MACKINAC FINANCIAL CORP /MI/
Form 10-Q
August 15, 2016
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2016

OR

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	38-2062816
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

130 SOUTH CEDAR STREET, MANISTIQUE, MI	49854
(Address of principal executive offices)	(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 No

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 No

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	Accelerated Filer
Non-accelerated Filer	Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes No

As of August 10, 2016, there were outstanding 6,226,246 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)

	June 30, 2016 (Unaudited)	December 31, 2015
ASSETS		
Cash and due from banks	$ 40,226	$ 25,005
Federal funds sold	9	3
Cash and cash equivalents	40,235	25,008
Interest-bearing deposits in other financial institutions	7,184	5,089
Securities available for sale	71,114	53,728
Federal Home Loan Bank stock	2,639	2,169
Loans:		
Commercial	503,508	450,275
Mortgage	206,007	152,272
Consumer	16,120	15,847
Total Loans	725,635	618,394
Allowance for loan losses	(4,733)	(5,004)
Net loans	720,902	613,390
Premises and equipment	14,699	12,524
Other real estate held for sale	3,492	2,324
Deferred tax asset	10,147	9,213
Deposit based intangibles	1,992	1,076
Goodwill	5,173	3,805
Other assets	14,751	10,943
TOTAL ASSETS	$ 892,328	$ 739,269
LIABILITIES AND SHAREHOLDERS’ EQUITY		
LIABILITIES:		
Deposits:		
Noninterest bearing deposits	$ 149,435	$ 122,775
NOW, money market, interest checking	251,140	202,784

Savings	48,978	30,882
CDs<$250,000	130,053	124,084
CDs>$250,000	5,417	8,532
Brokered	153,340	121,266
Total deposits	738,363	610,323
Borrowings	70,604	45,754
Fed funds purchased	—	—
Other liabilities	6,280	6,590
Total liabilities	815,247	662,667
SHAREHOLDERS' EQUITY:		
Preferred stock - No par value:		
Authorized - 500,000 shares, Issued and outstanding - none	—	—
Common stock and additional paid in capital - No par value Authorized - 18,000,000 shares Issued and outstanding - 6,226,246 and 6,217,620, respectively	61,283	61,133
Retained earnings	14,982	15,221
Accumulated other comprehensive income		
Unrealized gains on available for sale securities	865	297
Minimum pension liability	(49)	(49)
Total shareholders' equity	77,081	76,602
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 892,328	$ 739,269

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CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in Thousands, Except per Share Data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016 (Unaudited)	2015 (Unaudited)	2016 (Unaudited)	2015 (Unaudited)
INTEREST INCOME:				
Interest and fees on loans:				
Taxable	$ 8,684	$ 7,742	$ 16,644	$ 15,967
Tax-exempt	13	3	15	6
Interest on securities:				
Taxable	304	261	566	563
Tax-exempt	26	53	57	94
Other interest income	66	40	121	102
Total interest income	9,093	8,099	17,403	16,732
INTEREST EXPENSE:				
Deposits	771	801	1,540	1,624
Borrowings	326	298	579	588
Total interest expense	1,097	1,099	2,119	2,212
Net interest income	7,996	7,000	15,284	14,520
Provision for loan losses	150	200	150	505
Net interest income after provision for loan losses	7,846	6,800	15,134	14,015
OTHER INCOME:				
Deposit service fees	248	244	464	428
Income from loans sold on the secondary market	339	282	606	449
SBA/USDA loan sale gains	166	282	166	400
Mortgage servicing (amortization) income	(8)	199	(62)	230
Net realized security gains	12	259	109	269
Other	139	84	240	198
Total other income	896	1,350	1,523	1,974
OTHER EXPENSE:				
Salaries and employee benefits	3,519	2,916	6,906	5,963
Occupancy	640	626	1,280	1,202
Furniture and equipment	425	390	808	789
Data processing	333	359	678	714
Advertising	181	120	337	246

Professional service fees	257	279	498	580
Loan and deposit	155	125	282	263
Writedowns and (gains) losses on other real estate held for sale	(14)	20	2	37
FDIC insurance assessment	117	140	225	248
Telephone	122	106	234	238
Transaction related expenses	2,449	—	2,516	—
Other	709	619	1,325	1,176
Total other expenses	8,893	5,700	15,091	11,456
Income before provision for income taxes	(151)	2,450	1,566	4,533
Provision for income taxes	(26)	836	559	1,548
NET INCOME AVAILABLE TO COMMON SHAREHOLDERS	$ (125)	$ 1,614	$ 1,007	$ 2,985
INCOME PER COMMON SHARE:				
Basic	$ (0.02)	$ 0.26	$ .16	$ .48
Diluted	$ (0.02)	$ 0.26	$ .16	$ .48

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MACKINAC FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS COMPREHENSIVE INCOME

(Dollars in Thousands)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Net income	$ (125)	$ 1,614	$ 1,007	$ 2,985
Other comprehensive income				
Change in securities available for sale:				
Unrealized gains (losses) arising during the period	544	(461)	969	72
Reclassification adjustment for securities gains included in net income	(12)	(259)	(109)	(269)
Tax effect	(181)	380	(292)	118
Net change in unrealized gains on available for sale securities	351	(340)	568	(79)
Total comprehensive income	$ 226	$ 1,274	$ 1,575	$ 2,906

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CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(Dollars in Thousands)

(Unaudited)

	Six Months Ended June 30, 2016				
	Shares of Common Stock	Common Stock and Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance, beginning of period	6,217,620	$ 61,133	$ 15,221	$ 248	$ 76,602
Net income for period	—	—	1,007	—	1,007
Other comprehensive income					
Net unrealized gain on securities available for sale	—	—	—	568	568
Actuarial loss on defined benefit pension obligation	—	—	—	—	—
Total comprehensive income	—	—	1,007	568	1,575
Stock compensation	—	300	—	—	300
Issuance of common stock:					
Restricted stock award vesting	22,626	—	—	—	—
Repurchase of common stock	(14,000)	(150)	—	—	(150)
Dividend on common stock	—	—	(1,246)	—	(1,246)
Balance, end of period	6,226,246	$ 61,283	$ 14,982	$ 816	$ 77,081

	Six Months Ended June 30, 2015				
	Shares of Common Stock	Common Stock and Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance, beginning of period	6,266,756	$ 61,679	$ 11,804	$ 513	$ 73,996
Net income for period	—	—	2,985	—	2,985
Other comprehensive income					
Net unrealized gain on securities available for sale	—	—	—	(79)	(79)
Actuarial loss on defined benefit pension obligation	—	—	—	—	—
Total comprehensive income	—	—	2,985	(79)	2,906
Stock compensation	—	288	—	—	288
Issuance of common stock:					
Restricted stock award vesting	16,194	—	—	—	—
Repurchase of common stock	(43,700)	(506)	—	—	(506)
Dividend on common stock	—	—	(938)	—	(938)
Balance, end of period	6,239,250	$ 61,461	$ 13,851	$ 434	$ 75,746

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in Thousands)

(Unaudited)

	Six Months Ended June 30, 2016	2015
Cash Flows from Operating Activities:		
Net income	$ 1,007	$ 2,985
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	825	841
Provision for loan losses	150	505
Deferred income taxes, net	559	1,548
Gain on sales/calls of securities	(109)	(269)
Gain on sale of loans sold in the secondary market	(514)	(362)
Origination of loans held for sale in the secondary market	(31,910)	(22,420)
Proceeds from sale of loans in the secondary market	32,424	22,782
(Gain) loss on sale of premises, equipment, and other real estate held for sale	(3)	12
Writedown of other real estate held for sale	—	25
Stock compensation	300	288
Change in other assets	12,670	8,574
Change in other liabilities	(595)	(6,682)
Net cash provided by operating activities	14,804	7,827
Cash Flows from Investing Activities:		
Net increase in loans	(28,383)	(14,715)
Net decrease in interest bearing deposits in other financial institutions	100	459
Purchase of securities available for sale	(5,225)	(10,016)
Proceeds from maturities, sales, calls or paydowns of securities available for sale	10,906	14,939
Proceeds from FHLBI repurchases of excess stock	—	804
Capital expenditures	(1,020)	(674)
Net cash used in Eagle acquisition and reimbursement of contract termination fee	(12,500)	—
Proceeds from sale of premises, equipment, and other real estate	565	1,049
Net cash (used in) provided by investing activities	(35,557)	(8,154)
Cash Flows from Financing Activities:		
Net increase (decrease) in deposits	23,526	(18,152)
Increase in federal funds purchased	—	15,000
Net activity on lines of credit	(5,750)	(163)
New term debt issuance	19,800	—

Principal payments on borrowings	(200)	(200)
Repurchase of common stock	(150)	(506)
Dividend on common stock	(1,246)	(938)
Net cash (provided by) used in financing activities	35,980	(4,959)
Net increase (decrease) in cash and cash equivalents	15,227	(5,286)
Cash and cash equivalents at beginning of period	25,008	21,947
Cash and cash equivalents at end of period	$ 40,235	$ 16,661
Supplemental Cash Flow Information:		
Cash paid during the year for:		
Interest	$ 2,041	$ 2,218
Income taxes	100	150
Noncash Investing and Financing Activities:		
Transfers of Foreclosures from Loans to Other Real Estate Held for Sale	851	495

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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 three and six-month period ended June 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. 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, 2015.

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, the valuation of investment securities, the valuation of foreclosed real estate, deferred tax assets, mortgage servicing rights, and the assessment of goodwill for impairment.

Acquired Loans

Loans acquired with evidence of credit deterioration since inception and for which it is probable that all contractual payments will not be received are accounted for under ASC Topic 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality ("ASC 310-30"). These loans are recorded at fair value at the time of acquisition, with no carryover of the related allowance for loan losses. Fair value of acquired loans is determined using a discounted cash flow methodology based on assumptions about the amount and timing of principal and interest payments, principal prepayments and principal defaults and losses, and current market rates. In recording the fair values of acquired impaired loans at acquisition date, management calculates a non-accretable difference (the credit component of the purchased loans) and an accretable difference (the yield component of the purchased loans).

Over the life of the acquired loans, management continues to estimate cash flows expected to be collected on pools of loans sharing common risk characteristics, which are treated in the aggregate when applying various valuation techniques. Management evaluates at each balance sheet date whether the present value of our pools of loans determined using the effective interest rates has decreased significantly and if so, recognizes a provision for loan loss in our consolidated statement of income. For any significant increases in cash flows expected to be collected, we adjust the amount of the accretable yield recognized on a prospective basis over the pool's remaining life.

Performing acquired loans are accounted for under Financial Accounting Standards Board ("FASB") Topic 310-20, Receivables – Nonrefundable Fees and Other Costs. Performance of certain loans may be monitored and based on management's assessment of the cash flows and other facts available, portions of the accretable difference may be delayed or suspended if management deems appropriate. The Corporation's policy for determining when to discontinue accruing interest on performing acquired loans and the subsequent accounting for such loans is essentially the same as the policy for originated loans.

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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 Corporation's 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.

Stock Compensation Plans

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 Company's common stock issuable under the plan is 575,000. Awards are made at the discretion of management and the Board of Directors. Compensation cost equal to the fair value of the award is recognized over the vesting period.

2.RECENT ACCOUNTING PRONOUNCEMENTS

In May 2014, the FASB issued guidance on the recognition of revenue from contracts with customers. Revenue recognition will depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance also requires disclosures regarding the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The guidance permits two methods of adoption: retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application. The guidance is effective January 1, 2018 and early adoption is permitted only as of January 1, 2017. The Corporation is currently evaluating the impact of the new guidance and the method of adoption in the consolidated financial results.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities ("ASU 2016-01"). ASU 2016-01 amends current guidance by requiring companies to recognize changes in fair value for equity investments that have a readily determinable fair value through net income rather than through other comprehensive income. Under ASU 2016-01, equity investments that do not have a readily determinable fair value will either be accounted for the same as equity investments that have a readily determinable fair value, with changes in fair value recognized through net income or carried at cost, adjusted for changes in observable prices based on orderly transactions for identical or similar investments issued by the same issuer and further adjusted for impairment, if applicable. ASU 2016-01 also requires a qualitative assessment of impairment indicators each reporting period. If this assessment indicates that impairment exists, companies must adjust the investment to fair value and recognize an impairment loss in net income, even if the impairment is determined to be temporary. ASU 2016-01 is effective for public companies for interim and annual periods beginning after December 15, 2017. The Corporation's adoption of ASU 2016-01 is not expected to have a material impact on the Corporation's consolidated financial condition or results of operations.

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In February 2016, the FASB issued ASU 2016-02, Leases, which will supersede the current lease requirements in ASC 840. The ASU requires lessees to recognize an asset with the right of use and related lease liability for all leases, with a limited exception for short-term leases. Leases will be classified as either finance or operating, with the classification affecting the pattern of expense recognition in the statement of operations. Currently, leases are classified as either capital or operating, with only capital leases recognized on the balance sheet. The reporting of lease related expenses in the statements of operations and cash flows will be generally consistent with the current guidance. The new lease guidance will be effective for the Corporation's year ending December 31, 2019 and will be applied using modified retrospective transition method to the beginning of the earliest period presented. The effect of applying the new lease guidance on the financial statements has not yet been determined.

In June, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments ("ASU 2016-13"). ASU 2016-13 changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income.

ASU 2016-13 requires an entity to measure expected credit losses for financial assets over the estimated lifetime of expected credit loss and record an allowance that, when deducted from the amortized cost basis of the financial asset, presents the net amount expected to be collected on the financial asset. The standard includes the following core concepts in determining the expected credit loss estimate must: (a) be based on an asset's amortized cost (including premiums or discounts, net deferred fees and costs, foreign exchange and fair value hedge accounting adjustments), (b) reflect losses expected over the remaining contractual life of an asset (considering the effect of voluntary prepayments), (c) consider available relevant information about the estimated collectability of cash flows (including information about past events, current conditions, and reasonable and supportable forecasts), and (d) reflect the risk of loss, even when that risk is remote.

ASU 2016-13 also amends the recording of purchased credit-deteriorated assets. Under the new guidance, an allowance will be recognized at acquisition through a gross-up approach whereby an entity will record as the initial amortized cost the sum of (a) the purchase price and (b) an estimate of credit losses as of the date of acquisition. In addition, the guidance also requires immediate recognition in earnings of any subsequent changes, both favorable and unfavorable, in expected cash flows by adjusting this allowance.

ASU 2016-13 amends the impairment model for available-for-sale debt securities and requires entities to determine whether all or a portion of the unrealized loss on an available-for-sale debt security is a credit loss. Management may not use the length of time a security has been in an unrealized loss position as a factor in concluding whether a credit loss exists, as is currently permitted. In addition, an entity will recognize an allowance for credit losses on available-for-sale debt securities as a contra-account to the amortized cost basis rather than as a direct reduction of the amortized cost basis of the investment, as is currently required. As a result, entities will recognize improvements to credit losses on available-for-sale debt securities immediately in earnings rather than as interest income over time under current practice.

New disclosures required by ASU 2016-13 include: (a) for financial assets measured at amortized cost, an entity will be required to disclose information about how it developed its allowance, including changes in the factors that

influenced management’s estimate of expected credit losses and the reasons for those changes, (b) for financial receivables and net investments in leases measured at amortized cost, an entity will be required to further disaggregate the information it currently discloses about the credit quality of these assets by year or the asset’s origination or vintage for as many as five annual periods, and (c) for available-for-sale debt securities, an entity will be required to provide a roll-forward of the allowance for credit losses and an aging analysis for securities that are past due.

Upon adoption of ASU 2016-13, a cumulative-effect adjustment to retained earnings will be recorded as of the beginning of the first reporting period in which the guidance is effective. ASU 2016-13 is effective for public companies for interim and annual periods beginning after December 15, 2019, with early adoption permitted for annual periods beginning after December 15, 2018. The Corporation is currently evaluating the provisions of ASU 2016-13 to determine the potential impact on the Corporation's consolidated financial condition and results of operations.

3.EARNINGS PER SHARE

Diluted earnings per share, which reflects the potential dilution that could occur if outstanding stock options were exercised and stock awards were fully vested and resulted in the issuance of common stock that then shared in our

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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 six months ended June 30, 2016 and 2015 (dollars in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
(Numerator):				
Net income	$ (125)	$ 1,614	$ 1,007	$ 2,985
(Denominator):				
Weighted average shares outstanding	6,227,730	6,247,004	6,220,906	6,251,713
Effect of dilutive stock options, and vesting of restricted stock units	28,656	42,594	20,461	27,514
Diluted weighted average shares outstanding	6,256,386	6,289,598	6,241,367	6,279,227
Income per common share:				
Basic	$ (0.02)	$ 0.26	$ .16	$ .48
Diluted	$ (0.02)	$ 0.26	$ .16	$ .48

4.INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities available for sale as of June 30, 2016 and December 31, 2015 are as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
June 30, 2016				
US Agencies - MBS	$ 11,806	$ 166	$ (146)	$ 11,826
US Agencies	22,778	310	—	23,088
Corporate Bonds	18,335	156	—	18,491

Other	4,261	13	(51)	4,223
Obligations of states and political subdivisions	12,624	862	—	13,486
Total securities available for sale	$ 69,804	$ 1,507	$ (197)	$ 71,114
December 31, 2015				
US Treasury	$ 12,710	$ —	$ (64)	$ 12,646
US Agencies	27,358	62	(43)	27,377
US Agencies - MBS	3,738	31	(10)	3,759
Obligations of states and political subdivisions	9,472	592	(118)	9,946
Total securities available for sale	$ 53,278	$ 685	$ (235)	$ 53,728

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 $7.899 million and $8.008 million, respectively, at June 30, 2016.

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5.LOANS

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

	June 30, 2016	December 31, 2015
Commercial real estate	$ 354,878	$ 312,805
Commercial, financial, and agricultural	130,054	122,140
One to four family residential real estate	194,167	140,502
Construction :		
Consumer	11,840	11,770
Commercial	18,576	15,330
Consumer	16,120	15,847
Total loans	$ 725,635	$ 618,394

The Corporation completed the acquisition of Peninsula Financial Corporation ("PFC") on December 5, 2014 and The First National Bank of Eagle River ("Eagle") on April 29, 2016. The acquired loans were divided into loans with evidence of credit quality deterioration, which are accounted for under ASC 310-30 ("acquired impaired") and loans that do not meet that criteria, which are accounted for under ASC 310-20 ("acquired nonimpaired"). The PFC acquired impaired loans totaled $10.312 million and the Eagle acquired impaired loans totaled $3.401 million. The Corporation recorded all acquired loans at fair value taking into account a number of factors, including remaining life, estimated loss, estimated value of the underlying collateral and net present values of cash flows. In the first six months of 2015, the Corporation had positive resolution of one PFC acquired nonperforming loan which resulted in the recognition of approximately $.429 million of the accretable interest.

The table below details the outstanding balances of the PFC acquired portfolio and the fair value adjustments at acquisition date (dollars in thousands):

	Acquired Impaired	Acquired Non-impaired	Acquired Total
Loans acquired - contractual payments	$ 13,290	$ 53,849	$ 67,139
Nonaccretable difference	(2,234)	—	(2,234)
Expected cash flows	11,056	53,849	64,905
Accretable yield	(744)	(2,100)	(2,844)
Carrying balance at acquisition date	$ 10,312	$ 51,749	$ 62,061

The table below details the outstanding balances of the Eagle acquired portfolio and the fair value adjustments at acquisition date (dollars in thousands):

	Acquired Impaired	Acquired Non-impaired	Acquired Total
Loans acquired - contractual payments	$ 3,401	$ 82,639	$ 86,040
Nonaccretable difference	(1,172)	—	(1,172)
Expected cash flows	2,229	82,639	84,868
Accretable yield	(391)	(1,700)	(2,091)
Carrying balance at acquisition date	$ 1,838	$ 80,939	$ 82,777

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The table below presents a rollforward of the accretable yield on acquired loans for the six months ended June 30, 2016 (dollars in thousands):

	Peninsula Acquired Impaired	Acquired Non-impaired	Acquired Total	Eagle Acquired Impaired	Acquired Non-impaired	Acquired Total
Balance, December 31, 2015	$ 426	$ 1,342	$ 1,768	$ —	$ —	$ —
Acquisition of Eagle River	—	—	—	391	1,700	2,091
Accretion	—	(350)	(350)	—	(94)	(94)
Reclassification from nonaccretable difference	(68)	—	(68)	—	—	—
Balance, June 30, 2016	$ 358	$ 992	$ 1,350	$ 391	$ 1,606	$ 1,997

The table below presents a rollforward of the accretable yield on acquired loans for the six months ended June 30, 2015 (dollars in thousands):

	Acquired Impaired	Acquired Non-impaired	Acquired Total
Balance, December 31, 2014	$ 744	$ 2,042	$ 2,786
Accretion	(429)	(350)	(779)
Reclassification from nonaccretable difference	188	—	188
Balance, June 30, 2015	$ 503	$ 1,692	$ 2,195

An analysis of the allowance for loan losses for the six months ended June 30, 2016 and the year ended December 31, 2015 is as follows (dollars in thousands):

	June 30, 2016	December 31, 2015
Balance, January 1	$ 5,004	$ 5,140
Recoveries on loans previously charged off	84	690

Loans charged off	(505)	(2,030)
Provision	150	1,204
Balance at end of period	$ 4,733	$ 5,004

In the first half of 2016, net charge-offs were $.421 million, or .13% of average loans, annualized, compared to net charge-offs of $.045 million in the same period in 2015. In the first six months of 2016, the Corporation recorded a provision for loan loss of $.150 million compared to $.505 million in the first six months of 2015. 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.

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A breakdown of the allowance for loan losses and recorded balances in loans at June 30, 2016 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 June 30, 2016								
Allowance for loan loss reserve:								
Beginning balance ALLR	$ 1,615	$ 580	$ 74	$ 257	$ 7	$ 40	$ 2,251	$ 4,824
Charge-offs	(224)	(25)	—	(10)	—	(10)	—	(269)
Recoveries	15	10	—	1	—	2	—	28
Provision	418	135	4	100	(2)	(9)	(496)	150
Ending balance ALLR	$ 1,824	$ 700	$ 78	$ 348	$ 5	$ 23	$ 1,755	$ 4,733
Six Months Ended June 30, 2016								
Allowance for loan loss reserve:								
Beginning balance ALLR	$ 1,611	$ 645	$ 79	$ 274	$ 7	$ 64	$ 2,324	$ 5,004
Charge-offs	(224)	(214)	—	(49)	—	(18)	—	(505)
Recoveries	22	49	—	2	7	4	—	84
Provision	415	220	(1)	121	(9)	(27)	(569)	150
Ending balance ALLR	$ 1,824	$ 700	$ 78	$ 348	$ 5	$ 23	$ 1,755	$ 4,733
At June 30, 2016								
Loans:								
Ending balance	$ 354,878	$ 130,054	$ 18,576	$ 194,167	$ 11,840	$ 16,120	$ —	$ 725,635
Ending balance	(1,824)	(700)	(78)	(348)	(5)	(23)	(1,755)	(4,733)

ALLR Net loans	$ 353,054	$ 129,354	$ 18,498	$ 193,819	$ 11,835	$ 16,097	$ (1,755)	$ 720,902
Ending balance ALLR:								
Individually evaluated	$ 533	$ 252	$ —	$ 48	$ —	$ 16	$ —	$ 849
Collectively evaluated	1,291	448	78	300	5	7	1,755	3,884
Acquired with deteriorated credit quality	—	—	—	—	—	—	—	—
Total	$ 1,824	$ 700	$ 78	$ 348	$ 5	$ 23	$ 1,755	$ 4,733
Ending balance Loans:								
Individually evaluated	$ 1,755	$ 354	$ —	$ 1,021	$ —	$ 48	$ —	$ 3,178
Collectively evaluated	347,677	129,647	18,576	188,033	11,760	16,070	—	711,763
Acquired with deteriorated credit quality	5,446	53	—	5,113	80	2	—	10,694
Total	$ 354,878	$ 130,054	$ 18,576	$ 194,167	$ 11,840	$ 16,120	$ —	$ 725,635

Impaired loans, by definition, are individually evaluated.

A breakdown of the allowance for loan losses and recorded balances in loans as of and for the twelve months ended December 31, 2015 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	$ 2,813	$ 1,539	$ 142	$ 285	$ 6	$ 13	$ 342	$ 5,140

Charge-offs	(52)	(1,749)	—	(142)	—	(87)	—	(2,030)
Recoveries	588	22	52	2	—	26	—	690
Provision	(1,738)	833	(115)	129	1	112	1,982	1,204
Ending balance ALLR	$ 1,611	$ 645	$ 79	$ 274	$ 7	$ 64	$ 2,324	$ 5,004
Loans:								
Ending balance	$ 312,805	$ 122,140	$ 15,330	$ 140,502	$ 11,770	$ 15,847	$ —	$ 618,394
Ending balance ALLR	(1,611)	(645)	(79)	(274)	(7)	(64)	(2,324)	(5,004)
Net loans	$ 311,194	$ 121,495	$ 15,251	$ 140,228	$ 11,763	$ 15,783	$ (2,324)	$ 613,390
Ending balance ALLR:								
Individually evaluated	$ 420	$ 192	$ —	$ 60	$ —	$ 55	$ —	$ 727
Collectively evaluated	1,191	453	79	214	7	9	2,324	4,277
Acquired with deteriorated credit quality	—	—	—	—	—	—	—	—
Total	$ 1,611	$ 645	$ 79	$ 274	$ 7	$ 64	$ 2,324	$ 5,004
Ending balance Loans:								
Individually evaluated	$ 1,086	$ 617	$ —	$ 325	$ 83	$ —	$ —	$ 2,111
Collectively evaluated	307,336	121,345	15,330	136,940	11,686	15,845	—	608,482
Acquired with deteriorated credit quality	4,383	178	—	3,237	1	2	—	7,801
Total	$ 312,805	$ 122,140	$ 15,330	$ 140,502	$ 11,770	$ 15,847	$ —	$ 618,394

Impaired loans, by definition, are individually evaluated.

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A breakdown of the allowance for loan losses and recorded balances in loans at June 30, 2015 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 June 30, 2015 Allowance for loan loss reserve:								
Beginning balance ALLR	$ 2,770	$ 2,353	$ 144	$ 244	$ 6	$ 19	$ (9)	$ 5,527
Charge-offs	—	(110)	—	(30)	—	(7)	—	(147)
Recoveries	11	—	—	1	—	8	—	20
Provision	(231)	328	(16)	67	(1)	7	46	200
Ending balance ALLR	$ 2,550	$ 2,571	$ 128	$ 282	$ 5	$ 27	$ 37	$ 5,600
Six Months Ended June 30, 2015 Allowance for loan loss reserve:								
Beginning balance ALLR	$ 2,813	$ 1,539	$ 142	$ 285	$ 6	$ 13	$ 342	$ 5,140
Charge-offs	—	(110)	—	(30)	—	(18)	—	(158)
Recoveries	92	—	—	1	1	19	—	113
Provision	(355)	1,142	(14)	26	(2)	13	(305)	505
Ending balance ALLR	$ 2,550	$ 2,571	$ 128	$ 282	$ 5	$ 27	$ 37	$ 5,600
At June 30, 2015 Loans:								
Ending balance	$ 320,013	$ 107,205	$ 19,868	$ 142,276	$ 8,722	$ 17,163	$ —	$ 615,247
Ending balance	(2,550)	(2,571)	(128)	(282)	(5)	(27)	(37)	(5,600)

ALLR								
Net loans	$ 317,463	$ 104,634	$ 19,740	$ 141,994	$ 8,717	$ 17,136	$ (37)	$ 609,647
Ending balance ALLR:								
Individually evaluated	$ 570	$ 1,591	$ —	$ 53	$ —	$ 18	$ —	$ 2,232
Collectively evaluated	1,980	980	128	229	5	9	37	3,368
Total	$ 2,550	$ 2,571	$ 128	$ 282	$ 5	$ 27	$ 37	$ 5,600
Ending balance Loans:								
Individually evaluated	$ 1,984	$ 4,905	$ —	$ 368	$ —	$ 33	$ —	$ 7,290
Collectively evaluated	312,969	102,110	19,762	137,846	8,722	17,127	—	598,536
Acquired with deteriorated credit quality	5,060	190	106	4,062	—	3	—	9,421
Total	$ 320,013	$ 107,205	$ 19,868	$ 142,276	$ 8,722	$ 17,163	$ —	$ 615,247

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.

Strong (1)

Borrower is not vulnerable to sudden economic or technological changes. They have “strong” balance sheets and are within an industry that is very typical for our markets or type of lending culture. Borrowers also have “strong” financial and cash flow performance and excellent collateral (low loan to value or readily available to liquidate collateral) in conjunction with an impeccable repayment history.

Good (2)

Borrower shows limited vulnerability to sudden economic change. These borrowers have “above average” financial and cash flow performance and a very good repayment history. The balance sheet of the company is also very good as compared to peer and the company is in an industry that is familiar to our markets or our type of lending. The collateral securing the deal is also very good in terms of its type, loan to value, etc.

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Average (3)

Borrower is typically a well-seasoned business, however may be susceptible to unfavorable changes in the economy, and could be somewhat affected by seasonal factors. The borrowers within this category exhibit financial and cash flow performance that appear “average” to “slightly above average” when compared to peer standards and they show an adequate payment history. Collateral securing this type of credit is good, exhibiting above average loan to values, etc.

Acceptable/Acceptable Watch (4)

A borrower within this category exhibits financial and cash flow performance that appear adequate and satisfactory when compared to peer standards and they show a satisfactory payment history. The collateral securing the request is within supervisory limits and overall is acceptable. Borrowers rated acceptable could also be newer businesses that are typically susceptible to unfavorable changes in the economy, and more than likely could be affected by seasonal factors.

Special Mention (5)

The borrower may have potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution’s credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. Examples of this type of credit include a start-up company fully based on projections, a documentation issue that needs to be corrected or a general market condition that the borrower is working through to get corrected.

Substandard (6)

Substandard loans are classified assets exhibiting 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 classified as substandard clearly represent troubled and deteriorating credit situations requiring constant supervision.

Doubtful (7)

Loans in this category exhibit the same, if not more pronounced weaknesses used to describe the substandard credit. 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.

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. 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.

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Below is a breakdown of loans by risk category as of June 30, 2016 (dollars in thousands):

	(1) Strong	(2) Good	(3) Average	(4) Acceptable/ Acceptable Watch	(5) Spl. Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	$ 1	$ 25,183	$ 118,729	$ 204,188	$ —	$ 6,777	$ —	$ —	$ 354,878
Commercial, financial and agricultural	5,829	3,977	52,084	66,556	—	1,608	—	—	130,054
Commercial construction	—	942	3,882	7,329	—	407	—	6,016	18,576
One-to-four family residential real estate	501	1,510	3,677	9,329	—	5,829	—	173,321	194,167
Consumer construction	29	—	—	—	—	21	—	11,790	11,840
Consumer	19	—	16	2	—	60	—	16,023	16,120
Total loans	$ 6,379	$ 31,612	$ 178,388	$ 287,404	$ —	$ 14,702	$ —	$ 207,150	$ 725,635

Below is a breakdown of loans by risk category as of December 31, 2015 (dollars in thousands):

	(1) Strong	(2) Good	(3) Average	(4) Acceptable/ Acceptable Watch	(5) Spl. Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	$ 2,072	$ 26,197	$ 113,868	$ 164,954	$ —	$ 5,714	$ —	$ —	$ 312,805
Commercial, financial and agricultural	13,067	5,954	47,194	53,791	—	2,134	—	—	122,140
Commercial construction	—	400	3,869	8,257	—	395	—	2,409	15,330
One-to-four family residential real estate	591	1,222	3,172	4,078	—	4,093	—	127,346	140,502
Consumer construction	—	—	—	—	—	—	—	11,770	11,770

Consumer	24	—	19	—	—	61	—	15,743	15,847
Total loans	$ 15,754	$ 33,773	$ 168,122	$ 231,080	$ —	$ 12,397	$ —	$ 157,268	$ 618,394

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. Interest income recorded during impairment for the three and six months ended June 30, 2016 was $.185 million and $.542 million. Interest income that would have been recognized during this period was $.205 million and $.588 million, respectively. For the three months and six months ended June 30, 2015, interest income recorded during impairment was $.105 million and $.628 million, and the amount that would have been recognized was $.236 million and $.831 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

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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.

Purchased loans acquired in a business combination are recorded at estimated fair value on their purchase date with no carryover of the related allowance for loan losses. In determining the estimated fair value of purchased loans, management considers a number of factors including the remaining life of the acquired loans, estimated prepayments, estimated loss ratios, estimated value of the underlying collateral, net present value of cash flows expected to be received, among others. Purchased loans are accounted for in accordance with guidance for certain loans acquired in a transfer (ASC 310-30), when the loans have evidence of credit deterioration since origination and it is probable at the date of acquisition that the acquirer will not collect all contractually required principal and interest payments. The difference between contractually required payments and the cash flows expected to be collected at acquisition is referred to as the non-accretable difference.   Subsequent decreases to the expected cash flows will generally result in a provision for loan losses. Subsequent increases in expected cash flows will result in a reversal of the provision for loan losses to the extent of prior charges and then an adjustment to accretable yield, which would have a positive impact on interest income.

The ASC 310-30 mark on PFC impaired loans totaled $2.978 million as of the acquisition date. The accretable yield related to these impaired loans was estimated at $.744 million. The Corporation recorded no accretable yield of the PFC loan mark in 2016 and recorded $.429 million due to the positive resolution of one large acquired nonperforming commercial loan relationship in the first quarter of 2015.

The ASC 310-30 mark on Eagle impaired loans totaled $1.563 million as of the acquisition date. The accretable yield related to these impaired loans was estimated at $.391 million. The Corporation recorded no accretable yield of the Eagle loan mark in 2016.

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

						Three Months Ended		Six 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

June 30, 2016									
With no valuation reserve:									
Commercial real estate	$ 614	$ 3,344	$ 4,502	$ 4,354	$ —	$ 71	$ 80	$ 295	$ 311
Commercial, financial and agricultural	—	—	75	243	—	—	—	6	10
Commercial construction	—	—	—	—	—	—	—	—	—
One to four family residential real estate	1,247	3,168	4,291	3,914	—	110	121	237	262
Consumer construction	19	—	20	20	—	4	4	4	4
Consumer	53	—	54	56	—	—	—	—	1
With a valuation reserve:									
Commercial real estate	$ 1,233	$ —	$ 912	$ 475	$ 113	$ —	$ —	—	$ —
Commercial, financial and agricultural	—	—	—	—	—	—	—	—	—
Commercial construction	—	—	—	—	—	—	—	—	—
One to four family residential real estate	149	—	104	90	39	—	—	—	—
Consumer construction	—	—	—	—	—	—	—	—	—
Consumer	6	—	6	7	6	—	—	—	—
Total:									
Commercial real estate	$ 1,847	$ 3,344	$ 5,414	$ 4,829	$ 113	$ 71	$ 80	$ 295	$ 311
Commercial, financial and agricultural	—	—	75	243	—	—	—	6	10
Commercial construction	—	—	—	—	—	—	—	—	—
One to four family residential real estate	1,396	3,168	4,395	4,004	39	110	121	237	262
	19	—	20	20	—	4	4	4	4

Consumer construction									
Consumer	59	—	60	63	6	—	—	—	1
Total	$ 3,321	$ 6,512	$ 9,964	$ 9,159	$ 158	$ 185	$ 205	$ 542	$ 588

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December 31, 2015	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	$ 471	$ 4,051	$ 7,205	$ —	$ 576	$ 655
Commercial, financial and agricultural	—	1,778	4,849	—	78	214
Commercial construction	—	—	260	—	3	6
One to four family residential real estate	1,267	2,385	5,413	—	137	205
Consumer construction	20	2	99	—	—	1
Consumer	50	1	102	—	1	2
With a valuation reserve:						
Commercial real estate	$ —	$ —	$ —	$ —	$ —	$ —
Commercial, financial and agricultural	460	—	699	192	—	36
Commercial construction	—	—	—	—	—	—
One to four family residential real estate	229	—	232	58	—	6
Consumer construction	—	—	—	—	—	—
Consumer	10	0	10	1	0	0
Total:						
Commercial real estate	$ 471	$ 4,051	$ 7,205	$ —	$ 576	$ 655
Commercial, financial and agricultural	460	1,778	5,548	192	78	250
Commercial construction	—	—	260	—	3	6
One to four family residential real estate	1,496	2,385	5,645	58	137	211
Consumer construction	20	2	99	—	—	1
Consumer	60	1	112	1	1	2
Total	$ 2,507	$ 8,217	$ 18,869	$ 251	$ 795	$ 1,125

						Three Months Ended		Six Months Ended	
June 30, 2015	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

With no valuation reserve:									
Commercial real estate	$ 1,418	$ 3,328	$ 4,862	$ 5,607	$ —	$ 66	$ 83	$ 533	$ 566
Commercial, financial and agricultural	69	190	229	517	—	2	3	19	21
Commercial construction	—	106	174	281	—	1	1	3	7
One to four family residential real estate	1,291	2,645	4,094	4,708	—	36	52	72	113
Consumer construction	22	—	23	131	—	—	1	—	1
Consumer	29	3	30	21	—	—	—	1	1
With a valuation reserve:									
Commercial real estate	$ 981	$ —	$ 981	$ 753	$ 570	$ —	$ 15	$ —	$ 20
Commercial, financial and agricultural	4,836	—	5,704	3,599	1,591	—	71	—	90
Commercial construction	—	—	—	—	—	—	—	—	0
One to four family residential real estate	866	—	667	599	—	—	10	—	12
Consumer construction	—	—	—	—	82	—	—	—	—
Consumer	—	—	—	—	—	—	—	—	—
Total:									
Commercial real estate	$ 2,399	$ 3,328	$ 5,843	$ 6,360	$ 570	$ 66	$ 98	$ 533	$ 586
Commercial, financial and agricultural	4,905	190	5,933	4,116	1,591	2	74	19	111
Commercial construction	—	106	174	281	—	1	1	3	7
One to four family residential real estate	2,157	2,645	4,761	5,307	—	36	62	72	125
Consumer construction	22	—	23	131	82	—	1	—	1
Consumer	29	3	30	21	—	—	—	1	1

Total	$ 9,512	$ 6,272	$ 16,764	$ 16,216	$ 2,243	$ 105	$ 236	$ 628	$ 831

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A summary of past due loans at June 30, 2016 and December 31, 2015 is as follows (dollars in thousands):

	June 30, 2016			December 31, 2015		
	30-89 days Past Due (accruing)	90+ days Past Due/ Nonaccrual	Total	30-89 days Past Due (accruing)	90+ days Past Due/ Nonaccrual	Total
Commercial real estate	$ 1,189	$ 550	$ 1,739	$ 521	$ 471	$ 992
Commercial, financial and agricultural	550	21	571	222	460	682
Commercial construction	24	—	24	270	—	270
One to four family residential real estate	374	1,063	1,437	807	1,528	2,335
Consumer construction	—	19	19	—	20	20
Consumer	985	64	1,049	130	60	190
Total past due loans	$ 3,122	$ 1,717	$ 4,839	$ 1,950	$ 2,539	$ 4,489

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.

There were no troubled debt restructurings that occurred during the six months ended June 30, 2016 or June 30, 2015.

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):

	Six Months Ended June 30, 2016	Year ended December 31, 2015
Loans outstanding, January 1	$ 6,887	$ 8,789
New loans	—	—
Net activity on revolving lines of credit	895	778
Repayment	(2,090)	(2,680)
Loans outstanding at end of period	$ 5,692	$ 6,887

There were no loans to related parties classified substandard as of June 30, 2016 or December 31, 2015. In addition to the outstanding balances above, there were unfunded commitments of $1.694 million to related parties at June 30, 2016.

6.GOODWILL AND OTHER INTANGIBLE ASSETS

During the fourth quarter of 2014, the Corporation recorded $3.805 million of goodwill and $1.206 million of deposit based intangible assets associated with the acquisition of PFC. During the second quarter of 2016 the Corporation recorded $1.368 million of goodwill and $.993 million of deposit based intangible assets associated with the acquisition of Eagle.

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The excess of the cost of acquired entities over the fair value of identifiable assets acquired less liabilities assumed is recorded as goodwill. In accordance with FASB ASC 350, amortization of goodwill and indefinite-lived assets is not recorded. However, the recoverability of goodwill and other intangible assets are annually tested for impairment. Intangible assets, including core deposits and customer business relationships, are amortized primarily on a straight-line basis over their estimated useful lives. The Corporation is currently amortizing the deposit based intangible over a ten-year estimated life.

The deposit based intangible is reported net of accumulated amortization at $1.992 million at June 30, 2016. Amortization expense in the first six months of 2016 is $.077 million. Amortization expense for the next five years is expected to be at $.220 million per year.

7.SERVICING RIGHTS

Mortgage Loans

Mortgage servicing rights ("MSRs") are recorded when loans are sold in the secondary market with servicing retained. As of June 30, 2016, the Corporation had obligations to service approximately $225.746 million of residential first mortgage loans. The valuation of MSRs 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. On a quarterly basis, management evaluates the MSRs for impairment. The key economic assumptions used in determining the fair value of the MSRs include an annual constant prepayment speed of 9.45% and a discount rate of 8.97% for June 30, 2016.

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

	Six Months Ended June 30, 2016	Year Ended December 31, 2015
Balance at beginning of period	$ 1,965	$ 1,994
Additions from loans sold with servicing retained	—	585
Acquired MSRs	120	—

Amortization	(339)	(614)
Balance at end of period	$ 1,746	$ 1,965
Balance of loan servicing portfolio	$ 225,746	$ 224,612
Mortgage servicing rights as % of portfolio	.77%	.87%

Commercial Loans

The Corporation also retains the servicing on commercial loans that have been sold. These loans were originated and underwritten under the SBA and USDA government guarantee programs, in which the guaranteed portion of the loan was sold to a third party with servicing retained. The balance of these sold loans with servicing retained at June 30, 2016 and December 31, 2015 was approximately $50.5 million and $63.0 million, respectively. The Corporation valued these servicing rights at $.155 million as of June 30, 2016 and at $.170 million as of December 31, 2015. This valuation was established in consideration of the discounted cash flow of expected servicing income over the life of the loans.

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8.BORROWINGS

Borrowings consist of the following at June 30, 2016 and December 31, 2015 (dollars in thousands):

	June 30, 2016	December 31, 2015
Federal Home Loan Bank fixed rate advances at June 30, 2016 with a weighted average rate of 2.01% maturing in 2016, 2017, 2018, 2019 and 2020	$ 46,000	$ 35,000
Correspondent bank line of credit - holding company	2,800	7,750
Correspondent bank term note, current floor rate of 4%, maturing April 30, 2019	21,100	2,300
USDA Rural Development, fixed-rate note payable, maturing August 24, 2024 interest payable at 1%	704	704
	$ 70,604	$ 45,754

The Federal Home Loan Bank borrowings are collateralized at June 30, 2016 by the following: a collateral agreement on the Corporation's one to four family residential real estate loans with a book value of approximately $32.961 million; mortgage related and municipal securities with an amortized cost and estimated fair value of $7.899 million and $8.008 million, respectively; and Federal Home Loan Bank stock owned by the Bank totaling $2.169 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 June 30, 2016.

The USDA Rural Development borrowing is collateralized by loans totaling $.110 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 $.665 million, and guaranteed by the Corporation.

The Corporation currently has one banking borrowing relationship. The relationship consists of a non-revolving line of credit and a term note. The line of credit bears interest at 90-day LIBOR plus 2.75%, with a floor rate of 4.00% and has an initial term that expires on April 30, 2018. The term note bears the same interest and matures on April 30, 2019 and requires quarterly principal payments of $550,000 beginning March 31, 2017. This relationship is secured by all of the outstanding mBank stock.

9.DEFINED BENEFIT PENSION PLAN

The Corporation acquired the Peninsula Financial Corporation noncontributory defined benefit pension plan. Effective December 31, 2005, the plan was amended to freeze participation in the plan; therefore, no additional employees are eligible to become participants in the plan. The benefits are based on years of service and the employee's compensation at the time of retirement. The Plan was amended effective December 31, 2010, to freeze benefit accrual for all participants. Expected contributions to the Plan in 2016 are $.063 million. The anticipated distributions over the next five years and through December 31, 2025 are detailed in the table below:

2016	$ 134
2017	132
2018	129
2019	126
2020	125
2021-2025	690
Total	$ 1,336

At June 30, 2016, the plan's assets had a fair value of $2.033 million and the Corporation had a net liability of $1.147 million. The accumulated benefit obligation was $3.180 million. At June 30, 2015, the plan's assets had a fair value of $2.107 million and the Corporation had a net liability of $1.183 million. The accumulated benefit obligation at June 30, 2015 was $3.290 million.

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Assumptions in the actuarial valuation are:

	2016
Weighted average discount rate	3.99 %
Rate of increase in future compensation levels	N/A
Expected long-term rate of return on plan assets	8.00 %

The expected long-term rate of return on plan assets reflects management's expectations of long-term average rates of return on funds invested to provide for benefits included in the projected benefit obligation. The expected return is based on the outlook for inflation, fixed income returns and equity returns, while also considering historical returns, asset allocation and investment strategy. The discount rate assumption is based on investment yields available on AA rated long-term corporate bonds.

The primary investment objective is to maximize growth of the pension plan assets to meet the projected obligations to the beneficiaries over a long period of time, and to do so in a manner that is consistent with the Corporation's risk tolerance. The intention of the plan sponsor is to invest the plan assets in mutual funds with the following asset allocation:

	Target Allocation	Actual Allocation
Equity securities	50% to 70%	60%
Fixed income securities	30% to 50%	40%

10.STOCK COMPENSATION PLANS

On May 22, 2012, the Company'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, RSUs, or stock appreciation rights. The aggregate number of shares of the Company's common stock issuable under the plan is 575,000, which included 392,152 option shares outstanding at that time. Awards are made at the discretion of management and the Board of Directors. Compensation cost equal to the fair value of the award is recognized over the vesting period.

Restricted Stock Awards

The Corporation's restricted stock awards require certain service-based or performance requirements and have a vesting period of four years. Compensation expense is recognized on a straight-line basis over the vesting period. Shares are subject to certain restrictions and risk of forfeiture by the participants.

The Corporation has historically granted RSUs to members of the Board of Directors and management. In August 2012, 148,500 RSUs were granted at a market value of $7.91 and will vest equally over a four year term. In exchange for the grant of these RSUs various previously issued stock option awards were surrendered. In March 2014, 52,774 RSUs were granted at a market value of $12.95, also vesting equally over a four year term. In March 2015, 37,730 RSUs were granted at a market value of $11.15, also vesting over a four year term. In February 2016, 35,733 RSUs were granted at a market value of $9.91, also vesting over a four-year term. The RSUs were awarded at no cost to the employee. Compensation cost to be recognized over the four year vesting periods, is $1.175 million, $.683 million, $.421 million and$ .354 million, respectively. On August 31, 2013, 2014 and 2015, the Corporation issued 37,125 shares of its common stock for vested RSUs, in each year. In March 2015, the Corporation issued 13,194 shares of its common stock for vested RSUs. In May 2015, the Corporation granted 3,000 shares, which were immediately vested and issued. In March 2016, the Corporation issued 22,626 shares of its common stock for vested RSUs.

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A summary of changes in our nonvested shares for the period follows:

	Number Outstanding	Weighted Average Grant Date Fair Value
Nonvested balance at January 1, 2016	114,435	$ 10.72
Granted during the year	35,733	9.91
Vested during the year	(22,626)	12.20
Nonvested balance at June 30, 2016	127,542	$ 10.23

A summary of stock option transactions for the six months ended June 30, 2016 and 2015, and the year ended December 31, 2015, is as follows:

	June 30, 2016	December 31, 2015
Outstanding shares at beginning of year	10,000	20,000
Granted during the year	—	—
Exercised during the year	—	—
Expired during the year	—	(10,000)
Outstanding shares at end of period	10,000	10,000
Exercisable shares at end of period	2,000	2,000
Weighted average exercise price per share at end of period	$ 12.00	$ 12.00
Shares available for grant at end of period	—	—

There were no options granted in the first six months of 2016 and 2015.

Following is a summary of the options outstanding and exercisable at June 30, 2016.

Exercise Price	Number Outstanding	Exercisable	Unvested Options	Weighted Average Remaining Contractual Life-Years

$ 12.00	10,000	2,000	8,000	.50

Options issued since the Corporation's recapitalization in December of 2004 call for 20% immediate vesting upon issue and subsequent vesting to occur over a two to five year period, based upon the market value appreciation of the Corporatino's underlying stock. Compensation related to these options was expensed based upon the vesting period without consideration given to market value appreciation. There are no future compensation expenses related to existing option programs.

11.INCOME TAXES

The Corporation has reported deferred tax assets of $10.147 million at June 30, 2016. 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 June 30, 2016 had a net operating loss and tax credit carryforwards for tax purposes of approximately $11.200 million, and $2.300 million, respectively. The Corporation evaluated the future benefits from these carryforwards as of June 30, 2016 and determined that it was "more likely than not" that they would be utilized prior to expiration. 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 and credit carryforwards are subject to the limitations for utilization as set forth in Section 382 of the Internal Revenue Code. The annual limitation is $1.404 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 will continue to evaluate the future benefits from these carryforwards in order to determine if any adjustment to the deferred tax asset is warranted.

The Corporation recognized a federal income tax benefit of approximately $.026 million for the three months ended June 30, 2016 and an expense of $.559 million for the six months ended June 30, 2016 and a deferred tax expense of $.836 million and $1.548 million for the three and six months ended June 30, 2015.

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12.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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The following table presents information for financial instruments at June 30, 2016 and December 31, 2015 (dollars in thousands):

		June 30, 2016		December 31, 2015	
	Level in Fair Value Hierarchy	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:					
Cash and cash equivalents	Level 1	$ 40,235	$ 40,235	$ 25,008	$ 25,008
Interest-bearing deposits	Level 2	7,184	7,184	5,089	5,089
Securities available for sale	Level 2	71,114	71,114	53,728	53,728
Federal Home Loan Bank stock	Level 2	2,639	2,639	2,169	2,169
Net loans	Level 3	720,902	722,258	613,390	614,187
Accrued interest receivable	Level 3	1,946	1,946	1,416	1,416
Total financial assets		$ 844,020	$ 845,376	$ 700,800	$ 701,597
Financial liabilities:					
Deposits	Level 2	$ 738,363	$ 738,371	$ 610,323	$ 607,636
Borrowings	Level 2	70,604	72,450	45,754	45,989
Accrued interest payable	Level 3	252	252	174	174
Total financial liabilties		$ 809,219	$ 811,073	$ 656,251	$ 653,799

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 June 30, 2016, 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 June 30, 2016, December 31, 2015 and June 30, 2015 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 4 Investment Securities."

The Corporation had no Level 3 assets or liabilities measured at fair value on a recurring basis as of June 30, 2016, or December 31, 2015.

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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 certain impaired 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 June 30, 2016

(dollars in thousands)	Balance at June 30, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total (Gains) Losses for Three Months Ended June 30, 2016	Total (Gains) Losses for Six Months Ended June 30, 2016
Assets						
Impaired loans	$ 9,833	$ —	$ —	$ 9,833	$ 267	$ 503
Other real estate owned	3,492	—	—	3,492	(19)	(3)
					$ 248	500

Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2015

(dollars in thousands)	Balance at December 31, 2015	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses for Twelve months ended December 31, 2015
Assets					
Impaired loans	$ 10,724	$ —	$ —	$ 10,724	$ 1,852
Other real estate held for sale	2,324	—	—	2,324	332

$ 2,184

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).

13.SHAREHOLDERS' EQUITY

The Corporation currently has a share repurchase program. The program is conducted under authorizations from time to time by the Board of Directors. The Corporation repurchased 14,000 shares thus far in 2016, 102,455 shares in 2015, 13,700 shares in 2014 and 55,594 shares in 2013. The share repurchases were conducted under Board authorizations made and publically announced of $600,000 on February 27, 2013, $600,000 on December 17, 2013 and an additional $750,000 on April 28, 2015. None of these authorizations has an expiration date. As of June 30, 2016, $.026 million of the total authorization was available for future purchases.

14.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.

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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):

	June 30, 2016	December 31, 2015
Commitments to extend credit:		
Variable rate	$ 61,432	$ 53,628
Fixed rate	36,186	26,846
Standby letters of credit - Variable rate	8,061	6,390
Credit card commitments - Fixed rate	5,219	3,747
	$ 110,898	$ 90,611

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 June 30, 2016 represents $102.427 million, or 22.15%, compared to $102.380 million, or 22.90%, of the commercial loan portfolio on June 30, 2015. 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.

15. BUSINESS COMBINATIONS

The First National Bank of Eagle River

The Corporation completed its acquisition of The First National Bank of Eagle River ("Eagle") in April 2016. Eagle had three branch offices and approximately $125 million in assets as of April 29, 2016. The results of operations due to the merger have been included in the Corporation's results since the acquisition date. The merger was effected by a cash payment of $12.500 million.

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The table below highlights the allocation of the purchase price (dollars in thousands):

Purchase Price:		
Eagle shares outstanding	85,776	
Price per share/Cash price	$ 145.73	
Total purchase price		$ 12,500
Reimbursement of termination fees		(1,763)
Cash consideration		$ 10,737
Net assets acquired:		
Cash and cash equivalents	$ 10,600	
Securities available for sale	24,046	
Valuation mark	(750)	
FRB & FHLB Stock	575	
Total Loans	84,138	
Allowance for loan losses	(611)	
Valuation mark - ASC 310-30, nonperforming	(1,563)	
- ASC 310-20, performing	(1,700)	
Allowance for loan loss reversal	611	
Premises and equipment	1,931	
Other real estate owned	1,795	
Valuation mark	(891)	
Deposit based intangible	993	
Mortgage servicing rights	120	
Deferred tax benefit - book for valuation marks	1,419	
Bank owned life insurance	4,132	
Other assets	323	
Total assets	125,168	
Non-interest bearing deposits	22,349	
Interest bearing deposits	82,165	
Total deposits	104,514	
FHLB Borrowings	11,000	
Other liabilities	285	
Total liabilities	115,799	
Net assets acquired		9,369
Goodwill		$ 1,368

The results of operations for the six months ended June 30, 2016 include the operating results of the acquired assets and assumed liablities for the 63 days subsequent to the acquisition date. Eagle's results of operations prior to the acquisition date are not included in the Corporation's consolidated statement of comprehensive income.

In addition to the data processing termination fees of $1.763 million, the Corporation incurred other transaction related expenses of $.753 million, for a total of $2.516 million, or $1.712 million on an after tax basis during the six months ended June 30, 2016. These expenses included professional services such as legal, accounting and contractual arrangements for consulting services.

The following table provides the unaudited pro forma information for the results of operations for the six months ended June 30, 2016, and the year ended December 31, 2016 as if the acquisition had occurred on January 1 of each year. These adjustments reflect the impact of certain purchase accounting fair value measurements, primarily on the loan and deposit portfolios of Eagle. In addition, the merger related costs noted above are excluded from the six months ended

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June 30, 2016 results of operations, for comparative proforma purposes. Further operating cost savings are expected along with additional business synergies as a result of the merger which are not presented in the pro forma amounts. These unaudited pro forma results are presented for illustrative purposes only and are not intended to represent or be indicative of the actual results of operations of the combined banking organization that would have been achieved had the merger occurred at the beginning of the period presented, nor are the intended to represent or be indicative of future results of the Corporation.

Proforma Mackinac Financial Combined with Eagle River

	Six months ended June 30, 2016	Year Ended December 31, 2015
Net interest income	$ 16,846	$ 33,001
Noninterest income	1,856	4,705
Noninterest expense	13,912	28,076
Net income	3,304	5,988
Net income per diluted share	$ .53	.95

Fair Value

In most instances, determining the fair value of the acquired assets and assumed liabilities required the Corporation to estimate the cash flows expected to result from those assets and liabilities and to discount those cash flows at appropriate rates of interest. The most significant of those determinations is related to the valuation of acquired loans. For such loans, the excess cash flows expected at merger over the estimated fair value is recognized as interest income over the remaining lives of the loans. The difference between contractually required payments at merger and the cash flows expected to be collected at merger reflects the impact of estimated credit losses and other factors, such as prepayments. In accordance with the applicable accounting guidance for business combinations, there was no carry-over of Eagle's previously established allowance for loan losses.

The acquired loans were divided into loans with evidence of credit quality deterioration, which are accounted for under ASC 310-30 ("acquired impaired") and loans that do not meet the criteria, which are accounted for under ASC 310-20 ("acquired non-impaired"). In addition, the loans are further categorized into different pools based primarily on the type and purpose of the loan.

Niagara Bancorporation

On May 24, 2016, the Corporation announced the execution of a definitive agreement to acquire Niagara Bancorporation ("Niagara"), the holding company for First National Bank of Niagara, headquartered in Niagara, Wisconsin in an all cash transaction for a fixed $7.325 million purchase price. Niagara has four full-service banking locations in Wisconsin and approximately $70 million in assets. The transaction is expected to close prior to the end of the third quarter of 2016.

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Forward Looking Statements/Risk Factors

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.

· As a community banking organization, the Corporation’s success depends upon local and regional economic conditions and has different lending risks than larger banks.

We manage our credit exposure through careful monitoring of loan applicants and loan concentrations in particular industries and through loan approval and review procedures. We have established an evaluation process designed to determine the adequacy of our allowance for loan losses. While this evaluation process uses historical and other objective information, the classification of loans and the establishment of loan losses is estimated based on experience, judgment and expectations regarding borrowers and economic conditions, as well as regulator judgments. We can make no assurance that our loan loss reserves will be sufficient to absorb future loan losses or prevent a material adverse effect on our business, profitability or financial condition.

· 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.

- We may not realize the expected benefits of our recently completed acquisition of The First National Bank of Eagle River or our pending acquisition of The First National Bank of Niagara.

- Our controls and procedures may fail or be circumvented.

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- 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 June 30, 2016, net deferred tax assets were approximately $10.147 million. If a 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 of breach in security.

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 implemented Dodd-Frank Act is currently unknown and subject to significant uncertainty.

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

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, the related notes, and other supplemental information presented elsewhere in this report. This discussion should also 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, 2015. Throughout this discussion and elsewhere in this report, the term "Bank" refers to mBank, the principal banking subsidiary of the Corporation.

FINANCIAL OVERVIEW

The Corporation recorded a net loss, after certain acquisition transaction expenses described below, for the second quarter 2016 of ($.125) million or ($.02) per share compared to net income of $1.614 million, or $.26 per share, for the second quarter of 2015. Net income for the first six months of 2016 totaled $1.007 million, or $.16 per share, after acquisition transaction expenses, compared to $2.985 million, or $.48 per share, for the same period in 2015.

Weighted average shares for the six month period in 2016 totaled 6,220,906, compared to 6,251,713 shares in the same period of 2015. Weighted average shares for the second quarter of 2016 were 6,227,730, compared to 6,247,004 for the same period in 2015.

On April 29, 2016, the company completed the acquisition of First National Bank of Eagle River ("Eagle River"). In connection with this acquisition, the Corporation had GAAP pre-tax transaction related expenses totaling $2.516 million. These one-time costs, largely associated with the early termination of the Eagle River data processing system, reduced the reported net income for the quarter by $1.712 million, or $.27 per share, on an after tax basis. While the data processing termination fee was incurred by Eagle River and factored into the purchase price paid for the assets, GAAP business combination guidance requires the Corporation to expense the entire $1.585 million in the second quarter of 2016. The accounting treatment of the termination fee does not adversely affect the overall economics of the purchase. All expenses were considered by management in its price and impact analysis of the transaction. The adjusted net income for the second quarter of 2016 (exclusive of the transaction related expenses) would equate to $1.588 million, or $.25 per share. Adjusted net income for the first six months of 2016 for the Corporation is $2.770 million, or $.45 per share.

The net interest margin for the second quarter of 2016 was $7.996 million, or 4.19%, compared to $7.000 million, or 4.17% in the second quarter of 2015. The six month net interest margin in 2016 was $15.284 million, or 4.25%, compared to $14.520 million, or 4.35%, in 2015.

Total assets of the Corporation at June 30, 2016 were $892.328 million, up by $153.059 million, or 20.70%, from the $739.269 million in total assets reported at year-end 2015.

FINANCIAL CONDITION

Cash and Cash Equivalents

Cash and cash equivalents increased $15.227 million during the first six months of 2016. See further discussion of the change in cash and cash equivalents in the Liquidity section.

Investment Securities

Securities available for sale increased $17.386 million from December 31, 2015 to June 30, 2016, with the balance on June 30, 2016 totaling $71.114 million. Investment securities are utilized in an effort to manage interest rate risk and liquidity. As of June 30, 2016, investment securities with an estimated fair value of $20.262 million were pledged against borrowings at the FHLB and certain customer relationships.

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Loans

Through the first six months of 2016, loan balances increased by $107.241 million, from December 31, 2015 balances of $618.394 million. During the first six months of 2016, the Bank had total loan production of $124.9 million, which included $31.9 million of secondary market loan production. This loan production, however, was offset by loan principal runoff, paydowns and amortization.

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 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 June 31, 2016 and December 31, 2015 (dollars in thousands):

	June 30, 2016	Percent of Total	December 31, 2015	Percent of Total
Commercial real estate	$ 354,878	48.91%	$ 312,805	50.59%
Commercial, financial, and agricultural	130,054	17.92	122,140	19.75
One to four family residential real estate	194,167	26.76	140,502	22.72
Construction:				
Consumer	11,840	1.63	11,770	1.90
Commercial	18,576	2.56	15,330	2.48
Consumer	16,120	2.22	15,847	2.56
Total loans	$ 725,635	100.00%	$ 618,394	100.00%

Following is a table showing the significant industry types in the commercial loan portfolio as of June 30, 2016 and December 31, 2015 (dollars in thousands):

	June 30, 2016			December 31, 2015		
	Outstanding Balance	Percent of Loans	Percent of Capital	Outstanding Balance	Percent of Loans	Percent of Capital

Real estate - operators of nonresidential buildings	111,523	22.15%	144.68%	102,620	22.79%	133.97%
Hospitality and tourism	48,295	9.59	62.65	41,300	9.17	53.92
Lessors of residential buildings	26,662	5.30	34.59	25,930	5.76	33.85
Gasoline stations and convenience stores	20,582	4.09	26.70	21,647	4.81	28.26
Commercial construction	18,576	3.69	24.10	15,330	3.40	20.01
Real estate agents and managers	16,655	3.31	21.61	11,225	2.49	14.65
Other	261,215	51.87	338.88	232,223	51.58	303.16
Total Commercial Loans	$ 503,508	100.00%		$ 450,275	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 June 30, 2016. 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 June 30, 2016, our residential loan portfolio totaled $206.007 million, or 28.39% of our total outstanding loans.

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

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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.

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 six months ended June 30, 2016 amounted to $.421 million, compared to net charge-offs of $.044 million, for the same period in 2015. 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):

	June 30, 2016	December 31, 2015
Nonperforming Assets:		
Nonaccrual loans	$ 3,177	$ 2,353
Loans past due 90 days or more	—	32
Restructured loans	144	154
Total nonperforming loans	3,321	2,539
Other real estate owned	3,492	2,324
Total nonperforming assets	$ 6,813	$ 4,863
Nonperforming loans as a % of loans	0.46%	0.41%
Nonperforming assets as a % of assets	0.76%	0.66%
Reserve for Loan Losses:		
At period end	$ 4,733	$ 5,004
As a % of average loans	.73%	.83%
As a % of nonperforming loans	142.52%	197.09%
As a % of nonaccrual loans	148.98%	212.66%
Texas Ratio	9.13%	6.34%

Nonperforming assets at $6.813 million have increased in 2016 by $1.950 million from the $4.863 million at 2015 year end, largely a result of the nonperforming assets garnered in the Eagle acquisition.

The following ratios provide additional information relative to the Corporation's credit quality (dollars in thousands):

	At Period End	
	June 30, 2016	December 31, 2015
Total loans, at period end	$ 725,635	618,394
Average loans for the period	$ 652,573	$ 602,904

	For the Period Ended	
	Six Months Ended June 30, 2016	Twelve Months Ended December 31, 2015
Net charge-offs (recoveries) during the period	$ 421	1,340
Net charge-offs to average loans, annualized	.13%	.22%

Management continues to address market issues impacting its loan customer base. In conjunction with the Corporation's senior lending staff and bank regulatory examinations, management reviews the Corporation's loans, related collateral evaluations, and the overall lending process. The Corporation also utilizes an outside loan consultant to perform a review of the loan portfolio. The opinion of this consultant upon completion of the 2015 independent review provided

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findings similar to management with respect to credit quality. In 2016, the Corporation continues to utilize a consultant for loan review.

As of June 30, 2016, the allowance for loan losses represented .65% of total loans. At June 30, 2016, the allowance included specific reserves in the amount of $.849 million, as compared to specific reserves of $.727 million at December 31, 2015. 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):

	Six Months Ended June 30, 2016	Year Ended December 31, 2015
Balance at beginning of period	$ 2,324	$ 3,010
Other real estate acquired, net of purchase accounting adjustments	904	—
Other real estate transferred from loans due to foreclosure	851	1,376
Other real estate sold, net of purch accounting adjustments	(585)	(1,702)
Writedowns on other real estate held for sale, incl purch acct adj	—	(295)
Loss on sale of other real estate held for sale	(2)	(65)
Balance at end of period	$ 3,492	$ 2,324

During the first six months of 2016, the Corporation received real estate in lieu of loan payments of $.851 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 six months of 2016. Total deposits increased by $128.040 million, or 20.98 %, in the first six months of 2016. The increase in deposits for the first six months of 2016 is composed of an increase in core deposits of $99.081 million and an increase in noncore deposits of $28.959 million. These increases included the acquisition of Eagle deposits amounting to $104.514 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. Management also utilizes brokered deposits as a funding source, which provides flexibility in managing interest rate risk for fixed rate longer term loan fundings.

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.

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

	June 30, 2016	% of Total	December 31, 2015	% of Total
Noninterest bearing	$ 149,435	20.24%	$ 122,775	20.12%
NOW, money market, checking	251,140	34.01	202,784	33.23
Savings	48,978	6.63	30,882	5.06
Certificates of Deposit <$250,000	130,053	17.61	124,084	20.33
Total core deposits	579,606	78.50	480,525	78.73
Certificates of Deposit >$250,000	5,417	.73	8,532	1.40
Brokered CDs	153,340	20.77	121,266	19.87
Total non-core deposits	158,757	21.50	129,798	21.27
Total deposits	$ 738,363	100.00%	$ 610,323	100.00%

Borrowings

The Corporation also utilizes FHLB borrowings as a source of funding. At June 30, 2016, this source of funding totaled $46 million and the Corporation secured this funding by pledging loans and investments. The $46 million of FHLB borrowings has a weighted average maturity of 2.0 years and a weighted average rate of 2.01% at June 30, 2016. The Corporation also has a USDA Rural Development loan held by its wholly owned subsidiary, First Rural Relending, that has an outstanding balance of $.704 million, with a fixed interest rate of 1% that matures in August 2024.

In addition to the above, the Corporation currently has one banking borrowing relationship. The relationship consists of a nonrevolving line of credit and a term note. The line of credit had a June 30, 2016 balance of $2.800 million and bears interest at 90-day LIBOR plus 2.75%, with a floor rate of 4.00% and has an initial term that expires on April 30, 2018. The term note had a June 30, 2016 balance of $21.100 million, bears the same interest and matures on April 30, 2019 and requires quarterly principal payments of $550,000 beginning March 31, 2017.

Shareholders' Equity

Total shareholders' equity increased $.479 million from December 31, 2015 to June 30, 2016. Contributing to the increase in shareholders' equity was net income available to common shareholders of $1.007 million, a reduction for

cash dividends on common stock of $1.246 million, increases due to stock compensation of $.300 million, an increase in the market value of securities of $.568 million and a decrease due to the repurchase of common stock of $.150 million.

RESULTS OF OPERATIONS

Summary

The Corporation reported net income available to common shareholders of $1.007 million, or $.16 per share, in the first six months of 2016, compared to $2.985 million, or $.48 per share, for the first six months of 2015.

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 $15.322 million, 4.27% of average earning assets, in the first half of 2016, compared to $14.571 million, and 4.36% of average earning assets, in the first half of 2015.

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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								
								2016-2015	
	Average Balances			Average Rates		Interest		Income/	
	June 30,		Increase/	June 30,		June 30,		Expense	V
(dollars in thousands)	2016	2015	(Decrease)	2016	2015	2016	2015	Variance	V
Loans (1,2,3)	$ 689,462	$ 607,330	$ 82,132	5.08%	5.12%	$ 8,710	$ 7,746	$ 964	$
Taxable securities	63,929	54,354	9,575	1.96	2.27	311	307	4	
Nontaxable securities (2)	6,354	4,115	2,239	1.58	0.97	25	10	15	
Federal funds sold	117	3	114	—	—	—	—	—	
Other interest-earning assets	7,500	8,172	(672)	3.59	1.96	67	40	27	
Total earning assets	767,362	673,974	93,388	4.78	4.82	9,113	8,103	1,010	
Reserve for loan losses	(5,253)	(5,488)	235						
Cash and due from banks	29,631	26,008	3,623						
Fixed Assets	14,106	12,657	1,449						
Other Real Estate	3,884	2,446	1,438						
Other assets	24,944	23,382	1,562						
Total assets	$ 834,674	$ 732,979	$ 101,695						
NOW and money market deposits	$ 191,841	$ 149,898	$ 41,943	.30%	.31%	$ 144	$ 115	$ 29	$
Interest checking	49,005	52,885	(3,880)	.16	.18	19	24	(5)	
Savings deposits	45,870	29,714	16,156	.10	.11	11	8	3	
Certificates of deposit	129,215	159,488	(30,273)	.90	1.02	289	404	(115)	
Brokered deposits	128,645	96,547	32,098	.96	1.0	308	249	59	
Borrowings	75,001	54,653	20,348	1.75	2.2	326	298	28	
Total interest-bearing liabilities	619,577	543,185	76,392	.71	.81	1,097	1,098	(1)	
Demand deposits	134,606	105,734	28,872						
Other liabilities	1,010	8,496	(7,486)						
Shareholders' equity	79,481	75,564	3,917						
Total liabilities and shareholders' equity	$ 834,674	$ 732,979	$ 101,695						
Rate spread				4.07%	4.01%				
Net interest margin/revenue				4.20%	4.17%	$ 8,016	$ 7,005	$ 1,011	$

	Six Months Ended									
	Average Balances			Average Rates		Interest		2016-2015 Income/		
	June 30,		Increase/	June 30,		June 30,		Expense	Volume	Rate
ousands)	2016	2015	(Decrease)	2016	2015	2016	2015	Variance	Variance	Varianc
)	$ 652,573	$ 603,711	$ 48,862	5.14%	5.34%	$ 16,688	$ 15,975	$ 713	$ 1,293	$ (579)
rities	56,265	58,020	(1,755)	2.02	1.96	566	563	3	(17)	19
securities	5,592	3,295	2,297	2.41	8.75	67	143	(76)	100	(104)
s sold	643	3	640	-	—	—	—	—	—	—
t-earning	7,362	8,322	(960)	3.31	2.47	121	102	19	(12)	34
g assets	722,435	673,351	49,084	4.86	5.03	17,442	16,783	659	1,364	(630)
oan	(5,095)	(5345)	250							
e from	28,523	22,806	5,717							
.	13,303	12,673	630							
Estate	3,316	2,588	728							
	23,399	29,152	(5,753)							
	$ 785,881	$ 735,225	$ 50,656							
oney										
sits	$ 176,813	$ 158,044	$ 18,769	.32	.29	$ 282	$ 231	$ 51	$ 27	$ 20
king	48,333	51,955	(3,622)	.16	.19	39	48	(9)	(2)	(6)
osits	38,477	29,103	9,374	.10	.1	20	14	6	2	1
of deposit	130,458	160,129	(29,671)	.94	1.06	609	840	(231)	(77)	(95)
posits	120,393	98,063	22,330	.99	1.01	591	491	100	56	(11)
	63,579	54,629	8,950	1.83	2.17	579	588	(9)	48	(92)
t-bearing	578,053	551,923	26,130	.74	.81	2,120	2,212	(92)	54	(183)
osits	127,299	100,511	26,788							
ies	2,146	7,826	(5,680)							
s' equity	78,383	74,965	3,418							
ies and ' equity	$ 785,881	$ 735,225	$ 50,656							
				4.12%	4.22%					
nue				4.27%	4.36%	$ 15,322	$ 14,571	$ 751	$ 1,310	$ (447)

(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 equivalent basis, using a 34% tax rate.
(3) Interest income on loans includes fees.

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In 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.

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 six months of 2016, the Corporation recorded a loan loss provision of $.150 million, compared to $.505 million in the first six months of 2015. There were net charge-offs of $.421 million in the first six months of 2016, compared to net charge-offs of $.044 million for the same period in 2015.

Other Income

Other income was $1.523 million in the first six months of 2016, compared to $1.974 million in the same period in 2015. The decreases year over year was largely a result of decreased SBA/USDA loan sale gains and decreased mortgage servicing income. With respect to mortgage servicing income, the Corporation has slowed the retention of mortgage servicing on those loans sold to the secondary market, which has contributed to the decrease year over year in this category.

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 six months ended June 30, 2016 and 2015 (dollars in thousands):

	Three Months Ended June 30,				Six Months Ended June 30,			
			Increase/(Decrease)				Increase/(Decrease)	
	2016	2015	Dollars	Percent	2016	2015	Dollars	Percent

Deposit service fees	$ 248	$ 244	$ 4	1.64%	$ 464	$ 428	$ 36	8.41%
Income from loans sold in the secondary market	339	282	57	20.21	606	449	157	34.97
SBA/USDA loan sale gains	166	282	(116)	(41.13)	166	400	(234)	(58.50)
Mortgage servicing (amortization) income	(8)	199	(207)	(104.02)	(62)	230	(292)	(126.96)
Net realized security gains	12	259	(247)	(95.37)	109	269	(160)	(59.48)
Other noninterest income	139	84	55	65.48	240	198	42	21.21
Total other income	$ 896	$ 1,350	$ (454)	-33.63%	$ 1,523	$ 1,974	$ (451)	-22.85%

Other Expense

For the first six months of 2016, the Corporation recorded other expenses of $15.091 million, compared to $11.456 million in 2015, an increase of $3.635 million. The 2016 increase from the first six months of 2015 was due to transaction related expenses of $2.516 million incurred with the acquisition of First National Bank of Eagle River, as well as customary employee compensation and retention related costs to ensure our personnel infrastructure keeps pace with our growing asset base and subsequent regulatory platform monitoring needs.

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The following table details other expense for the three and six months ended June 30, 2016 and 2015 (dollars in thousands):

	Three Months Ended June 30,		Increase/(Decrease)		Six Months Ended June 30,		Increase/(Decrease)	
	2016	2015	Dollars	Percentage	2016	2015	Dollars	Percentage
Salaries and employee benefits	$ 3,519	$ 2,916	$ 603	20.68%	$ 6,906	$ 5,963	$ 943	15.81%
Occupancy	640	626	14	2.24	1,280	1,202	78	6.49
Furniture and equipment	425	390	35	8.97	808	789	19	2.41
Data processing	333	359	(26)	(7.24)	678	714	(36)	(5.04)
Advertising	181	120	61	50.83	337	246	91	36.99
Professional service fees	257	279	(22)	(7.89)	498	580	(82)	(14.14)
Loan and deposit	155	125	30	24.00	282	263	19	7.22
Writedowns and losses on other real estate held for sale	(14)	20	(34)	(170.00)	2	37	(35)	(94.59)
FDIC insurance premiums	117	140	(23)	(16.43)	225	248	(23)	(9.27)
Telephone	122	106	16	15.09	234	238	(4)	(1.68)
Transaction related expenses	2,449	—	2,449	N/A	2,516	—	2,516	N/A
Other	709	619	90	14.54	1,325	1,176	149	12.67
Total other expense	$ 8,893	$ 5,700	$ 3,193	56.02%	$ 15,091	$ 11,456	$ 3,635	31.73%

Federal Income Taxes

The Corporation recognized a federal income tax expense for the six months ended June 30, 2016 of $.559 million, compared to $1.548 million a year earlier.

The Corporation has reported deferred tax assets of $10.147 million at June 30, 2016. 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 June 30, 2016 had a net operating loss and tax credit carryforwards for tax purposes of approximately $11.200 million and $2.300 million, respectively. The Corporation evaluated the future benefits from these carryforwards as of June 30, 2016 and determined it was "more likely than not" that they would be utilized

prior to expiration. 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 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 $1.404 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 will continue to evaluate the future benefits from these carryforwards in order to determine if any adjustment to the deferred tax asset is warranted.

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 $40.235 million in cash and cash equivalents and $50.852 million of unpledged investment securities. Although current liquidity is deemed adequate, management will increase on hand liquidity in the near term by acquiring brokered CDs in order to fund anticipated loan growth.

During the first six months of 2016, the Corporation increased cash and cash equivalents by $15.227 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.

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The Corporation's primary source of liquidity on a stand-alone basis is dividends from the Bank. The Corporation also has a line of credit with a correspondent bank with current availability of $43.875 million. The Corporation's current plan for dividends from the Bank are dependent upon the profitability of the Bank, growth of assets at the Bank and the level of capital needed to stay "well capitalized."

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 $250,000. Noncore funding consists of certificates of deposit greater than $250,000, brokered deposits, and FHLB and Farmers' Home Administration borrowings. At June 30, 2016, the Bank's core deposits in relation to total funding were 71.65% compared to 71.95% at June 30, 2015. These ratios indicate that at June 30, 2016, that the Bank had slightly increased 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 adequate liquidity to support future growth. The Bank also has correspondent lines of credit available to meet unanticipated short-term liquidity needs. As of June 30, 2016, the Bank had $43.875 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 also has the ability to augment local deposit growth efforts with wholesale CD funding.

CAPITAL AND REGULATORY

The Corporation is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Corporation's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation must meet specific capital guidelines that involve quantitative measures of the Corporation's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting

practices. The Corporation's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Corporation to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets. Management has determined that, as of June 30, 2016, the Corporation is well capitalized.

Effective January 1, 2015, the Corporation became subject to new capital requirements due to the Basel III regulation, including:

- A new minimum ratio of Common Equity Tier I Capital to risk-weighted assets of 4.5%;
- An increase in the minimum required amount of Additional Tier 1 Capital to 6% of risk-weighted assets;
- A continuation of the current minimum required amount of Total Capital (Tier 1 plus Tier 2) of 8% of risk-weighted assets; and
- A minimum leverage ratio of Tier I Capital to total assets equal to 4% in all circumstances.

In order to be "well-capitalized" under the new guidelines, a depository institution must maintain a Common Equity Tier 1 Capital ratio of 6.5% or more; an Additional Tier 1 Capital ratio of 8% or more; a Total Capital ratio of 10% or more; and a leverage ratio of 5% or more.

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The Corporation's and the Bank's actual capital and ratios compared to generally applicable regulatory requirements as of June 30, 2016 are as follows (dollars in thousands):

	Actual		Adequacy Purposes		Well-Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital to risk weighted assets:						
Consolidated	$ 71,630	9.7% >	$ 59,413>	8.0% >	$ 74,266>	10.0%
mBank	$ 93,121	12.6%>	$ 59,170>	8.0% >	$ 73,963>	10.0%
Tier 1 capital to risk weighted assets:						
Consolidated	$ 66,897	9.0% >	$ 44,560>	6.0% >	$ 59,413>	8.0%
mBank	$ 88,429	12.0%>	$ 44,378>	6.0% >	$ 59,170>	8.0%
Common equity Tier 1 capital to risk weighted assets						
Consolidated	$ 66,897	9.0% >	$ 33,420>	4.5% >	$ 48,273>	6.5%
mBank	$ 88,429	12.0%>	$ 33,283>	4.5% >	$ 48,076>	6.5%
Tier 1 capital to average assets:						
Consolidated	$ 66,897	8.1% >	$ 32,973>	4.0% >	$ 41,216>	5.0%
mBank	$ 88,429	10.7%>	$ 32,969>	4.0% >	$ 41,212>	5.0%

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.

MACKINAC FINANCIAL CORPORATION

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.

As of June 30, 2016, the Corporation had established interest rate floors on approximately $153.206 million 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 $91.633 million of the "floor rate" loan balances will reprice with a 100 basis point increase on the prime rate, with another $54.233 million repricing in the next 100 basis point prime rate increase.

The Corporation also has $71.114 million of securities providing for scheduled monthly principal and interest payments as well as unanticipated prepayments of principal as of June 30, 2016. These cash flows are then reinvested into other

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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.

As of June 30, 2016, the Corporation has $449.553 million of transactional accounts, of which $149.435 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 managing 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.

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.

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The following is the Corporation’s repricing opportunities at June 30, 2016 (dollars in thousands):

	1-90 Days	91-365 Days	>1-5 Years	Over 5 Years	Total
Interest-earning assets:					
Loans	$ 272,363	176,505	274,313	2,454	$ 725,635
Securities	11,849	1,847	45,867	11,551	71,114
Other (1)	4,422	1,487	3,923	—	9,832
Total interest-earning assets	288,634	179,839	324,103	14,005	806,581
Interest-bearing obligations:					
NOW, money market, savings and interest checking	300,118	—	—	—	300,118
Time deposits	27,306	57,058	51,106	63	135,533
Brokered CDs	16,042	87,368	49,930	—	153,340
Borrowings	74	7,730	62,800	—	70,604
Total interest-bearing obligations	343,540	152,156	163,836	63	659,595
Gap	$ (54,906)	$ 27,683	$ 160,267	$ 13,942	$ 146,986
Cumulative gap	$ (54,906)	$ (27,223)	$ 133,044	$ 146,986	

(1) Includes Federal Home Loan Bank Stock.

The above analysis indicates that at June 30, 2016, the Corporation had a cumulative liability sensitivity gap position of $27.223 million within the one-year time frame. The Corporation’s cumulative liability sensitive gap suggests that if market interest rates were to increase in the next twelve months, the Corporation has the potential to earn less net interest income. This is because more liabilities would reprice at higher rates than assets. Conversely, if market interest rates decrease in the next twelve months, the above gap position suggests the Corporation’s net interest income would increase. 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, 2015, the Corporation had a cumulative liability sensitivity gap position of $37.492 million within the one-year time frame.

The borrowings in the gap analysis include $46.000 million of FHLB advances that have a weighted average maturity of 2.0 years and a weighted average rate of 2.01%.

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.

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

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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.

MACKINAC FINANCIAL CORPORATION

ITEM 4 CONTROLS AND PROCEDURES

As of June 30, 2016, 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 June 30, 2016.

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 June 30, 2016 that have materially affected, or are reasonably likely to materially affect, the Corporation’s internal control over financial reporting.

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MACKINAC FINANCIAL CORPORATION

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 2. Unregistered Sales of Equity Securities and Use of Proceeds

The Corporation currently has a share repurchase program. The program is conducted under authorizations from time to time by the Board of Directors. The shares reported in the table below are covered by Board authorizations made and publically announced for $600,000 on February 27, 2013, an additional $600,000 on December 17, 2013 and an additional $750,000 on April 28, 2015. None of these authorizations has an expiration date.

Issuer purchase of Equity Securities

Period of purchases	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of a publically announced plan or program	Maximum dollars yet to be used for stock purchases
April 1, 2016 to April 30, 2016	5,000	$ 10.35	5,000	$ 25,335
May 1, 2016 to May 31, 2016	—	$ —	—	25,335
June 1, 2016 to June 30, 2016	—	$ —	—	25,335
Total Second Quarter 2016	5,000	$ 10.35	5,000	

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

Exhibit 2.1	Stock Purchase Agreement, dated as of May 24, 2016, by and between Niagara Bancorporate, Inc. and Mackinac Financial Corporation, incorporated herein by reference
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:	August 15, 2016	By:	/s/ Paul D. Tobias PAUL D. TOBIAS, CHAIRMAN AND CHIEF EXECUTIVE OFFICER (principal executive officer)
		By:	/s/ Jesse A. Deering JESSE A. DEERING EVP/CHIEF FINANCIAL OFFICER (principal financial and accounting officer)