperforming Assets:** | | | |
| Nonaccrual Loans | **$ 4,313** | $ 4,687 | $ 3,122 |
| Loans past due 90 days or more | | | |
| Restructured loans | | | 2,168 |
| Total nonperforming loans | **4,313** | 4,687 | 5,290 |
| Other real estate owned | **2,568** | 3,212 | 3,511 |
| Total nonperforming assets | **$ 6,881** | $ 7,899 | $ 8,801 |
| Nonperforming loans as a % of loans | **.91%** | 1.04% | 1.22% |
| Nonperforming assets as a % of assets | **1.21%** | 1.45% | 1.60% |
| **Reserve for Loan Losses:** | | | |
| At period end | **$ 4,959** | $ 5,218 | $ 5,186 |
| As a % of loans | **1.05%** | 1.16% | 1.20% |
| As a % of nonperforming loans | **114.98%** | 111.33% | 98.03% |
| As a % of nonaccrual loans | **114.98%** | 111.33% | 166.11% |
| Texas ratio* | **9.56%** | 10.17% | 11.26% |

***calculated by taking total nonperforming assets divided by total equity plus reserve for loan losses***

Nonperforming assets at $6.881 million have been reduced in 2013 by $1.018 million from the $7.899 million at 2012 year end. This reduction in nonperforming assets reflects management s efforts in the aggressive remediation of problem credits and disposition of OREO properties.

The following ratios provide additional information relative to the Corporation s credit quality:

| | | At Period End | |
|---|---|---|---|
| | September 30, 2013 | December 31, 2012 | September30, 2012 |
| Total loans, at period end | **$ 472,495** | $ 449,177 | $ 433,958 |
| Average loans for the period | **$ 456,831** | $ 422,440 | $ 417,159 |

| | Nine Months Ended September 30, 2013 | For the Period Ended Twelve Months Ended December 31, 2012 | Nine Months Ended September 30, 2012 |
|---|---|---|---|
| Net charge-offs during the period | **$ 1,109** | $ 978 | $ 860 |
| Net charge-offs to average loans, annualized | **.32%** | .23% | .28% |
| Net charge-offs to beginning allowance balance | **21.25%** | 18.63% | 16.38% |

Management continues to address market issues impacting its loan customer base. In conjunction with the Corporation s senior lending staff and the bank regulatory examinations, management reviews the Corporation s loans, related collateral evaluations, and the overall lending process. The Corporation also utilizes an outside loan review consultant to perform a review of the loan portfolio. Historically, this independent review has provided findings similar to management as to the overall adequacy of the loan loss reserve and has substantiated the Corporation s loan rating system. In 2013, the Corporation again engaged a consultant for loan review.

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As of September 30, 2013, the allowance for loan losses represented 1.05% of total loans. At September 30, 2013, the allowance included specific reserves in the amount of $2.479 million, as compared to $1.939 million at December 31, 2012 and $1.631 million at September 30, 2012. In management s opinion, the allowance for loan losses is adequate to cover probable losses related to specifically identified loans, as well as probable losses inherent in the balance of the loan portfolio.

As part of the process of resolving problem credits, the Corporation may acquire ownership of collateral which secured such credits. The Corporation carries this collateral in other real estate on the balance sheet.

The following table represents the activity in other real estate for the periods indicated (dollars in thousands):

| | Nine Months Ended September 30 2013 | Year Ended December 31, 2012 | Nine Months Ended September 30, 2012 |
|---|---|---|---|
| Balance at beginning of period | **$ 3,212** | $ 3,162 | $ 3,162 |
| Other real estate transferred from loans due to foreclosure | **932** | 1,352 | 1,013 |
| Other real estate sold | **(1,429)** | (775) | (178) |
| Writedowns on other real estate held for sale | **(134)** | (496) | (474) |
| Loss on sale of other real estate held for sale | **(13)** | (31) | (12) |
| Balance at end of period | **$ 2,568** | $ 3,212 | $ 3,511 |

During the first nine months of 2013, the Corporation received real estate in lieu of loan payments of $.932 million. Other real estate is initially valued at the lower of cost or the fair value less selling costs. After the initial receipt, management periodically re-evaluates the recorded balances and any additional reductions in the fair value result in a write-down of other real estate.

**Deposits**

The Corporation had an increase in deposits in the first nine months of 2013. Total deposits increased by $27.131 million, or 6.24%, in the first nine months of 2013. The increase in deposits for the first nine months of 2013 is composed of an increase in noncore deposits of $24.461 million and an increase in core deposits of $2.670 million. In recent years, the Corporation has strategically emphasized the growth of core deposits. This strategic initiative is supported with an individual incentive plan, along with the introduction of several new deposit products and competitive deposit pricing. The core deposit balances increased primarily in transactional account deposits, our lowest cost of funds. Most recently, we have experienced some declines in core deposits and have increased brokered deposits to fund loan growth and manage interest rate risk. A portion of the decreases in core deposits can be attributed to individual customer deposit reductions due to various business related needs. In an effort to stem some runoff from core deposit CDs, management recently increased some offering rates on CD products.

Management continues to monitor existing deposit products in order to stay competitive as to both terms and pricing. It is the intent of management to be aggressive in its markets to grow core deposits with an emphasis placed on transactional deposits.

The following table represents detail of deposits at the end of the periods indicated (dollars in thousands):

| [redacted] | | | | | | |
|---|---|---|---|---|---|---|
| Noninterest bearing | **$ 70,063** | **15.17%** | $ 67,652 | 15.57% | $ 62,306 | 14.18% |
| [redacted] | | | | | | |
| Savings | **12,694** | **2.75** | 13,829 | 3.18 | 15,783 | 3.59 |
| [redacted] | | | | | | |
| Total core deposits | **375,166** | **81.26** | 372,496 | 85.72 | 372,500 | 84.78 |
| [redacted] | | | | | | |
| Certificates of Deposit >$100,000 | **23,816** | **5.16** | 24,355 | 5.60 | 25,390 | 5.78 |
| [redacted] | | | | | | |
| Total non-core deposits | **86,522** | **18.74** | 62,061 | 14.28 | 66,863 | 15.22 |
| [redacted] | | | | | | |
| Total deposits | **$ 461,688** | **100.00%** | $ 434,557 | 100.00% | $ 439,363 | 100.00% |

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**Borrowings**

The Corporation also utilizes FHLB borrowings as a source of funding. At September 30, 2013, this source of funding totaled $35 million and the Corporation secured this funding by pledging loans and investments. The $35 million of FHLB borrowings has a weighted average maturity of 2.71 years and a weighted average rate of 1.79% at September 30, 2013. The Corporation also has a USDA Rural Development loan held by its wholly owned subsidiary, First Rural Relending that has a fixed interest rate of 1% and matures in August 2024.

**Shareholders Equity**

Total shareholders equity decreased $5.403 million from December 31, 2012 to September 30, 2013.
Contributing to the change in shareholders equity was the redemption of Preferred Series A stock of $7.000 million, net income available to common shareholders of $2.719 million, a reduction for dividends on common stock of $.666 million, increases due to stock compensation of $.258 million, a decrease in the market value of securities of $.574 million and a decrease due to the repurchase of common stock of $.140 million.

*RESULTS OF OPERATIONS*

**Summary**

The Corporation reported net income available to common shareholders of $2.719 million, or $.49 per share, in the first nine months of 2013, compared to $2.536 million or $.60 per share for the first nine months of 2012, excluding the $3.0 million deferred tax valuation adjustment. The year to date results include a provision for loan losses of $.850 million. Operating results for the same period in 2012 include a provision for loan losses of $.795 million.

**Net Interest Income**

Net interest income is the Corporation s primary source of core earnings. Net interest income represents the difference between the average yield earned on interest earning assets and the average rate paid on interest bearing obligations. The net interest income is impacted by economic and competitive factors that influence rates, loan demand, and the availability of funding.

Net interest margin on a fully taxable equivalent basis amounted to $5.366 million, 4.13% of average earning assets, in the third quarter of 2013, compared to $4.948 million, and 4.18% of average earning assets, in the third quarter of 2012. In the first nine months of 2013, net interest margin increased to $15.826 million, 4.17% of average earning assets, compared to $14.722 million, 4.19% of average earning assets, for the same period in 2012.

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The following table presents the amount of interest income from average interest-earning assets and the yields earned on those assets, as well as the interest expense on average interest-bearing obligations and the rates paid on those obligations. All average balances are daily average balances.

| | Three Months Ended | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | 2013-2012 | | | |
| | Average Balances | | | Average Rates | | Interest | | Income/ | | | Rate/ |
| | September 30, | | Increase/ | September 30, | | September 30, | | Expense | Volume | Rate | Volume |
| (dollars in thousands) | 2013 | 2012 | (Decrease) | 2013 | 2012 | 2013 | 2012 | Variance | Variance | Variance | Variance |
| Loans (1,2,3) | **$ 464,324** | $ 424,461 | $ 39,863 | **5.23%** | 5.48% | **$ 6,117** | $ 5,846 | $ 271 | $ 549 | $ (269) | $ (9) |
| Taxable securities | **46,612** | 37,900 | 8,712 | **2.09** | 2.36 | **245** | 225 | 20 | 52 | (26) | (6) |
| Nontaxable securities (2) | **1,003** | 847 | 156 | **4.75** | 5.17 | **12** | 10 | 2 | 2 | | |
| Federal funds sold | **3** | 12,131 | (12,128) | | .13 | | 4 | (4) | (4) | (4) | 4 |
| Other interest-earning assets | **3,070** | 3,070 | | **4.26** | 4.92 | **33** | 38 | (5) | | (5) | |
| Total earning assets | **515,012** | 478,409 | 36,603 | **4.94** | 5.09 | **6,407** | 6,123 | 284 | 599 | (304) | (11) |
| Reserve for loan losses | **(5,093)** | (5,212) | 119 | | | | | | | | |
| Cash and due from banks | **24,099** | 43,388 | (19,289) | | | | | | | | |
| Fixed Assets | **10,596** | 10,523 | 73 | | | | | | | | |
| Other Real Estate | **2,434** | 3,484 | (1,050) | | | | | | | | |
| Other assets | **13,041** | 15,196 | (2,155) | | | | | | | | |
| Total assets | **$ 560,089** | $ 545,788 | $ 14,301 | | | | | | | | |
| | | | | | | | | | | | |
| NOW and money market deposits | **$ 119,225** | $ 118,627 | $ 598 | **.25%** | .34% | **$ 74** | $ 101 | $ (27) | $ 1 | $ (28) | $ |
| Interest checking | **33,771** | 31,938 | 1,833 | **.28** | .45 | **24** | 36 | (12) | 2 | (13) | (1) |
| Savings deposits | **12,810** | 14,665 | (1,855) | **.09** | .11 | **3** | 4 | (1) | (1) | (1) | 1 |
| CDs <$100,000 | **134,465** | 139,779 | (5,314) | **1.50** | 1.75 | **510** | 614 | (104) | (23) | (85) | 4 |
| CDs >$100,000 | **24,257** | 27,860 | (3,603) | **1.54** | 1.71 | **94** | 120 | (26) | (16) | (12) | 2 |
| Brokered deposits | **59,559** | 41,473 | 18,086 | **1.15** | 1.31 | **173** | 137 | 36 | 60 | (17) | (7) |
| Borrowings | **36,449** | 35,973 | 476 | **1.77** | 1.80 | **163** | 163 | | 2 | (3) | 1 |
| Total interest-bearing liabilities | **420,536** | 410,315 | 10,221 | **.98** | 1.14 | **1,041** | 1,175 | (134) | 25 | (159) | |
| Demand deposits | **72,103** | 64,985 | 7,118 | | | | | | | | |
| Other liabilities | **1,316** | 3,161 | (1,845) | | | | | | | | |
| Shareholders equity | **66,134** | 67,327 | (1,193) | | | | | | | | |
| Total liabilities and shareholders equity | **$ 560,089** | $ 545,788 | $ 14,301 | | | | | | | | |
| Rate spread | | | | **3.96%** | 3.95% | | | | | | |
| Net interest margin/revenue | | | | **4.13%** | 4.18% | **$ 5,366** | $ 4,948 | $ 418 | $ 574 | $ (145) | $ (11) |

(1) For purposes of these computations, nonaccruing loans are included in the daily average loan amounts outstanding.

(2) The amount of interest income on loans and nontaxable securities has been adjusted to a tax euivalent basis, using a 34% tax rate

(3) Interest income on loans includes fees

| | Nine Months Ended | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | 2013-2012 | | | |
| | Average Balances | | | Average Rates | | Interest | | Income/ | | | Rate/ |
| | September 30, | | Increase/ | September 30, | | September 30, | | Expense | Volume | Rate | Volume |
| (dollars in thousands) | 2013 | 2012 | (Decrease) | 2013 | 2012 | 2013 | 2012 | Variance | Variance | Variance | Variance |

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Loans (1,2,3) | **$ 456,831** | $ 417,159 | $ 39,672 | **5.30%** | 5.56% | **$ 18,104** | $ 17,346 | $ 758 | $ 1,650 | $ (799) | $ (93) |
| Taxable securities | **46,929** | 37,398 | 9,531 | **2.07** | 2.60 | **726** | 726 | | 185 | (147) | (38) |
| Nontaxable securities (2) | **889** | 851 | 38 | **4.81** | 5.18 | **32** | 33 | (1) | 1 | (2) | |
| Federal funds sold | **3** | 10,745 | (10,742) | | .15 | | 12 | (12) | (12) | (12) | 12 |
| Other interest-earning assets | **3,070** | 3,070 | | **4.18** | 3.66 | **96** | 84 | 12 | | 12 | |
| Total earning assets | **507,722** | 469,223 | 38,499 | **4.99** | 5.19 | **18,958** | 18,201 | 757 | 1,824 | (948) | (119) |
| Reserve for loan losses | **(5,133)** | (5,213) | 80 | | | | | | | | |
| Cash and due from banks | **20,216** | 28,834 | (8,618) | | | | | | | | |
| Fixed Assets | **10,621** | 10,095 | 526 | | | | | | | | |
| Other Real Estate | **2,965** | 3,388 | (423) | | | | | | | | |
| Other assets | **13,622** | 14,060 | (438) | | | | | | | | |
| Total assets | **$ 550,013** | $ 520,387 | $ 29,626 | | | | | | | | |
| | | | | | | | | | | | |
| NOW and money market deposits | **$ 120,267** | $ 118,841 | $ 1,426 | **.25%** | .36% | **$ 224** | $ 319 | $ (95) | $ 4 | $ (97) | $ (2) |
| Interest checking | **35,526** | 31,086 | 4,440 | **.31** | .49 | **82** | 114 | (32) | 16 | (42) | (6) |
| Savings deposits | **13,121** | 13,631 | (510) | **.10** | .12 | **10** | 12 | (2) | | (2) | |
| CDs <$100,000 | **132,365** | 137,810 | (5,445) | **1.58** | 1.78 | **1,567** | 1,831 | (264) | (72) | (198) | 6 |
| CDs >$100,000 | **24,497** | 25,596 | (1,099) | **1.62** | 1.72 | **297** | 330 | (33) | (14) | (19) | |
| Brokered deposits | **50,318** | 36,037 | 14,281 | **1.23** | 1.41 | **462** | 381 | 81 | 151 | (50) | (20) |
| Borrowings | **37,928** | 35,989 | 1,939 | **1.73** | 1.83 | **490** | 492 | (2) | 27 | (27) | (2) |
| Total interest-bearing liabilities | **414,022** | 398,990 | 15,032 | **1.01** | 1.17 | **3,132** | 3,479 | (347) | 112 | (435) | (24) |
| Demand deposits | **65,720** | 58,808 | 6,912 | | | | | | | | |
| Other liabilities | **1,672** | 3,007 | (1,335) | | | | | | | | |
| Shareholders equity | **68,599** | 59,582 | 9,017 | | | | | | | | |
| Total liabilities and shareholders equity | **$ 550,013** | $ 520,387 | $ 29,626 | | | | | | | | |
| Rate spread | | | | **3.98%** | 4.02% | | | | | | |
| Net interest margin/revenue | | | | **4.17%** | 4.19% | **$ 15,826** | $ 14,722 | $ 1,104 | $ 1,712 | $ (513) | $ (95) |

(1) For purposes of these computations, nonaccruing loans are included in the daily average loan amounts outstanding.

(2) The amount of interest income on loans and nontaxable securities has been adjusted to a tax euivalent basis, using a 34% tax rate

(3) Interest income on loans includes fees

In the past several years of a low interest rate environment, the Corporation repriced all of its brokered deposits along with the majority of its bank time deposits. This repricing of liabilities has been a major factor for the increased interest margin, on a fully taxable equivalent basis in recent reported periods.

During this relatively low interest environment, the Corporation has also repriced a significant portion of its loan portfolio. Management has been diligent when repricing maturing or new loans in establishing interest rate floors in order to maintain our improved interest rate spread. The Corporation is anticipating some margin pressure in future periods as we continue to see extremely competitive pricing on new and renewable loans.

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**Provision for Loan Losses**

The Corporation records a provision for loan losses when it believes it is necessary to adjust the allowance for loan losses to maintain an adequate level after considering factors such as loan charge-offs and recoveries, changes in identified levels of risk in the loan portfolio, changes in the mix of loans in the portfolio, loan growth, and other economic factors. During the first nine months of 2013, the Corporation determined through this analysis that a $.850 million provision for loan loss was required, compared to $.795 million in the first nine months of 2012. Impacting the loan loss provision for the nine month period in 2013 were net charge-offs of $1.109 million.

**Other Income**

Other income for the nine months ended September 30, 2013 was $2.747 million compared to $3.060 million in 2012. Included in the nine month results is income from secondary market loans of $.781 million and income from SBA/USDA loan sales of $.798 million, compared to $.844 million and $1.126 million in 2012.

Management continues to evaluate deposit products and services for ways to better serve its customer base and also enhance service fee income through a broad array of products that price services based on income contribution and cost attributes.

The following table details other income for the three and nine months ended September 30, 2013 and 2012 (dollars in thousands):

| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | | | Increase/(Decrease) | | | | Increase/(Decrease) | |
| | **2013** | **2012** | **Dollars** | **Percent** | **2013** | **2012** | **Dollars** | **Percent** |
| Deposit service fees | **$ 158** | $ 155 | $ 3 | 1.94% | **$ 495** | $ 538 | $ (43) | (7.99)% |
| Income from loans sold in the secondary market | **203** | 320 | (117) | (36.56) | **781** | 844 | (63) | (7.46) |
| SBA/USDA loan sale gains | **135** | 506 | (371) | (73.32) | **798** | 1,126 | (328) | (29.13) |
| Mortgage servicing income | **128** | 92 | 36 | 100.00 | **413** | 292 | 121 | 100.00 |
| Other noninterest income | **114** | 76 | 38 | 50.00 | **260** | 260 | | |
| Total other income | **$ 738** | $ 1,149 | $ (411) | (35.77)% | **$ 2,747** | $ 3,060 | $ (313) | (10.23)% |

**Other Expense**

For the first nine months of 2013, the Corporation recorded other expenses of $13.193 million, compared to $12.408 million in 2012, an increase of $.785 million. A significant portion of this increase in expense, approximately $.300 million, was due to the initial start-up and operational costs of our newly formed asset based lending subsidiary. Additional costs are also a result of the Corporation s growing operational platform and the need to keep pace both from a personnel and infrastructure standpoint, with the changing internal risk profile of the Corporation and the external banking regulatory environment.

The following table details other expense for the three and nine months ended September 30, 2013 and 2012 (dollars in thousands):

| | **Three Months Ended September 30,** | | | | **Nine Months Ended September 30,** | | | |
|---|---|---|---|---|---|---|---|---|
| | | | **Increase/(Decrease)** | | | | **Increase/(Decrease)** | |
| | **2013** | **2012** | **Dollars** | **Percentage** | **2013** | **2012** | **Dollars** | **Percentage** |
| Salaries and employee benefits | **$ 2,226** | $ 2,063 | $ 163 | 7.90% | **$ 6,907** | $ 6,041 | $ 866 | 14.34% |
| Occupancy | **362** | 370 | (8) | (2.16) | **1,107** | 1,050 | 57 | 5.43 |
| Furniture and equipment | **274** | 213 | 61 | 28.64 | **799** | 660 | 139 | 21.06 |
| Data processing | **269** | 253 | 16 | 6.32 | **802** | 739 | 63 | 8.53 |
| Professional service fees | **161** | 210 | (49) | (23.33) | **706** | 700 | 6 | 0.86 |
| Loan and deposit | **55** | 195 | (140) | (71.79) | **173** | 674 | (501) | (74.33) |
| Writedowns and losses on other real estate held for sale | **57** | 265 | (208) | (78.49) | **146** | 450 | (304) | (67.56) |
| FDIC insurance premiums | **100** | 36 | 64 | 177.78 | **300** | 354 | (54) | (15.25) |
| Telephone | **84** | 56 | 28 | 50.00 | **229** | 168 | 61 | 36.31 |
| Advertising | **119** | 96 | 23 | 23.96 | **334** | 292 | 42 | 14.38 |
| Other | **652** | 610 | 42 | 6.89 | **1,690** | 1,280 | 410 | 32.03 |
| Total other expense | **$ 4,359** | $ 4,367 | $ (8) | (.18)% | **$ 13,193** | $ 12,408 | $ 785 | 6.33% |

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**Federal Income Taxes**

A valuation allowance is provided against deferred tax assets when it is more likely than not that some or all of the deferred tax asset will not be realized. The Corporation, as of September 30, 2013 had a net operating loss and tax credit carryforwards for tax purposes of approximately $19.2 million, and $2.1 million, respectively. The net operating loss carryforwards expire twenty years from the date they originated. These carryforwards, if not utilized, will begin to expire in the year 2023. A portion of the NOL, approximately $14.2 million, and all of the credit carryforwards are subject to the limitations for utilization as set forth in Section 382 of the Internal Revenue Code. The annual limitation is $1.400 million for the NOL and the equivalent value of tax credits, which is approximately $.476 million. These limitations for use were established in conjunction with the recapitalization of the Corporation in December 2004.

The Corporation recognized deferred taxes of $1.508 million for the nine months ended September 30, 2013 and a deferred tax benefit of $1.458 million for the same period in 2012. The valuation allowance at September 30, 2013 was approximately $3.0 million. Management evaluated the deferred tax valuation allowance as of September 30, 2013 and determined that no adjustment to the valuation was warranted. The Corporation will continue to evaluate the future benefits from these carryforwards and at such time as it becomes more likely than not that they would be utilized prior to expiration will recognize the additional benefits as an adjustment to the valuation allowance.

*LIQUIDITY*

Liquidity is defined as the ability to generate cash at a reasonable cost to fulfill lending commitments and support asset growth, while satisfying the withdrawal demands of customers and make payments on existing borrowing commitments. The Bank s principal sources of liquidity are core deposits and loan and investment payments and prepayments. Providing a secondary source of liquidity is the available for sale investment portfolio. As a final source of liquidity, the Bank can exercise existing credit arrangements.

Current balance sheet liquidity consists of $22.794 million in cash and due from balances negligbile federal funds sold and, $39.597 million of unpledged investment securities. Although current liquidity is deemed adequate, management will increase on hand liquidity in the near term by issuing brokered CDs in order to fund anticipated loan growth.

During the first nine months of 2013, the Corporation decreased cash and cash equivalents by $4.167 million. As shown on the Corporation s condensed consolidated statement of cash flows, liquidity was impacted by cash used by investing activities, with a net increase in loans of $25.393 million. Offsetting the net decrease used by investing activities was cash provided by financing activities, primarily a net increase in deposits of $27.131 million. The management of bank liquidity for funding of loans and deposit maturities and withdrawals includes monitoring projected loan fundings and scheduled prepayments and deposit maturities within a 30 day period, a 30 to 90 day period and from 90 days until the end of the year. This funding forecast model is completed weekly.

The Corporation s primary source of liquidity on a stand-alone basis is dividends from the Bank. At this time, the Corporation does not have any definitive plans for payments of dividends by the Bank however may consider doing so in future periods.

Liquidity is managed by the Corporation through its Asset and Liability Committee ( ALCO ). The ALCO Committee meets monthly to discuss asset and liability management in order to address liquidity and funding needs to provide a process to seek the best alternatives for investments of assets, funding costs, and risk management. The liquidity position of the Bank is managed daily, thus enabling the Bank to adapt its position according to market fluctuations. Core deposits are important in maintaining a strong liquidity position as they represent a stable and relatively low cost source of funds. The Bank s liquidity is best illustrated by the mix in the Bank s core and noncore funding dependence ratio, which explains the degree of reliance on noncore liabilities to fund long-term assets.

Core deposits are herein defined as demand deposits, NOW (negotiable order withdrawals), money markets, savings and certificates of deposit under $100,000. Noncore funding consists of certificates of deposit greater than $100,000, brokered deposits, and FHLB and Farmers Home Administration borrowings. At September 30, 2013, the Bank s core deposits in relation to total funding were 75.40% compared to 78.37% at September 30, 2012. These ratios indicated at September 30, 2013, that the Bank has decreased its reliance on noncore deposits and borrowings to fund the Bank s long-term assets, namely loans and investments. The bank believes that by maintaining adequate volumes of short-term investments and implementing competitive pricing strategies on deposits, it can ensure

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adequate liquidity to support future growth. The Bank also has correspondent lines of credit available to meet unanticipated short-term liquidity needs. As of September 30, 2013, the Bank had $28.375 million of unsecured lines available and additional funding sources available if secured. The bank believes that its liquidity position remains strong to meet both present and future financial obligations and commitments, events or uncertainties that have resulted or are reasonably likely to result in material changes with respect to the Bank s liquidity.

From a long-term perspective, the Corporation s strategy is to increase core deposits in the Corporation s local markets. Management continually evaluates deposit products offered in order to remain competitive in its goal of increasing core deposits. The Corporation will and has the ability to augment local deposit growth efforts with wholesale CD funding.

*CAPITAL AND REGULATORY*

As a bank holding company, the Corporation is required to maintain certain levels of capital under government regulation. There are several measurements of regulatory capital and the Corporation is required to meet minimum requirements under each measurement. The federal banking regulators have also established capital classifications beyond the minimum requirements in order to risk-rate deposit insurance premiums and to provide trigger points for prompt corrective action in the event an institution becomes financially troubled. As of September 30, 2013, the Corporation and Bank were well capitalized.

The following table details sources of capital for the periods indicated (dollars in thousands):

| | | **September 30, 2013** | | **December 31, 2012** | | **September 30, 2012** |
|---|---|---|---|---|---|---|
| **Capital Structure** | | | | | | |
| Shareholders equity | **$** | **63,045** | $ | 61,448 | $ | 61,945 |
| Preferred stock | | **4,000** | | 11,000 | | 11,000 |
| Total shareholders equity | **$** | **67,045** | $ | 72,448 | $ | 72,945 |
| Total capitalization | **$** | **67,045** | $ | 72,448 | $ | 72,945 |
| Tangible capital | **$** | **67,045** | $ | 72,448 | $ | 72,945 |
| | | | | | | |
| **Intangible Assets** | | | | | | |
| Core deposit premium | **$** | | $ | | $ | |
| Other identifiable intangibles | | **834** | | 688 | | 571 |
| Total intangibles | **$** | **834** | $ | 688 | $ | 571 |
| | | | | | | |
| **Regulatory capital** | | | | | | |
| Tier 1 capital: | | | | | | |
| Shareholders equity | **$** | **67,045** | $ | 72,448 | $ | 72,945 |
| Net unrealized (gains) losses on available for sale securities | | **(350)** | | (924) | | (870) |
| Less: disallowed deferred tax asset | | **(6,200)** | | (7,100) | | (8,000) |
| Less: intangibles | | **(83)** | | (69) | | (57) |
| Total Tier 1 capital | **$** | **60,412** | $ | 64,355 | $ | 64,018 |
| Tier 2 Capital: | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Allowable reserve for loan losses | **$** | **4,959** | $ | 5,218 | $ | 5,186 |
| Qualifying long-term debt | | | | | | |
| Total Tier 2 capital | | **4,959** | | 5,218 | | 5,186 |
| Total capital | **$** | **65,371** | $ | 69,573 | $ | 69,204 |
| Risk-adjusted assets | **$** | **483,229** | $ | 466,039 | $ | 456,754 |
| | | | | | | |
| Capital ratios: | | | | | | |
| Tier 1 Capital to average assets | | **10.90**% | | 11.98% | | 11.93% |
| Tier 1 Capital to risk weighted assets | | **12.50**% | | 13.81% | | 14.02% |
| Total Capital to risk weighted assets | | **13.53**% | | 14.93% | | 15.15% |

Regulatory capital is not the same as shareholders equity reported in the accompanying condensed consolidated financial statements. Certain assets cannot be considered assets for regulatory purposes, such as acquisition intangibles and noncurrent deferred tax benefits.

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Presented below is a summary of the capital position in comparison to generally applicable regulatory requirements:

| | Shareholders Equity to Quarter-end Assets | Tangible Equity to Quarter-end Assets | Tier 1 Capital to Average Assets | Tier 1 Capital to Risk-Weighted Assets | Total Capital to Risk-Weighted Assets |
|---|---|---|---|---|---|
| Regulatory minumum for capital adequacy purposes | N/A | N/A | 4.00% | 4.00% | 8.00% |
| Regulatory defined well capitalized guideline | N/A | N/A | 5.00% | 6.00% | 10.00% |
| | | | | | |
| **The Corporation:** | | | | | |
| **September 30, 2013** | **11.81%** | **11.81%** | **10.90%** | **12.50%** | **13.53%** |
| September 30, 2012 | 13.24% | 13.23% | 11.93% | 14.02% | 15.15% |
| | | | | | |
| **The Bank:** | | | | | |
| **September 30, 2013** | **11.17%** | **11.17%** | **10.20%** | **11.70%** | **12.72%** |
| September 30, 2012 | 10.61% | 10.60% | 9.26% | 10.89% | 12.02% |

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## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

*INTEREST RATE RISK*

In general, the Corporation attempts to manage interest rate risk by investing in a variety of assets which afford it an opportunity to reprice assets and increase interest income at a rate equal to or greater than the interest expense associated with repricing liabilities.

Interest rate risk is the exposure of the Corporation to adverse movements in interest rates. The Corporation derives its income primarily from the excess of interest collected on its interest-earning assets over the interest paid on its interest-bearing obligations. The rates of interest the Corporation earns on its assets and owes on its obligations generally are established contractually for a period of time. Since market interest rates change over time, the Corporation is exposed to lower profitability if it cannot adapt to interest rate changes. Accepting interest rate risk can be an important source of profitability and shareholder value; however, excess levels of interest rate risk could pose a significant threat to the Corporation s earnings and capital base. Accordingly, effective risk management that maintains interest rate risk at prudent levels is essential to the Corporation s safety and soundness.

Loans are the most significant earning asset. Management offers commercial and real estate loans priced at interest rates which fluctuate with various indices such as the prime rate or rates paid on various government issued securities. In addition, the Corporation prices the majority of fixed rate loans so it has an opportunity to reprice the loan within 12 to 36 months.

The Corporation has established interest rate floors on approximately $153 million, or 80% of its variable rate commercial loans. These interest rate floors will result in a lag on the repricing of these variable rate loans when and if interest rates increase in future periods. Approximately $88 million of the floor rate loan balances will reprice with a 100 basis point increase on the prime rate, with another $61 million repricing in the next 100 basis point prime rate increase.

The Corporation also has $48.046 million of securities providing for scheduled monthly principal and interest payments as well as unanticipated prepayments of principal. These cash flows are then reinvested into other earning assets at current market rates. The Corporation also has federal funds sold to correspondent banks as well as other interest-bearing deposits with correspondent banks. These funds are generally repriced on a daily basis.

The Corporation has $241.345 million of transactional accounts, of which $70.063 million consists of noninterest bearing demand deposit balances. Transaction account balances have increased significantly in the last year due in part to the Corporation s focus on these low costs accounts by developing new attractive products and increased sales efforts to municipalities, schools and businesses. These transactional account balances provide additional repricing flexibility in changing interest rate environments since they have no scheduled maturities and interest rates can be reset at any time.

Other deposit products have a variety of terms ranging from deposits whose interest rates can change on a weekly basis to certificates of deposit with repricing terms of up to five years. Longer term deposits generally include penalty provisions for early withdrawal.

Beyond general efforts to shorten the loan pricing periods and extend deposit maturities, management can manage interest rate risk by the maturity periods of securities purchased, selling securities available for sale, and borrowing funds with targeted maturity periods, among other strategies. Also, the rate of interest rate changes can impact the actions taken since the rate environment affects borrowers and depositors differently.

Exposure to interest rate risk is reviewed on a regular basis. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect of interest rate changes on net interest income and to structure the composition of the balance sheet to minimize interest rate risk and at the same time maximize income. Management realizes certain risks are inherent and that the goal is to identify and minimize the risks. Tools used by management include maturity and repricing analysis and interest rate sensitivity analysis. The Bank has monthly asset/liability meetings with an outside consultant to review its current position and strategize about future opportunities on risks relative to pricing and positioning of assets and liabilities.

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The difference between repricing assets and liabilities for a specific period is referred to as the gap. An excess of repricable assets over liabilities is referred to as a positive gap. An excess of repricable liabilities over assets is referred to as a negative gap. The cumulative gap is the summation of the gap for all periods to the end of the period for which the cumulative gap is being measured.

Assets and liabilities scheduled to reprice are reported in the following time frames. Those instruments with a variable interest rate tied to an index and considered immediately repricable are reported in the 1- to 90-day time frame. The estimates of principal amortization and prepayments are assigned to the following time frames.

The following is the Corporation s opportunities at September 30, 2013 (dollars in thousands):

| | 1-90 Days | 91 - 365 Days | >1-5 Years | Over 5 Years | Total |
|---|---|---|---|---|---|
| **Interest-earning assets:** | | | | | |
| **Loans** | **$ 278,596** | **$ 13,102** | **$ 57,634** | **$ 123,163** | **$ 472,495** |
| **Securities** | **2,506** | **4,277** | **26,863** | **14,450** | **48,096** |
| **Other (1)** | **13** | | | **3,060** | **3,073** |
| **Total interest-earning assets** | **281,115** | **17,379** | **84,497** | **140,673** | **523,664** |
| **Interest-bearing obligations:** | | | | | |
| **NOW, money market, savings, interest checking** | **171,282** | | | | **171,282** |
| **Time deposits** | **20,783** | **54,437** | **82,239** | **178** | **157,637** |
| **Brokered CDs** | | **4,967** | **57,739** | | **62,706** |
| **Borrowings** | | | **35,000** | **852** | **35,852** |
| **Total interest-bearing obligations** | **192,065** | **59,404** | **174,978** | **1,030** | **427,477** |
| **Gap** | **$ 89,050** | **$ (42,025)** | **$ (90,481)** | **$ 139,643** | **$ 96,187** |
| **Cumulative gap** | **$ 89,050** | **$ 47,025** | **$ (43,456)** | **$ 96,187** | |

(1) Includes Federal Home Loan Bank Stock

The above analysis indicates that at September 30, 2013, the Corporation had a cumulative asset sensitivity gap position of $47.025 million within the one-year time frame. The Corporation s cumulative asset sensitive gap suggests that if market interest rates continue to decline in the next twelve months, the Corporation may experience a decrease in net interest income. A limitation of the traditional gap analysis is that it does not consider the timing or magnitude of non-contractual repricing or expected prepayments. In addition, the gap analysis treats savings, NOW, and money market accounts as repricing within 90 days, while experience suggests that these categories of deposits are actually comparatively resistant to rate sensitivity.

At December 31, 2012, the Corporation had a cumulative liability sensitivity gap position of $44.838 million within the one-year time frame.

The borrowings in the gap analysis include $35.000 million of FHLB advances that have a weighted average maturity of 2.7 years and a weighted average rate of 1.79%.

The Corporation s primary market risk exposure is interest rate risk and, to a lesser extent, liquidity risk and foreign exchange risk. The Corporation has no market risk sensitive instruments held for trading purposes. The Corporation has limited agricultural-related loan assets and therefore has minimal significant exposure to changes in commodity prices. Any impact that changes in foreign exchange rates and commodity prices would have on interest rates are assumed to be insignificant.

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Evaluating the exposure to changes in interest rates includes assessing both the adequacy of the process used to control interest rate risk and the quantitative level of exposure. The Corporation s interest rate risk management process seeks to ensure that appropriate policies, procedures, management information systems, and internal controls are in place to maintain interest rate risk at prudent levels with consistency and continuity. In evaluating the quantitative level of interest rate risk, the Corporation assesses the existing and potential future effects of changes in interest rates on its financial condition, including capital adequacy, earnings, liquidity, and asset quality.

In addition to changes in interest rates, the level of future net interest income is also dependent on a number of variables, including: the growth, composition and levels of loans, deposits, and other earning assets and interest-bearing obligations, and economic and competitive conditions; potential changes in lending, investing, and deposit strategies; customer preferences; and other factors.

*FOREIGN EXCHANGE RISK*

In addition to managing interest rate risk, management also actively manages risk associated with foreign exchange. The Corporation provides foreign exchange services, makes loans to, and accepts deposits from, Canadian customers primarily at its banking offices in Sault Ste. Marie, Michigan. To protect against foreign exchange risk, the Corporation monitors the volume of Canadian deposits it takes in and then invests these Canadian funds in Canadian commercial loans and securities. Management believes the exposure to short-term foreign exchange risk is minimal and at an acceptable level for the Corporation.

*OFF-BALANCE-SHEET RISK*

Derivative financial instruments include futures, forwards, interest rate swaps, option contracts and other financial instruments with similar characteristics. The Corporation currently does not enter into futures, forwards, swaps, or options. However, the Corporation is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit and involve to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the condensed consolidated balance sheets. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates and may require collateral from the borrower if deemed necessary by the Corporation. Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party up to a stipulated amount and with specified terms and conditions.

Commitments to extend credit and standby letters of credit are not recorded as an asset or liability by the Corporation until the instrument is exercised.

*IMPACT OF INFLATION AND CHANGING PRICES*

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and results of operations in historical dollars without considering the change in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of the Corporation s operations. Nearly all the assets and liabilities of the Corporation are financial, unlike industrial or commercial companies. As a result, the Corporation s performance is directly impacted by changes in interest rates, which are indirectly influenced by inflationary expectations. The Corporation s ability to match the interest sensitivity of its financial assets to the interest sensitivity of its financial liabilities tends to minimize the effect of changes in interest rates on the Corporation s performance. Changes in interest rates do not necessarily move to the same extent as changes in the price of goods and services.

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## ITEM 4 CONTROLS AND PROCEDURES

As of September 30, 2013, we carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15 of the Securities Exchange Act of 1934. Our management, which includes our principal executive officer and our principal financial officer, does not expect that our disclosure controls and procedures will prevent all errors and all fraud.

A control system, no matter how well conceived and operated, can provide only reasonable, but not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints; additionally, the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Corporation have been detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is also based, in part, upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate due to changes in conditions; also the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Our principal executive officer and principal accounting officer have concluded, based on our evaluation of our disclosure controls and procedures, that our disclosure controls and procedures, as defined, under Rule 13a-15 of the Securities Exchange Act of 1934 are effective as of September 30, 2012.

*Changes in Internal Control Over Financial Reporting*

There were no changes in the Corporation s internal control over financial reporting that occurred during the quarter ended September 30, 2013 that have materially affected, or are reasonably likely to materially affect, the Corporation s internal control over financial reporting.

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PART II. OTHER INFORMATION

**Item 1. Legal Proceedings**

The Corporation and its subsidiaries are subject to routine litigation incidental to the business of banking.

**Item 6. Exhibits and Reports on Form 8-K**

(a) Exhibits:

| | |
|---|---|
| Exhibit 31.1 | Rule 13a-14(a) Certification of Chief Executive Officer. |
| Exhibit 31.2 | Rule 13a-14(a) Certification of Chief Financial Officer. |
| Exhibit 32.1 | Section 1350 Certification of Chief Executive Officer. |
| Exhibit 32.2 | Section 1350 Certification of Chief Financial Officer. |
| 101.INS | XBRL Instance Document. |
| 101.SCH | XBRL Taxonomy Extension Schema Document. |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document. |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document. |
| 101.LAB | XBRL Taxonomy Extension Labels Linkbase Document. |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document. |

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## SIGNATURES

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

MACKINAC FINANCIAL CORPORATION
(Registrant)

| | | |
|---|---|---|
| Date: November 13, 2013 | By: | /s/ Paul D. Tobias<br>PAUL D. TOBIAS,<br>CHAIRMAN AND CHIEF EXECUTIVE OFFICER<br>(principal executive officer) |
| | By: | /s/ Ernie R. Krueger<br>ERNIE R. KRUEGER<br>EVP/CHIEF FINANCIAL OFFICER<br>(principal financial and accounting officer) |