

MACKINAC FINANCIAL CORP /MI/

Form 10-Q

May 15, 2014

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

**For the quarterly period ended March 31, 2014**

**OR**

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

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

**Commission file number: 0-20167**

**MACKINAC FINANCIAL CORPORATION**

(Exact name of registrant as specified in its charter)

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**MICHIGAN**

(State or other jurisdiction of  
incorporation or organization)

**38-2062816**

(I.R.S. Employer Identification No.)

**130 SOUTH CEDAR STREET, MANISTIQUE, MI**

(Address of principal executive offices)

**49854**

(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 April 30, 2014, there were outstanding 5,527,690 shares of the registrant's common stock, no par value.

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## MACKINAC FINANCIAL CORPORATION

PART I. FINANCIAL INFORMATIONITEM 1. FINANCIAL STATEMENTS

## CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands)

	March 31, 2014 (Unaudited)	December 31, 2013	March 31, 2013 (Unaudited)
<b>ASSETS</b>			
Cash and due from banks	\$ 24,748	\$ 18,216	\$ 12,598
Federal funds sold	3	3	3
Cash and cash equivalents	24,751	18,219	12,601
Interest-bearing deposits in other financial institutions	10	10	10
Securities available for sale	47,411	44,388	48,556
Federal Home Loan Bank stock	3,060	3,060	3,060
Loans:			
Commercial	361,299	359,368	345,032
Mortgage	110,759	110,663	97,216
Consumer	13,804	13,801	11,803
Total Loans	485,862	483,832	454,051
Allowance for loan losses	(4,883)	(4,661)	(5,037)
Net loans	480,979	479,171	449,014
Premises and equipment	9,800	10,210	10,587
Other real estate held for sale	2,166	1,884	3,825
Deferred tax asset	9,533	9,933	8,726
Other assets	5,882	5,925	5,517
<b>TOTAL ASSETS</b>	<b>\$ 583,592</b>	<b>\$ 572,800</b>	<b>\$ 541,896</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>			
<b>LIABILITIES:</b>			
Deposits:			
Noninterest bearing deposits	\$ 68,027	\$ 72,936	\$ 57,547
NOW, money market, interest checking	148,023	149,123	161,445
Savings	14,425	13,039	13,273
CDs<\$100,000	154,371	140,495	130,646
CDs>\$100,000	23,317	23,159	24,619
Brokered	67,547	67,547	37,706
Total deposits	475,710	466,299	425,236

## Borrowings:

Fed funds purchased			5,000
FHLB and other	38,852	37,852	35,925
Total borrowings	38,852	37,852	40,925
Other liabilities	3,300	3,400	2,696
Total liabilities	517,862	507,551	468,857

## SHAREHOLDERS EQUITY:

Preferred stock - No par value:

Authorized 500,000 shares, Issued and outstanding - 11,000 shares			11,000
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Common stock and additional paid in capital - No par value

Authorized - 18,000,000 shares

Issued and outstanding - **5,527,690**; 5,541,390; and 5,557,859 shares respectively

	53,590	53,621	53,888
Retained earnings	11,796	11,412	7,181
Accumulated other comprehensive income	344	216	970

Total shareholders equity	65,730	65,249	73,039
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<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>	<b>\$ 583,592</b>	<b>\$ 572,800</b>	<b>\$ 541,896</b>
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See accompanying notes to condensed consolidated financial statements.

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## MACKINAC FINANCIAL CORPORATION

## CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in Thousands, Except per Share Data)

	2014	Three Months Ended March 31, (Unaudited)	2013
<b>INTEREST INCOME:</b>			
Interest and fees on loans:			
Taxable	\$	6,281	\$ 5,889
Tax-exempt		23	27
Interest on securities:			
Taxable		237	240
Tax-exempt		13	7
Other interest income		48	31
Total interest income		6,602	6,194
<b>INTEREST EXPENSE:</b>			
Deposits		822	877
Borrowings		187	161
Total interest expense		1,009	1,038
Net interest income		5,593	5,156
Provision for loan losses		183	375
Net interest income after provision for loan losses		5,410	4,781
<b>OTHER INCOME:</b>			
Deposit service fees		157	162
Income from loans sold on the secondary market		103	299
SBA/USDA loan sale gains		382	109
Mortgage servicing income		13	103
Other		36	85
Total other income		691	758
<b>OTHER EXPENSE:</b>			
Salaries and employee benefits		2,541	2,306
Occupancy		538	382
Furniture and equipment		319	270
Data processing		286	265
Advertising		107	104
Professional service fees		331	225
Loan and deposit		79	73
Writedowns and losses on other real estate held for sale			2
FDIC insurance assessment		85	105
Telephone		82	82
Other		739	497
Total other expenses		5,107	4,311
Income before provision for income taxes		994	1,228

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Provision for income taxes	334	415
<b>NET INCOME</b>	<b>660</b>	<b>813</b>
<b>Preferred dividend and accretion of discount</b>		<b>137</b>
<b>NET INCOME AVAILABLE TO COMMON SHAREHOLDERS</b>	<b>\$ 660</b>	<b>\$ 676</b>
<b>INCOME PER COMMON SHARE:</b>		
Basic	<b>\$ .12</b>	<b>\$ .12</b>
Diluted	<b>\$ .12</b>	<b>\$ .12</b>

See accompanying notes to condensed consolidated financial statements.

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## MACKINAC FINANCIAL CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS COMPREHENSIVE INCOME

(Dollars in Thousands)

(Unaudited)

	Three Months Ended March 31,	
	2014	2013
Net income	\$ 660	\$ 813
Net change in net unrealized gains and losses on securities available for sale:		
Unrealized gains arising during the period	193	69
Less: reclassification adjustment for gains included in net income		
Net securities gain during the period	193	69
Tax effect	(65)	(23)
Other comprehensive income	128	46
Total comprehensive income	\$ 788	\$ 859

## CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(Dollars in Thousands)

(Unaudited)

	2014		Three Months Ended March 31,		2013	
	Preferred Stock	Common Shareholders Equity	Total Shareholders Equity	Preferred Stock	Common Shareholders Equity	Total Shareholders Equity
Balance, beginning of period	\$	\$ 65,249	\$ 65,249	\$ 11,000	\$ 61,448	\$ 72,448
Net income for period		660	660		813	813
Net unrealized gain on securities available for sale		128	128		46	46
Total comprehensive income		788	788		859	859
Stock compensation		112	112		108	108
Dividend on common stock		(276)	(276)		(222)	(222)
Repurchase of common stock		(143)	(143)		(17)	(17)
Dividend on preferred stock					(137)	(137)
Balance, end of period	\$	\$ 65,730	\$ 65,730	\$ 11,000	\$ 62,039	\$ 73,039

See accompanying notes to condensed consolidated financial statements.





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MACKINAC FINANCIAL CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in Thousands)

(Unaudited)

	Three Months Ended March 31,	
	2014	2013
<b><u>Cash Flows from Operating Activities:</u></b>		
Net income	\$ 660	\$ 813
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	391	416
Provision for loan losses	183	375
Deferred income taxes, net	334	415
(Gain) on sale of loans sold to secondary market	(81)	(239)
Origination of loans held for sale in secondary market	(4,987)	(16,722)
Proceeds from sale of loans in the secondary market	5,068	16,961
Loss on sale of premises, equipment, and other real estate held for sale	29	2
Stock compensation	112	108
Change in other assets	43	(302)
Change in other liabilities	(100)	(354)
Net cash provided by operating activities	1,652	1,473
<b><u>Cash Flows from Investing Activities:</u></b>		
Net (increase) in loans	(2,272)	(6,110)
Purchase of securities available for sale	(3,027)	(4,974)
Proceeds from maturities, sales, calls or paydowns of securities available for sale	149	164
Capital expenditures	(499)	(250)
Proceeds from sale of premises, equipment, and other real estate	537	34
Net cash (used in) investing activities	(5,112)	(11,136)
<b><u>Cash Flows from Financing Activities:</u></b>		
Net increase (decrease) in deposits	9,411	(9,321)
Net increase in fed funds purchased		5,000
Net increase in borrowings	1,000	
Repurchase of common stock	(143)	(17)
Dividend on common stock	(276)	(222)
Dividend on preferred stock		(137)
Net cash provided by (used in) financing activities	9,992	(4,697)
Net increase (decrease) in cash and cash equivalents	6,532	(14,360)
Cash and cash equivalents at beginning of period	18,219	26,961
Cash and cash equivalents at end of period	\$ 24,751	\$ 12,601
<b><u>Supplemental Cash Flow Information:</u></b>		
Cash paid during the year for:		
Interest	\$ 1,001	\$ 603
Income taxes	25	

**Noncash Investing and Financing Activities:**

Transfers of Foreclosures from Loans to Other Real Estate Held for Sale (net of adjustments made through the allowance for loan losses)	282	649
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See accompanying notes to condensed consolidated financial statements.

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Basis of Presentation**

The unaudited condensed consolidated financial statements of Mackinac Financial Corporation (the "Corporation") have been prepared in accordance with generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three-month period ended March 31, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. 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, 2013.

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

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, and the valuation of deferred tax assets, mortgage servicing rights and other real estate held for sale.

**Allowance for Loan Losses**

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

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

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

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

**Stock Compensation Plans**

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, 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, which included 392,152 option shares outstanding at that time. Awards are made at the discretion of management. Compensation cost equal to the fair value of the award is recognized over the vesting period.

The Corporation, in August 2012 and March 2014, granted Restricted Stock Units ( 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. 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 and \$.683 million, respectively. On August 31, 2013, the Corporation issued 37,125 shares of its common stock for vested RSUs. As of March 31, 2014, RSUs totaling 164,149 were unvested and unrecognized compensation expense, was \$1.347 million.

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

2. **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 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.

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The following shows the computation of basic and diluted earnings per share for the three months ended March 31, 2014 and 2013 (dollars in thousands, except per share data):

	Three Months Ended March 31,	
	2014	2013
<b>(Numerator):</b>		
Net income	\$ 660	\$ 813
Preferred stock dividends and accretion of discount		137
Net income available to common shareholders	\$ 660	\$ 676
<b>(Denominator):</b>		
Weighted average shares outstanding - basic	5,530,908	5,559,570
Effect of dilutive stock options and vesting of restricted stock units	20,901	
Weighted average shares outstanding - diluted	5,551,809	5,559,570
Income per common share:		
Basic	\$ .12	\$ .12
Diluted	\$ .12	\$ .12

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## MACKINAC FINANCIAL CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**3. INVESTMENT SECURITIES**

The amortized cost and estimated fair value of investment securities available for sale as of March 31, 2014, December 31, 2013 and March 31, 2013 are as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<b><u>March 31, 2014</u></b>				
US Agencies	\$ 17,745	\$ 40	\$ (287)	\$ 17,498
Corporate Bonds	15,776	201		15,977
US Agencies - MBS	6,938	278		7,216
Obligations of states and political subdivisions	6,431	292	(3)	6,720
<b>Total securities available for sale</b>	<b>\$ 46,890</b>	<b>\$ 811</b>	<b>\$ (290)</b>	<b>\$ 47,411</b>
<b><u>December 31, 2013</u></b>				
US Agencies	\$ 15,227	\$	\$ (372)	\$ 14,855
Corporate Bonds	15,862	218	(1)	16,079
US Agencies - MBS	7,078	281		7,359
Obligations of states and political subdivisions	5,893	202		6,095
<b>Total securities available for sale</b>	<b>\$ 44,060</b>	<b>\$ 701</b>	<b>\$ (373)</b>	<b>\$ 44,388</b>
<b><u>March 31, 2013</u></b>				
US Agencies	\$ 15,206	\$ 116	\$ (2)	\$ 15,320
Corporate Bonds	18,660	271	(3)	18,928
US Agencies - MBS	7,797	414		8,211
Obligations of states and political subdivisions	5,424	674	(1)	6,097
<b>Total securities available for sale</b>	<b>\$ 47,087</b>	<b>\$ 1,475</b>	<b>\$ (6)</b>	<b>\$ 48,556</b>



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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 \$4.599 million and \$4.758 million, respectively, at March 31, 2014.

### 4. LOANS

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

Commercial real estate	\$	267,153	\$ 268,809 \$ 246,207
One to four family residential real estate		104,376	103,768 89,629
Consumer		6,383	6,895 7,587
Consumer		13,804	13,801 11,803
Total loans	\$	485,862	\$ 483,832 \$ 454,051

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## MACKINAC FINANCIAL CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**4. LOANS** (Continued)

An analysis of the allowance for loan losses for the three months ended March 31, 2014, the year ended December 31, 2013, and the three months ended March 31, 2013 is as follows (dollars in thousands):

	March 31, 2014	December 31, 2013	March 31, 2013
Balance at beginning of period	\$ 4,661	\$ 5,218	\$ 5,218
Recoveries on loans previously charged off	121	200	24
Loans charged off	(82)	(2,432)	(580)
Provision	183	1,675	375
Balance at end of period	\$ 4,883	\$ 4,661	\$ 5,037

In the first quarter of 2014 net recovery activity was \$39,000, compared to net charge-offs of \$.566 million, or .50% of average loans, in the same period in 2013. In the first quarter of 2014, the Corporation recorded a provision for loan loss of \$.183 million, compared to \$.375 million in the first quarter of 2013. The Corporation's allowance for loan loss reserve policy calls for a measurement of the adequacy of the reserve at each quarter end. This process includes an analysis of the loan portfolio to take into account increases in loans outstanding and portfolio composition, historical loss rates, and specific reserve requirements of nonperforming loans.

A breakdown of the allowance for loan losses and recorded balances in loans at March 31, 2014 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
<b>Allowance for loan loss reserve:</b>								
Beginning balance								
ALLR	\$ 1,849	\$ 1,378	\$ 80	\$ 516	\$ 25	\$ 148	\$ 665	\$ 4,661
Charge-offs	(1)	(62)		(3)		(16)		(82)
Recoveries	54	44	3	6		14		121
Provision	(146)	212	(42)	(128)	(9)	(32)	328	183
Ending balance ALLR	\$ 1,756	\$ 1,572	\$ 41	\$ 391	\$ 16	\$ 114	\$ 993	\$ 4,883
<b>Loans:</b>								
Ending balance	\$ 267,153	\$ 83,461	\$ 10,685	\$ 104,376	\$ 6,383	\$ 13,804		\$ 485,862
Ending balance ALLR	(1,756)	(1,572)	(41)	(391)	(16)	(114)	(993)	(4,883)

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Net loans	\$	265,397	\$	81,889	\$	10,644	\$	103,985	\$	6,367	\$	13,690	\$	(993)	\$	480,979
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**Ending balance ALLR:**

Individually evaluated	\$	189	\$	1,111	\$		\$	98	\$		\$	8	\$		\$	1,406
Collectively evaluated		1,567		461		41		293		16		106		993		3,477
Total	\$	1,756	\$	1,572	\$	41	\$	391	\$	16	\$	114	\$	993	\$	4,883

**Ending balance Loans:**

Individually evaluated	\$	610	\$	1,748	\$		\$	513	\$		\$	25	\$		\$	2,896
Collectively evaluated		266,543		81,713		10,685		103,863		6,383		13,779				482,966
Total	\$	267,153	\$	83,461	\$	10,685	\$	104,376	\$	6,383	\$	13,804	\$		\$	485,862

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

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## MACKINAC FINANCIAL CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**4. LOANS** (Continued)

A breakdown of the allowance for loan losses and recorded balances in loans at December 31, 2013 is as follows (dollars in thousands):

	Commercial real estate	Commercial, financial and agricultural	Commercial construction	One to four family residential real estate	Consumer construction	Consumer	Unallocated	Total
<b>Allowance for loan loss reserve:</b>								
Beginning balance ALLR	\$ 3,267	\$ 692	\$ 125	\$ 980	\$	\$	154	5,218
Charge-offs	(1,539)	(632)		(141)		(120)		(2,432)
Recoveries	92	56	2	26	2	22		200
Provision	29	1,262	(47)	(349)	23	246	511	1,675
Unallocated assignment								
Ending balance ALLR	\$ 1,849	\$ 1,378	\$ 80	\$ 516	\$ 25	\$ 148	\$ 665	\$ 4,661
<b>Loans:</b>								
Ending balance	\$ 268,809	\$ 79,655	\$ 10,904	\$ 103,768	\$ 6,895	\$ 13,801	\$	\$ 483,832
Ending balance ALLR	(1,849)	(1,378)	(80)	(516)	(25)	(148)	(665)	(4,661)
Net loans	\$ 266,960	\$ 78,277	\$ 10,824	\$ 103,252	\$ 6,870	\$ 13,653	\$ (665)	\$ 479,171
<b>Ending balance ALLR:</b>								
Individually evaluated	99	891		103		18		1,111
Collectively evaluated	1,750	487	80	413	25	130	665	3,550
Total	\$ 1,849	\$ 1,378	\$ 80	\$ 516	\$ 25	\$ 148	\$ 665	\$ 4,661
<b>Ending balance Loans:</b>								
Individually evaluated	\$ 649	\$ 1,830	\$	\$ 385	\$	\$ 42	\$	\$ 2,906
Collectively evaluated	268,160	77,825	10,904	103,383	6,895	13,759		480,926
Total	\$ 268,809	\$ 79,655	\$ 10,904	\$ 103,768	\$ 6,895	\$ 13,801	\$	\$ 483,832

A breakdown of the allowance for loan losses and recorded balances in loans at March 31, 2013 is as follows (dollars in thousands):

	Commercial real estate	Commercial, financial and agricultural	Commercial construction	One to four family residential real estate	Consumer construction	Consumer	Unallocated	Total
<b>Allowance for loan loss reserve:</b>								
Beginning balance ALLR	\$ 3,267	\$ 692	\$ 125	\$ 980	\$	\$	154	5,218
Charge-offs	(435)	(72)		(7)		(66)		(580)
Recoveries	12	3	1	5		3		24
Provision	120	224	(8)	12		76	(49)	375

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Unallocated  
assignment

Ending balance ALLR	\$	2,964	\$	847	\$	118	\$	990	\$	13	\$	105	\$	5,037
---------------------	----	-------	----	-----	----	-----	----	-----	----	----	----	-----	----	-------

**Loans:**

Ending balance	\$	246,207	\$	82,530	\$	16,295	\$	89,629	\$	7,587	\$	11,803	\$	454,051
Ending balance ALLR		(294)		(847)		(118)		(990)		(13)		(105)		(5,037)
Net loans	\$	245,913	\$	81,683	\$	16,177	\$	88,639	\$	7,587	\$	11,790	\$	449,014

**Ending balance**

**ALLR:**

Individually evaluated	\$	1,428	\$	321	\$	10	\$	150	\$	13	\$		\$	1,922
Collectively evaluated		1,536		526		108		840				105		3,115
Total	\$	2,964	\$	847	\$	118	\$	990	\$	13	\$	105	\$	5,037

**Ending balance**

**Loans:**

Individually evaluated	\$	21,836	\$	6,097	\$	975	\$	477	\$	13	\$		\$	29,398
Collectively evaluated		224,371		76,433		15,320		89,152		7,587		11,790		424,653
Total	\$	246,207	\$	82,530	\$	16,295	\$	89,629	\$	7,587	\$	11,803	\$	454,051

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. **LOANS** (Continued)

As part of the management of the loan portfolio, risk ratings are assigned to all commercial loans. Through the loan review process, ratings are modified as believed to be appropriate to reflect changes in the credit. Our ability to manage credit risk depends in large part on our ability to properly identify and manage problem loans.

To do so, we operate a credit risk rating system under which our credit management personnel assign a credit risk rating to each loan at the time of origination and review loans on a regular basis to determine each loan's credit risk rating on a scale of 1 through 8, with higher scores indicating higher risk. The credit risk rating structure used is shown below.

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

***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.

***Average (3)***

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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.

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. **LOANS** (Continued)

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

Commercial construction loans in the amount of \$3.323 million, \$2.951 million and \$3.317 million for the periods ended March 31, 2014, December 31, 2013 and March 31, 2013, respectively did not receive a specific risk rating. These amounts represent loans made for land development and unimproved land purchases. Below is a breakdown of loans by risk category as of March 31, 2014 (dollars in thousands):



	(1) Strong	(2) Good	(3) Average	(4) Acceptable/ Acceptable Watch	(5) Sp. Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	\$ 3,039	\$ 24,678	\$ 117,113	\$ 120,167	\$	\$ 2,156	\$		\$ 267,153
Commercial, financial and agricultural	3,634	3,388	28,004	45,309		3,126			83,461
Commercial construction	30	463	3,513	2,954		402		3,323	10,685
One to four family residential real estate		3,360	1,246	4,339				95,431	104,376
Consumer construction								6,383	6,383
Consumer				25				13,779	13,804
Total loans	\$ 6,703	\$ 31,889	\$ 149,876	\$ 172,794	\$	\$ 5,684	\$	\$ 118,916	\$ 485,862

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## MACKINAC FINANCIAL CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**4. LOANS** (Continued)

Below is a breakdown of loans by risk category as of December 31, 2013 (dollars in thousands):

	(1) Strong	(2) Good	(3) Average	(4) Acceptable/ Acceptable Watch	(5) Sp. Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	\$ 1,502	\$ 23,310	\$ 116,702	\$ 125,010	\$	\$ 2,285	\$	\$	\$ 268,809
Commercial, financial and agricultural	3,741	4,348	27,455	39,070		5,041			79,655
Commercial construction	30	479	2,702	4,340		402		2,951	10,904
One-to-four family residential real estate	251	3,074	1,275	4,482		710		93,976	103,768
Consumer construction								6,895	6,895
Consumer	10		37	43		30		13,681	13,801
Total loans	\$ 5,534	\$ 31,211	\$ 148,171	\$ 172,945	\$	\$ 8,468	\$	\$ 117,503	\$ 483,832

Below is a breakdown of loans by risk category as of March 31, 2013 (dollars in thousands):

	(1) Strong	(2) Good	(3) Average	(4) Acceptable/ Acceptable Watch	(5) Sp. Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	\$ 5,541	\$ 21,220	\$ 85,101	\$ 112,846	\$ 16,529	\$ 4,781	\$ 189	\$	\$ 246,207
Commercial, financial and agricultural	5,004	4,613	23,156	43,719	4,080	1,958			82,530
Commercial construction		740	5,392	5,687	757	402		3,317	16,295
One to four family residential real estate		1,961	3,109	4,667		534		79,358	89,629
Consumer construction								7,587	7,587

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Consumer			177		50		370								11,206	11,803		
Total loans	\$	10,545	\$	28,711	\$	116,808	\$	167,289	\$	21,366	\$	7,675	\$	189	\$	101,468	\$	454,051

**Impaired Loans**

Nonperforming loans are those which are contractually past due 90 days or more as to interest or principal payments, on nonaccrual status, or loans, the terms of which have been renegotiated to provide a reduction or deferral on interest or principal. There was no interest income recorded during impairment for the three months ended March 31, 2014. Interest income that would have been recognized during this period was \$.024 million. For the three months ended March 31, 2013, the income that would have been recorded was \$.058 million.

The accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Loans are considered impaired when, based on current information and events, it is probable the Corporation will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loans basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

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## MACKINAC FINANCIAL CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**4. LOANS** (Continued)

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

	Nonaccrual Basis	Accrual Basis	Average Investment	Related Valuation Reserve	Interest Income Recognized During Impairment	Interest Income on Accrual Basis
<i>March 31, 2014</i>						
<i>With no valuation reserve:</i>						
Commercial real estate	\$ 279	\$	\$ 322	\$	\$	\$ 4
Commercial, financial and agricultural	142		183			2
Commercial construction						
One to four family residential real estate	67		235			3
Consumer construction						
Consumer			9			
<i>With a valuation reserve:</i>						
Commercial real estate	\$ 176	\$	\$ 176	\$ 104	\$	\$ 4
Commercial, financial and agricultural	588		597	271		7
Commercial construction						
One to four family residential real estate	232		215	44		4
Consumer construction						
Consumer	7		8	1		
<i>Total:</i>						
Commercial real estate	\$ 455	\$	\$ 498	\$ 104	\$	\$ 8
Commercial, financial and agricultural	730		780	271		9
Commercial construction						
One to four family residential real estate	299		450	44		7
Consumer construction						
Consumer	7		17	1		
Total	\$ 1,491	\$	\$ 1,745	\$ 420	\$	\$ 24

*December 31, 2013**With no valuation reserve:*

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Commercial real estate	\$	513	\$	\$	3,045	\$	\$	\$	153
Commercial, financial and agricultural		59			505				13
Commercial construction					626				3
One to four family residential real estate		361			625				16
Consumer construction									
Consumer					2				
<i>With a valuation reserve:</i>									
Commercial real estate	\$	59	\$	\$	71	\$	14	\$	5
Commercial, financial and agricultural		752			834		265		18
Commercial construction									
One to four family residential real estate		250			261		78		20
Consumer construction									
Consumer		30			30		13		
<i>Total:</i>									
Commercial real estate	\$	572	\$	\$	3,116	\$	14	\$	158
Commercial, financial and agricultural		811			1,339		265		31
Commercial construction					626				3
One to four family residential real estate		611			886		78		36
Consumer construction									
Consumer		30			32		13		
Total	\$	2,024	\$	\$	5,999	\$	370	\$	228

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## MACKINAC FINANCIAL CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. **LOANS** (Continued)

	Nonaccrual Basis	Accrual Basis	Average Investment	Related Valuation Reserve	Interest Income Recognized During Impairment	Interest Income on Accrual Basis
<i>March 31, 2013</i>						
<i>With no valuation reserve:</i>						
Commercial real estate	\$ 738	\$	\$ 846	\$	\$	12
Commercial, financial and agricultural	316		306			3
Commercial construction			482			3
One to four family residential real estate	112		155			2
Consumer construction						
Consumer						
<i>With a valuation reserve:</i>						
Commercial real estate	\$ 2,225	\$	\$ 2,269	\$ 1,112	\$	30
Commercial, financial and agricultural	108		109	35		2
Commercial construction						
One to four family residential real estate	334		315	129		6
Consumer construction						
Consumer						
<i>Total:</i>						
Commercial real estate	\$ 2,963	\$	\$ 3,115	\$ 1,112	\$	42
Commercial, financial and agricultural	424		415	35		5
Commercial construction			482			3
One to four family residential real estate	446		470	129		8
Consumer construction						
Consumer						
Total	\$ 3,833	\$	\$ 4,482	\$ 1,276	\$	58

A summary of past due loans at March 31, 2014, December 31, 2013 and March 31, 2013 is as follows (dollars in thousands):

March 31,  
2014December 31,  
2013March 31,  
2013

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	30-89 days Past Due (accruing)	90+ days Past Due/ Nonaccrual	Total	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	\$ 729	\$ 455	\$ 1,184	\$	\$ 572	\$ 572	\$ 385	\$ 2,963	\$ 3,348
Commercial, financial and agricultural	18	730	748	4	811	815	186	424	610
Commercial construction				20		20	24		24
One to four family residential real estate	471	299	770	201	611	812	101	446	547
Consumer construction									
Consumer	18	7	25	14	30	44	13		13
Total past due loans	\$ 1,236	\$ 1,491	\$ 2,727	\$ 239	\$ 2,024	\$ 2,263	\$ 709	\$ 3,833	\$ 4,542

A roll-forward of nonaccrual activity for the three months ended March 31, 2014 (dollars in thousands):

For the Three Months Ended March 31, 2014							
	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer Construction	Consumer	Total
<b>NONACCRUAL</b>							
Beginning balance	\$ 572	\$ 811	\$	\$ 611	\$	\$ 30	\$ 2,024
Principal payments	(99)	(18)		(7)		(4)	(128)
Charge-offs		(53)		(3)		(19)	(75)
Advances							
Class transfers							
Transfers to OREO	(26)			(257)			(283)
Transfers to accruing		(10)		(127)			(137)
Transfers from accruing				82			82
Other	8						8
Ending balance	\$ 455	\$ 730	\$	\$ 299	\$	\$ 7	\$ 1,491

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## MACKINAC FINANCIAL CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**4. LOANS** (Continued)

A roll-forward of nonaccrual activity during the year ended December 31, 2013 (dollars in thousands):

	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer Construction	Consumer	Total
<b>NONACCRUAL</b>							
Beginning balance	\$ 3,071	\$ 436	\$ 675	\$ 505	\$	\$	\$ 4,687
Principal payments	(1,478)	(319)	(100)	(88)		(2)	(1,987)
Charge-offs	(1,304)	(616)		(141)		(4)	(2,065)
Advances							
Class transfers							
Transfers to OREO	(208)	(37)	(580)	(107)			(932)
Transfers to accruing							
Transfers from accruing	443	1,346		434		36	2,259
Other	48	1	5	8			62
Ending balance	\$ 572	\$ 811	\$	\$ 611	\$	\$ 30	\$ 2,024

A roll-forward of nonaccrual activity for the three months ended March 31, 2013 (dollars in thousands):

	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer Construction	Consumer	Total
<b>NONACCRUAL</b>							
Beginning balance	\$ 3,071	\$ 436	\$ 675	\$ 505	\$	\$	\$ 4,687
Principal payments	(117)	(2)	(100)	(49)			(268)
Charge-offs	(329)	(72)		(7)			(408)
Advances							



Class transfers														
Transfers to OREO				(580)		(69)			(649)					
Transfers to accruing														
Transfers from														
accruing	317		62			62			441					
Other	21			5		4			30					
Ending balance	\$	2,963	\$	424	\$		\$	446	\$		\$		\$	3,833

**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.

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## MACKINAC FINANCIAL CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. **LOANS** (Continued)

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

	Three Months Ended March 31, 2014		Year Ended December 31, 2013		Three Months Ended March 31, 2013	
	Number of Modifications	Recorded Investment	Number of Modifications	Recorded Investment	Number of Modifications	Recorded Investment
Commercial real estate		\$		\$		\$
Commercial, financial and agricultural			1	528	1	953
Commercial construction						
One to four family residential real estate						
Consumer construction						
Consumer						
Total troubled debt restructurings		\$	1	\$ 528	1	\$ 953

A roll-forward of troubled debt restructuring during the period ended March 31, 2014 (dollars in thousands):

	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer and Consumer Construction	Total
<b>ACCRUING</b>						
Beginning balance	\$ 3,520	\$ 1,186	\$ 858	\$ 99	\$	\$ 5,663
Principal payments	(2,511)			(3)		(2,514)
Charge-offs						
Advances						
New restructured						
Transferred out of TDR						
Transfer from nonaccrual				91		91
Transfers to nonaccrual						
Ending Balance	\$ 1,009	\$ 1,186	\$ 858	\$ 187	\$	\$ 3,240

NONACCRUAL										
Beginning balance	\$		\$	523	\$		\$	91	\$	614
Principal payments				(15)						(15)
Charge-offs										
Advances										
New restructured										
Transfer to accruing								(91)		(91)
Transfers from accruing										
Ending Balance	\$		\$	508	\$		\$		\$	508
TOTALS										
Beginning balance	\$	3,520	\$	1,709	\$	858	\$	190	\$	6,277
Principal payments		(2,511)		(15)				(3)		(2,529)
Charge-offs										
Advances										
New restructured										
Transfers out of TDRs										
Transfers from nonaccrual								91		91
Transfers to accruing								(91)		(91)
Ending Balance	\$	1,009	\$	1,694	\$	858	\$	187	\$	3,748

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## MACKINAC FINANCIAL CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**4. LOANS** (Continued)

A roll-forward of troubled debt restructuring during the year ended December 31, 2013 (dollars in thousands):

	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer and Consumer Construction	Total
<b>ACCRUING</b>						
Beginning balance	\$ 3,611	\$ 1,221	\$ 858	\$ 102	\$	\$ 5,792
Principal payments	(91)	(460)		(3)		(554)
Charge-offs						
Advances						
New restructured		953				953
Transferred out of TDR						
Transfers to nonaccrual		(528)				(528)
Ending Balance	\$ 3,520	\$ 1,186	\$ 858	\$ 99	\$	\$ 5,663
<b>NONACCRUAL</b>						
Beginning balance	\$ 2,162	\$	\$	\$ 102	\$	\$ 2,264
Principal payments	(1,376)	(5)		(15)		(1,396)
Charge-offs	(793)					(793)
Advances						
New restructured	7	528		4		539
Transfers to foreclosed properties						
Transfers from accruing						
Ending Balance	\$	\$ 523	\$	\$ 91	\$	\$ 614
<b>TOTALS</b>						
Beginning balance	\$ 5,773	\$ 1,221	\$ 858	\$ 204	\$	\$ 8,056
Principal payments	(1,467)	(465)		(18)		(1,950)
Charge-offs	(793)					(793)
Advances						
New restructured	7	1,481		4		1,492

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Transfers out of TDRs										
Transfers to nonaccrual		(528)				(528)				
Transfers to foreclosed properties										
Transfers from accruing										
Ending Balance	\$	3,520	\$	1,709	\$	858	\$	190	\$	6,277

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## MACKINAC FINANCIAL CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**4. LOANS** (Continued)

A roll-forward of troubled debt restructuring during the year ended March 31, 2013 (dollars in thousands):

	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer and Consumer Construction	Total
<b>ACCRUING</b>						
Beginning balance	\$ 3,611	\$ 1,221	\$ 858	\$ 102	\$	\$ 5,792
Principal payments	(23)			(2)		(25)
Charge-offs						
Advances						
New restructured		953				953
Transferred out of TDR						
Transfers to nonaccrual						
Ending Balance	\$ 3,588	\$ 2,174	\$ 858	\$ 100	\$	\$ 6,720
<b>NONACCRUAL</b>						
Beginning balance	\$ 2,162	\$	\$	\$ 102	\$	\$ 2,264
Principal payments						
Charge-offs						
Advances						
New restructured	7			4		11
Transfers to foreclosed properties						
Transfers from accruing						
Ending Balance	\$ 2,169	\$	\$	\$ 106	\$	\$ 2,275
<b>TOTALS</b>						
Beginning balance	\$ 5,773	\$ 1,221	\$ 858	\$ 204	\$	\$ 8,056
Principal payments	(23)			(2)		(25)
Charge-offs						
Advances						
New restructured	7	953		4		964
Transfers out of TDRs						
Transfers to nonaccrual						
Transfers to foreclosed properties						

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## Transfers from accruing

Ending Balance	\$	5,757	\$	2,174	\$	858	\$	206	\$	8,995
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## 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):

	March 31, 2014	December 31, 2013	March 31, 2013
Loans outstanding, beginning of period	\$ 9,043	\$ 11,297	\$ 11,297
New loans		496	25
Net activity on revolving lines of credit	760	(266)	(24)
Repayment	(1,436)	(2,484)	(405)
Loans outstanding, end of period	\$ 8,367	\$ 9,043	\$ 10,893

There were no loans to related parties classified substandard as of March 31, 2014, December 31, 2013 or March 31, 2013. In addition to the outstanding balances above, there were unfunded commitments of \$1.155 million to related parties at March 31, 2014.

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## MACKINAC FINANCIAL CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**5. MORTGAGE SERVICING RIGHTS**

Mortgage servicing rights ( MSRs ) are recorded when loans are sold in the secondary market with servicing retained. As of March 31, 2014, the Corporation had obligations to service approximately \$135 million of residential first mortgage loans. The valuation is based upon the net present value of the projected revenues over the expected life of the loans being serviced, as reduced by estimated internal costs to service these loans. The fair value of the capitalized servicing rights approximates the carrying value. The key economic assumptions used in determining the fair value of the mortgage servicing rights include an annual constant prepayment speed of 10.13% and a discount rate of 8.16% for March 31, 2014.

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

	Three Months Ended March 31, 2014	Year Ended December 31, 2013	Three Months Ended March 31, 2013
Balance at beginning of period	\$ 1,129	\$ 638	\$ 638
Additions from loans sold with servicing retained		675	75
Amortization	(72)	(184)	(38)
Balance at end of period	\$ 1,057	\$ 1,129	\$ 675

**6. BORROWINGS**

Borrowings consist of the following at March 31, 2014, December 31, 2013 and March 31, 2013 (dollars in thousands):

	March 31, 2014	December 31, 2013	March 31, 2013
Federal Home Loan Bank fixed rate advances at March 31, 2014 with a weighted average rate of 1.82% maturing in 2014, 2016 and 2018	\$ 35,000	\$ 35,000	\$ 35,000



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Correspondent bank line of credit	2,000		
Correspondent bank term note, current floor rate of 4%, maturing March 22, 2017	3,000		
USDA Rural Development, fixed-rate note payable, maturing August 24, 2024, interest payable at 1%	852	852	925
	\$ 38,852	\$ 37,852	\$ 35,925

The Federal Home Loan Bank borrowings are collateralized at March 31, 2014 by the following: a collateral agreement on the Corporation's one to four family residential real estate loans with a book value of approximately \$40.358 million; mortgage related and municipal securities with an amortized cost and estimated fair value of \$4.524 million and \$4.683 million, respectively; and Federal Home Loan Bank stock owned by the Bank totaling \$3.060 million. Prepayment of the advances is subject to the provisions and conditions of the credit policy of the Federal Home Loan Bank of Indianapolis in effect as of March 31, 2014.

The USDA Rural Development borrowing is collateralized by loans totaling \$.133 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 \$.873 million, and guaranteed by the Corporation.

The correspondent bank borrowing relationship consists of a 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 March 22, 2015. The term note bears the same interest and matures on March 22, 2017.

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## MACKINAC FINANCIAL CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**7. 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, 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, which included 392,152 option shares outstanding at that time.

The Corporation, in August 2012 and March 2014, granted Restricted Stock Units ( 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 the RSUs issued in August 2012, 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. 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 and \$.683 million, respectively. On August 31, 2013, the Corporation issued 37,125 shares of its common stock for vested RSUs. As of March 31, 2014, RSUs totaling 164,149 were unvested and unrecognized compensation expense, was \$1.347 million.

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

A summary of stock option transactions for the three months ended March 31, 2014 and 2013, and the year ended December 31, 2014, is as follows:

	March 31, 2014	December 31, 2013	March 31, 2013
Outstanding shares at beginning of year	237,152	242,152	242,152
Granted during the period			
Exercised during the period			
Expired / forfeited during the period		(5,000)	

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Outstanding shares at end of period	<b>237,152</b>	237,152	242,152
Exercisable shares at end of period	<b>124,861</b>	124,861	126,361
Weighted average exercise price per share at end of period	\$ <b>9.88</b>	\$ 9.88	\$ 9.88
Shares available for grant at end of period			

There were no options granted in the first three months of 2014 and 2013.

Following is a summary of the options outstanding and exercisable at March 31, 2014:

Exercise Price	Outstanding	Number Exercisable	Unvested Options	Weighted Average Remaining Contractual Life-Years
\$ 9.75	217,152	120,861	96,291	.73
\$ 10.65	10,000	2,000	8,000	1.29
\$ 12.00	10,000	2,000	8,000	2.71
	237,152	124,861	112,291	.84

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**7. STOCK COMPENSATION PLANS** (Continued)

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 underlying Corporation's 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.

**8. INCOME TAXES**

A valuation allowance is provided against deferred tax assets when it is more likely than not that some or all of the deferred tax asset will not be realized. The Corporation, as of March 31, 2014 had a net operating loss and tax credit carryforwards for tax purposes of approximately \$19.2 million, and \$2.1 million, respectively. The net operating loss carryforwards expire twenty years from the date they originated. These carryforwards, if not utilized, will begin to expire in the year 2023. A portion of the NOL, approximately \$12.8 million, and all of the credit carryforwards are subject to the limitations for utilization as set forth in Section 382 of the Internal Revenue Code. The annual limitation is \$1.400 million for the NOL and the equivalent value of tax credits, which is approximately \$.476 million. These limitations for use were established in conjunction with the recapitalization of the Corporation in December 2004.

The Corporation has reported deferred tax assets of \$9.533 million at March 31, 2014, which is net of a valuation allowance of \$.760 million. Management evaluated the deferred tax valuation allowance as of March 31, 2014 and determined that no adjustment to the valuation was warranted. The remaining valuation allowance pertains to the existing tax credit carryovers, which will only be utilized after all net operating loss carryforwards. Since a portion of these tax credits may expire before that occurs, a valuation allowance for these has been established. 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.

**9. FAIR VALUE MEASUREMENTS**

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

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

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

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

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

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

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

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## MACKINAC FINANCIAL CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

**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.

The following table presents information for financial instruments at March 31, 2014, December 31, 2013 and March 31, 2013 (dollars in thousands):

		March 31, 2014		December 31, 2013		March 31, 2013	
	Level in Fair Value Hierarchy	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<b>Financial assets:</b>							
Cash and cash equivalents	Level 1	\$ 24,751	\$ 24,751	\$ 18,219	\$ 18,219	\$ 12,601	\$ 12,601
Interest-bearing deposits	Level 2	10	10	10	10	10	10
Securities available for sale	Level 2	47,411	47,411	44,388	44,388	48,556	48,556
Federal Home Loan Bank stock	Level 2	3,060	3,060	3,060	3,060	3,060	3,060
Net loans	Level 3	480,979	481,101	479,171	479,538	449,014	443,522
Accrued interest receivable	Level 3	1,468	1,468	1,351	1,351	1,709	1,709
<b>Total financial assets</b>		<b>\$ 557,679</b>	<b>\$ 557,801</b>	<b>\$ 546,199</b>	<b>\$ 546,566</b>	<b>\$ 514,950</b>	<b>\$ 509,458</b>
<b>Financial liabilities:</b>							

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Deposits	Level 2	\$ 475,710	\$ 474,958	\$ 466,299	\$ 465,431	\$ 425,236	\$ 424,867
Borrowings	Level 2	38,852	38,604	37,852	37,487	40,925	40,400
Accrued interest payable	Level 3	190	190	182	182	219	219
Total financial liabilities		\$ 514,752	\$ 513,752	\$ 504,333	\$ 503,100	\$ 466,380	\$ 465,486

**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.

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

The following is information about the Corporation's assets and liabilities measured at fair value on a recurring basis at March 31, 2014, 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 March 31, 2014 and March 31, 2013 were based on level 2 inputs. There are no other assets or liabilities measured on a recurring basis at fair value. For additional information regarding investment securities, please refer to Note 3 Investment Securities.

The Corporation had no Level 3 assets or liabilities on a recurring basis as of March 31, 2014, December 31, 2013 or March 31, 2013.

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

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



discounted cash flow projections.

**Assets Measured at Fair Value on a Nonrecurring Basis at March 31, 2014**

(dollars in thousands)	Balance at March 31, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses for Three Months Ended March 31, 2014
<b>Assets</b>					
Impaired loans	\$ 1,491	\$	\$	\$ 1,491	\$ 77
Other real estate owned	2,166			2,166	
					\$ 77

**Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2013**

(dollars in thousands)	Balance at December 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses for Year Ended December 31, 2013
<b>Assets</b>					
Impaired loans	\$ 2,024	\$	\$	\$ 2,024	\$ 2,075
Other real estate owned	1,884			1,884	265
					\$ 2,340

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## MACKINAC FINANCIAL CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**9. FAIR VALUE MEASUREMENTS** (Continued)**Assets Measured at Fair Value on a Nonrecurring Basis at March 31, 2013**

(dollars in thousands)	Balance at March 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses for Year Ended March 31, 2013
<b>Assets</b>					
Impaired loans	\$ 3,833	\$	\$	\$ 3,833	\$ 408
Other real estate owned	3,825			3,825	2
					\$ 410

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

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

**10. SHAREHOLDERS' EQUITY**

In August 2012 the Corporation consummated the previously announced \$7.000 million rights offering and the investment by Steinhardt Capital Investors, LLLP (SCI) by issuing 2,140,123 shares of common stock for net proceeds of \$11.506 million. Also, in August 2012, the Corporation exited the TARP Capital Purchase Program (CPP) when the Corporation's 11,000 Series A Preferred Shares, issued in April, 2009 to the U.S. Treasury, were publically offered and sold. The Corporation repurchased the 379,310 of Common Stock Warrants issued to the U.S. Treasury under the CPP in December, 2012 for \$1.3 million. During 2013, the Corporation redeemed all of the outstanding Series A Preferred Shares.

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 55,594 shares in 2013 and 13,700 share in the first quarter of 2014. The share repurchases were

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conducted under Board authorizations made and publically announced of \$600,000 on February 27, 2013 and an additional \$600,000 on December 17, 2013. Neither of these authorizations has an expiration date.

### 11. COMMITMENTS, CONTINGENCIES AND CREDIT RISK

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

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

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

	March 31, 2014	December 31, 2013	March 31, 2013
Commitments to extend credit:			
Variable rate	\$ 40,704	\$ 36,039	\$ 41,978
Fixed rate	14,377	15,070	17,015
Standby letters of credit -			
Variable rate	5,396	5,077	2,894
Credit card commitments -			
Fixed rate	3,279	3,152	3,078
	\$ 63,756	\$ 59,338	\$ 64,965

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MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

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

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

**Legal Proceedings and Contingencies**

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

**Concentration of Credit Risk**

The Bank grants commercial, residential, agricultural, and consumer loans throughout Michigan. The Bank's most prominent concentration in the loan portfolio relates to commercial real estate loans to operators of nonresidential buildings. This concentration at March 31, 2014 represents \$97.153 million, or 26.89% compared to \$94.828 million, or 27.48%, of the commercial loan portfolio on March 31, 2013. The remainder of the commercial loan portfolio is diversified in such categories as hospitality and tourism, real estate agents and managers, new car dealers, gaming, petroleum, forestry, agriculture and construction. Due to the diversity of the Bank's locations, the ability of debtors of residential and consumer loans to honor their obligations is not tied to any particular economic sector.



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**Forward Looking Statements/Risk Factors**

**FORWARD LOOKING STATEMENTS**

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

**RISK FACTORS**

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

- *Our business may be adversely affected by conditions in the financial markets and economic conditions generally, as our borrowers ability to repay loans and the value of the collateral securing our loans decline.*
- *Weakness in the markets for residential or commercial real estate, including the secondary residential mortgage loan markets, could reduce our net income and profitability.*
- *Our allowance for loan losses may be insufficient.*

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

**Risks Related to Our Operations**

- *We are subject to interest rate risk.*

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

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- *Changes in our accounting policies or in accounting standards could materially affect how we report our financial results and condition.*
- *Our controls and procedures may fail or be circumvented.*
- *Impairment of deferred income tax assets could require charges to earnings, which could result in an adverse impact on our results of operations.*

In assessing the realizability of deferred income tax assets, management considers whether it is more likely than not that some allowance requires management to evaluate all available evidence, both negative and positive. Positive evidence necessary to overcome the negative evidence includes whether future taxable income in sufficient amounts and character within the carry back and carry forward periods is available under the tax law, including the use of tax planning strategies. When negative evidence (e.g. cumulative losses in recent years, history of operating loss or tax credit carry forwards expiring unused) exists, more positive evidence than negative evidence will be necessary. At March 31, 2014, net deferred tax assets are approximately \$9.533 million. If an additional valuation allowance becomes necessary with respect to such balance, it could have a material adverse effect on our business, results of operations and financial condition.

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

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**Risks Related to Legal and Regulatory Compliance**

- *We operate in a highly regulated environment, which could increase our cost structure or have other negative impacts on our operations.*
- *The full impact of the recently enacted Dodd-Frank Act is currently unknown given that many of the details and substance of the new laws will be implemented through agency rulemaking.*

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

**Strategic Risks**

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

**Reputation Risks**

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

**Liquidity Risks**

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

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

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



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

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

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

The following discussion will cover results of operations, asset quality, financial position, liquidity, interest rate sensitivity, and capital resources for the periods indicated. The information included in this discussion is intended to assist readers in their analysis of, and should be read in conjunction with, the consolidated financial statements and related notes and other supplemental information presented elsewhere in this report. This discussion should be read in conjunction with the consolidated financial statements and footnotes contained in the Corporation's Annual Report and Form 10-K for the year-ended December 31, 2013. Throughout this discussion, the term "Bank" refers to mBank, the principal banking subsidiary of the Corporation.

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

FINANCIAL OVERVIEW

The Corporation recorded a first quarter 2014 net income available to common shareholders of \$.660 million or \$.12 per share compared to net income of \$.676 million, or \$.12 per share for the first quarter of 2013. Operating results for the first quarter of 2014 included a provision for loan losses of \$.183 million compared to \$.375 million for the same period of 2013.

Weighted average shares outstanding totaled 5,530,908 for the first quarter of 2014 and 5,559,570 for the same period in 2013.

The net interest margin for the first quarter of 2014 increased to \$5.593 million, or 4.25%, compared to \$5.156 million, of 4.18% in the first quarter of 2013.

Total assets of the Corporation at March 31, 2014 were \$583.592 million, up by \$41.696 million, or 7.69% from the \$541.896 million in total assets reported at March 31, 2013 and up by \$10.792 million, or 1.88%, from total assets of \$572.800 million at year-end 2013. The loan portfolio increased \$2.030 million in the first quarter of 2014, from December 31, 2013 balances of \$483.832 million. Deposits totaled \$475.710 million at March 31, 2014, an increase of \$9.411 million from the \$466.299 million at December 31, 2013.

FINANCIAL CONDITION

**Cash and Cash Equivalents**

Cash and cash equivalents increased \$6.532 million during the first quarter of 2014. See further discussion of the change in cash and cash equivalents in the Liquidity section.

**Investment Securities**

Securities available for sale increased \$3.023 million, or 6.81%, from December 31, 2013 to March 31, 2014, with the balance on March 31, 2014, totaling \$47.411 million. Investment securities are utilized in an effort to manage interest rate risk and liquidity. As of March 31, 2014, investment securities with an estimated fair value of \$4.758 million were pledged.

## Loans

Through the first quarter of 2014, loan balances increased by \$2.030 million, or .42%, from December 31, 2013 balances of \$483.832 million. During the first three months of 2014, the Bank had total loan production of \$31.166 million, which included \$4.987 million of secondary market loan production. This loan production, however, was offset by loan principal runoff, paydowns and amortization, totaling \$30.535 million, and nonperforming loans transferred to other real estate owned ( OREO ) amounting to \$.282 million.

Management continues to actively manage the loan portfolio, seeking to identify and resolve problem assets at an early stage. Management believes a properly positioned loan portfolio provides the most attractive earning asset yield available to the Corporation and, with a diligent loan approval process and exception reporting, management can effectively manage the risk in the loan portfolio. Management intends to continue loan growth within its markets for mortgage, consumer, and commercial loan products while concentrating on loan quality, industry concentration issues, and competitive pricing.

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Following is a summary of the loan portfolio at March 31, 2014, December 31, 2013 and March 31, 2013 (dollars in thousands):

	March 31, 2014	Percent of Total	December 31, 2013	Percent of Total	March 31, 2013	Percent of Total
Commercial real estate	\$ 267,153	54.99%	\$ 268,809	55.56%	\$ 246,207	54.22%
Commercial, financial, and agricultural	83,461	17.18	79,655	16.46	82,530	18.18
One to four family residential real estate	104,376	21.48	103,768	21.45	89,629	19.74
Construction:						
Consumer	6,383	1.31	6,895	1.43	7,587	1.67
Commercial	10,685	2.20	10,904	2.25	16,295	3.59
Consumer	13,804	2.84	13,801	2.85	11,803	2.60
Total loans	\$ 485,862	100.00%	\$ 483,832	100.00%	\$ 454,051	100.00%

Following is a table showing the significant industry types in the commercial loan portfolio as of March 31, 2014, December 31, 2013 and March 31, 2013 (dollars in thousands):

	March 31, 2014			December 31, 2013			March 31, 2013		
	Outstanding Balance	Percent of Loans	Percent of Capital	Outstanding Balance	Percent of Loans	Percent of Capital	Outstanding Balance	Percent of Loans	Percent of Capital
Real estate - operators of nonres bldgs	\$ 97,153	26.89%	147.81%	\$ 100,333	27.92%	153.77%	\$ 94,828	27.48%	129.83%
Hospitality and tourism	44,243	12.24	67.31	45,360	12.62	69.01	42,733	12.39	58.51
Lessors of nonresidential buildings	13,649	3.78	20.77	14,191	3.95	21.75	13,162	3.81	18.02
Gasoline stations and convenience stores	11,980	3.32	18.23	11,534	3.21	17.68	11,201	3.25	15.33
Commercial construction	10,685	2.96	16.26	10,904	3.03	16.71	16,295	4.72	22.31
Insurance agencies and brokerages	10,331	2.86	15.72	10,097	2.81	15.47	11,854	3.44	16.23
Other	173,258	47.95	263.59	166,949	46.46	255.86	154,959	44.91	212.16
Total Commercial Loans	\$ 361,299	100.00%		\$ 359,368	100.00%		\$ 345,032	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

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March 31, 2014. 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 March 31, 2014, our residential loan portfolio totaled \$110.759 million, or 22.80% of our total outstanding loans.

The Corporation has also extended credit to governmental units, including Native American organizations. Tax-exempt loans and leases decreased from \$1.526 million at the end of December 31, 2013 to \$1.514 million at March 31, 2014. The Corporation has elected to reduce its tax-exempt portfolio, since it provides no current tax benefit, due to tax net operating loss carryforwards.

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

Table of Contents**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 recoveries for the three months ended March 31, 2014 amounted to \$39,000, compared to \$.566 million, or .50% of average loans outstanding, for the same period in 2013. 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):

	March 31, 2014	December 31, 2013	March 31, 2013
<b>Nonperforming Assets:</b>			
Nonaccrual Loans	\$ 983	\$ 1,410	\$ 3,833
Loans past due 90 days or more			
Restructured loans	508	614	
Total nonperforming loans	1,491	2,024	3,833
Other real estate owned	2,166	1,884	3,825
Total nonperforming assets	\$ 3,657	\$ 3,908	\$ 7,658
Nonperforming loans as a % of loans	.31%	.42%	.84%
Nonperforming assets as a % of assets	.63%	.68%	1.41%
<b>Reserve for Loan Losses:</b>			
At period end	\$ 4,883	\$ 4,661	\$ 5,037
As a % of loans	1.01%	.96%	1.11%
As a % of nonperforming loans	327.50%	230.29%	131.41%
As a % of nonaccrual loans	497.74%	330.27%	131.41%
Texas ratio*	5.18%	5.59%	9.90%

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

Nonperforming assets at \$3.657 million have been reduced in 2014 by \$.251 million from the \$3.908 million at 2013 year end. This reduction in nonperforming assets reflects management's continued efforts in the remediation of problem credits and disposition of OREO properties. The current low level of nonperforming assets is also representative of the overall quality of the Corporation's loan portfolio.

The following provides additional information relative to the Corporation's credit quality:

	March 31, 2014	At Period End December 31, 2013	March 31, 2013
Total loans, at period end	\$ 485,862	\$ 483,832	\$ 454,051
Average loans for the period	\$ 486,354	\$ 462,500	\$ 449,065

	Three Months Ended March 31, 2014	For the Period Ended Twelve Months Ended December 31, 2013	Three Months Ended March 31, 2013
Net charge-offs during the period	\$ (39)	\$ 2,232	\$ 556
Net charge-offs to average loans	N/M%	.48%	.50%
Net charge-offs to beginning allowance balance	N/M%	42.78%	10.66%

Management continues to address market issues impacting its loan customer base. In conjunction with the Corporation's senior lending staff and the bank regulatory examinations, management reviews the Corporation's loans, related collateral evaluations, and the overall lending process. The Corporation also utilizes an outside loan review consultant to perform a review of the loan portfolio. Historically, this independent review has provided findings similar to management as to the overall adequacy of the loan loss reserve and has substantiated the Corporation's loan rating system. In 2014, the Corporation will again utilize a consultant for loan review.

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As of March 31, 2014, the allowance for loan losses represented 1.01% of total loans. At March 31, 2014, the allowance included specific reserves in the amount of \$1.406 million, as compared to \$1.111 million at December 31, 2013 and \$1.922 million at March 31, 2013. 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):

	Three Months Ended March 31, 2014	Year Ended December 31, 2013	Three Months Ended March 31, 2013
Balance at beginning of period	\$ 1,884	\$ 3,212	\$ 3,212
Other real estate transferred from loans due to foreclosure	282	932	649
Other real estate sold		(1,996)	(34)
Writedowns on other real estate held for sale		(231)	
Loss on sale of other real estate held for sale		(33)	(2)
Balance at end of period	\$ 2,166	\$ 1,884	\$ 3,825

During the first quarter of 2014, the Corporation received real estate in lieu of loan payments of \$.282 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 quarter of 2014. Total deposits increased by \$9.411 million, or 2.02%, in the first quarter of 2014. The increase in deposits for the first quarter of 2014 is composed of an increase in noncore deposits of \$.158 million and an increase in core deposits of \$9.253 million. In recent years, the Corporation strategically emphasized the growth of core deposits. This strategic initiative is supported with an individual incentive plan, along with the introduction of several new deposit products and competitive deposit pricing. The core deposit balances increased primarily in transactional account deposits, our lowest cost of funds. Most recently, we have experienced some declines in core deposits. A portion of these decreases can be attributed to individual customer deposit reductions due to various business related needs. In an effort to stem some runoff from core deposit CDs, management recently increased some offering rates on CD products.

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



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

	March 31, 2014	% of Total	December 31, 2013	% of Total	March 31, 2013	% of Total
Noninterest bearing	\$ 68,027	14.30%	\$ 72,936	15.64%	\$ 57,547	13.53%
NOW, money market, checking	148,023	31.12	149,123	31.98	161,445	37.97
Savings	14,425	3.03	13,039	2.80	13,273	3.12
Certificates of Deposit <\$100,000	154,371	32.45	140,495	30.13	130,646	30.72
Total core deposits	384,846	80.90	375,593	80.55	362,911	85.34
Certificates of Deposit >\$100,000	23,317	4.90	23,159	4.97	24,619	5.79
Brokered CDs	67,547	14.20	67,547	14.48	37,706	8.87
Total non-core deposits	90,864	19.10	90,706	19.45	62,325	14.66
Total deposits	\$ 475,710	100.00%	\$ 466,299	100.00%	\$ 425,236	100.00%

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**Borrowings**

The Corporation also utilizes FHLB borrowings as a source of funding. At March 31, 2014, this source of funding totaled \$35 million and the Corporation secured this funding by pledging loans and investments. The \$35 million of FHLB borrowings has a weighted average maturity of 2.21 years and a weighted average rate of 1.79% at March 31, 2014. The Corporation also has a USDA Rural Development loan held by its wholly owned subsidiary, First Rural Relending that has a fixed interest rate of 1% and matures in August 2024.

In addition to the above, the Corporation maintains a relationship with a correspondent bank, which consists of a 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 March 22, 2015. The term note bears the same interest and matures on March 22, 2017.

**Shareholders' Equity**

Total shareholders' equity increased \$.481 million from December 31, 2013 to March 31, 2014. Contributing to the increase in shareholders' equity was net income available to common shareholders of \$.660 million, a reduction for dividends on common stock of \$.276 million, increases due to stock compensation of \$.112 million, an increase in the market value of securities of \$.128 million and a decrease due to the repurchase of common stock of \$.143 million.

RESULTS OF OPERATIONS

**Summary**

The Corporation reported net income available to common shareholders of \$.660 million, or \$.12 per share, in the first quarter of 2014, compared to \$.676 million or \$.12 per share for the first quarter of 2013. The first quarter results include a provision for loan losses of \$.183 million. Operating results for the same period in 2013 include a provision for loan losses of \$.375 million.

**Net Interest Income**

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

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Net interest margin on a fully taxable equivalent basis amounted to \$5.608 million, 4.26% of average earning assets, in the first quarter of 2014, compared to \$5.174 million, and 4.20% of average earning assets, in the first quarter of 2013. Margin improvement in 2014 was primarily due to a reduction in funding costs between periods.

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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											
(dollars in thousands)	Average Balances			Average Rates		Interest		Income/	2014-2013		
	March 31,		Increase/	March 31,		March 31,		Expense	Volume	Rate	Rate/
	2014	2013	(Decrease)	2014	2013	2014	2013	Variance	Variance	Variance	Volume
Loans (1,2,3)	\$ 486,354	\$ 448,925	\$ 37,429	5.27%	5.36%	\$ 6,315	\$ 5,930	\$ 385	\$ 495	\$ (101)	\$ (9)
Taxable securities	43,257	46,704	(3,447)	2.22	2.08	237	240	(3)	(18)	16	(1)
Nontaxable securities (2)	1,505	843	662	4.85	4.81	18	10	8	8		
Federal funds sold	3	3									
Other interest-earning assets	3,070	3,070		6.21	4.10	47	31	16		16	
Total earning assets	534,189	499,545	34,644	5.02	5.04	6,617	6,211	406	485	(69)	(10)
Reserve for loan losses	(4,852)	(5,086)	234								
Cash and due from banks	23,847	18,562	5,285								
Fixed Assets	10,288	10,633	(345)								
Other Real Estate	2,058	3,294	(1,236)								
Other assets	15,186	14,212	974								
Total assets	\$ 580,716	\$ 541,160	\$ 39,556								
NOW and money market deposits	\$ 116,847	\$ 126,149	\$ (9,302)	.21%	.25%	\$ 61	\$ 79	\$ (18)	\$ (6)	\$ (13)	\$ 1
Interest checking	33,090	36,071	(2,981)	.18	.31	15	28	(13)	(2)	(12)	1
Savings deposits	13,569	14,997	(1,428)	.09	.11	3	4	(1)		(1)	
CDs <\$100,000	151,317	131,641	19,676	1.23	1.64	460	533	(73)	80	(133)	(20)
CDs >\$100,000	23,205	24,630	(1,425)	1.40	1.66	80	101	(21)	(6)	(16)	1
Brokered deposits	67,557	37,706	29,851	1.22	1.43	203	133	70	104	(19)	(15)
Borrowings	38,808	35,755	3,053	1.95	1.80	187	159	28	14	13	1
Total interest-bearing liabilities	444,393	406,949	37,444	.92	1.03	1,009	1,037	(28)	184	(181)	(31)
Demand deposits	68,366	71,376	(3,010)								
Other liabilities	2,495	2,545	(50)								
Shareholders equity	65,462	60,290	5,172								
Total liabilities and shareholders equity	\$ 580,716	\$ 541,160	\$ 39,556								
Rate spread				4.10%	4.01%						
Net interest margin/revenue				4.26%	4.20%	\$ 5,608	\$ 5,174	\$ 434	\$ 301	\$ 112	\$ 21

(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

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

During this relatively low interest environment, the Corporation has also repriced a significant portion of its loan portfolio. Management has been diligent when repricing maturing or new loans in establishing interest rate floors in order to maintain our improved interest rate spread.

The Corporation is anticipating some margin pressure in future periods as we continue to see extremely competitive pricing on new and renewable loans.

#### **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 quarter of 2014, the Corporation determined through this analysis that a \$.183 million provision for loan loss was required, compared to \$.375 required in the first quarter of 2013. There were net recoveries of \$39,000 in the first quarter of 2014 and net charge-offs of \$.556 million in the same period of 2013.

#### **Other Income**

Other income decreased by \$.067 million for the three months ended March 31, 2014, compared to the three months ended March 31, 2013. Included in first quarter of 2014 is income from loans sold on the secondary market of \$.103 million and income from SBA/USDA loan sales of \$.382 million, compared to \$.299 million for secondary market loans and \$.109 million from SBA/USDA loans sales in the first quarter of 2013.

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.

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The following table details other income for the three months ended March 31, 2014 and 2013 (dollars in thousands):

	2014	2013	Three Months Ended March 31, Increase/(Decrease)	
			Dollars	Percent
Deposit service fees	\$ 157	\$ 162	\$ (5)	(3.09)%
Income from secondary market loans sold	103	299	(196)	(65.55)
SBA/USDA loan sale gains	382	109	273	100.00
Mortgage servicing income	13	103	(90)	(87.38)
Other noninterest income	36	85	(49)	(57.65)
Total other income	\$ 691	\$ 758	\$ (67)	(8.84)%

**Other Expense**

For the first quarter of 2014, the Corporation recorded other expense of \$5.107 million compared to \$4.311 million in 2013, an increase of \$.796 million. Included in other expense for the quarter is an increase in salaries and employee benefits of \$.235 million, reflective of the compensation packages for the staff up of our asset based lending subsidiary formed in the third quarter of 2013. We also had increased occupancy costs between periods due primarily to our new branch office in Marquette, which we moved into late in 2013. Also included in the increase in the first quarter of 2014 were legal costs incurred for the exploration of an acquisition and additional SEC work needed this year.

The following table details other expense for the three months ended March 31, 2014 and 2013 (dollars in thousands):

	2014	2013	Three Months Ended March 31, Increase/(Decrease)	
			Dollars	Percentage
Salaries and employee benefits	\$ 2,541	\$ 2,306	\$ 235	10.19%
Occupancy	538	382	156	40.84
Furniture and equipment	319	270	49	18.15
Data processing	286	265	21	7.92
Advertising	107	104	3	2.88
Professional service fees	331	225	106	47.11
Loan and deposit	79	73	6	8.22
Writedowns and losses on other real estate held for sale		2	(2)	(100.00)
FDIC insurance premiums	85	105	(20)	(19.05)
Telephone	82	82		
Other	739	497	242	48.69
Total other expense	\$ 5,107	\$ 4,311	\$ 796	18.46%

**Federal Income Taxes**

A valuation allowance is provided against deferred tax assets when it is more likely than not that some or all of the deferred tax asset will not be realized. The Corporation, as of March 31, 2014 had a net operating loss and tax credit carryforwards for tax purposes of approximately \$19.2 million, and \$2.1 million, respectively. The net operating loss carryforwards expire twenty years from the date they originated. These carryforwards, if not utilized, will begin to expire in the year 2023. A portion of the NOL, approximately \$12.8 million, and all of the credit carryforwards are subject to the limitations for utilization as set forth in Section 382 of the Internal Revenue Code. The annual limitation is \$1.400 million for the NOL and the equivalent value of tax credits, which is approximately \$.476 million. These limitations for use were established in conjunction with the recapitalization of the Corporation in December 2004.

The Corporation has reported deferred tax assets of \$9.533 million at March 31, 2014, which is net of a valuation allowance of \$.760 million. Management evaluated the deferred tax valuation allowance as of March 31, 2014 and determined that no adjustment to the valuation was warranted. The remaining valuation allowance pertains to the existing tax credit carryovers, which will only be utilized after all net operating loss carryforwards. Since a portion of these tax credits may expire before that occurs, a valuation allowance for these has been established. 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.

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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 \$24.751 million in cash and due from balances, negligible federal funds sold and \$42.653 million of unpledged investment securities. Although current liquidity is deemed adequate, management will increase on hand liquidity in the near term by issuing brokered CDs in order to fund anticipated loan growth.

During the first quarter of 2014, the Corporation increased cash and cash equivalents by \$6.532 million. As shown on the Corporation's condensed consolidated statement of cash flows, liquidity was impacted by cash used in investing activities, with a net increase in investment securities of \$2.878 million and a net increase in loans of \$2.272 million. The management of bank liquidity for funding of loans and deposit maturities and withdrawals includes monitoring projected loan fundings and scheduled prepayments and deposit maturities within a 30 day period, a 30 to 90 day period and from 90 days until the end of the year. This funding forecast model is completed weekly.

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

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

Core deposits are herein defined as demand deposits, NOW (negotiable order withdrawals), money markets, savings and certificates of deposit under \$100,000. Noncore funding consists of certificates of deposit greater than \$100,000, brokered deposits, and FHLB and Farmers Home Administration borrowings. At March 31, 2014, the Bank's core deposits in relation to total funding were 74.79% compared to 77.85% at March 31, 2013. These ratios indicated at March 31, 2014, that the Bank has 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 March 31, 2014, the Bank had \$28.375 million of unsecured lines available and additional funding sources available if secured. The bank believes that its liquidity position remains strong to meet both present and future financial obligations and commitments, events or uncertainties that have resulted or are reasonably likely to result in material changes with respect to the Bank's liquidity.



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

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As a bank holding company, the Corporation is required to maintain certain levels of capital under government regulation. There are several measurements of regulatory capital and the Corporation is required to meet minimum requirements under each measurement. The federal banking regulators have also established capital classifications beyond the minimum requirements in order to risk-rate deposit insurance premiums and to provide trigger points for prompt corrective action in the event an institution becomes financially troubled. As of March 31, 2014, the Corporation and Bank were well capitalized. During the first quarter of 2014, total capitalization increased by \$.481 million.

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

	March 31, 2014	December 31, 2013	March 31, 2013
<b>Capital Structure</b>			
Shareholders' equity	\$ 65,730	\$ 65,249	\$ 62,039
Preferred stock			11,000
Total shareholders' equity	\$ 65,730	\$ 65,249	\$ 73,039
Total capitalization	\$ 65,730	\$ 65,249	\$ 73,039
Tangible capital	\$ 65,730	\$ 65,249	\$ 72,314
<b>Intangible Assets</b>			
Core deposit premium	\$	\$	\$
Other identifiable intangibles	1,057	1,129	725
Total intangibles	\$ 1,057	\$ 1,129	\$ 725
<b>Regulatory capital</b>			
Tier 1 capital:			
Shareholders' equity	\$ 65,730	\$ 65,249	\$ 73,039
Net unrealized (gains) on available for sale securities	(344)	(216)	(970)
Less: disallowed deferred tax asset	(6,500)	(7,000)	(6,800)
Less: intangibles	(106)	(113)	(73)
Total Tier 1 capital	\$ 58,780	\$ 57,920	\$ 65,196
Tier 2 Capital:			
Allowable reserve for loan losses	\$ 4,883	\$ 4,661	\$ 5,037
Qualifying long-term debt			
Total Tier 2 capital	4,883	4,661	5,037
Total capital	\$ 63,663	\$ 62,581	\$ 70,233
Risk-adjusted assets	\$ 492,356	\$ 489,407	\$ 466,377
<b>Capital ratios:</b>			
Tier 1 Capital to average assets	10.24%	10.31%	12.23%
Tier 1 Capital to risk weighted assets	11.94%	11.83%	13.98%
Total Capital to risk weighted assets	12.93%	12.79%	15.06%

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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.

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

	Shareholders Equity to Quarter-end Assets	Tangible Equity to Quarter-end Assets	Tier 1 Capital to Average Assets	Tier 1 Capital to Risk-Weighted Assets	Total Capital to Risk-Weighted Assets
Regulatory minimum for capital adequacy purposes	N/A	N/A	4.00%	4.00%	8.00%
Regulatory defined well capitalized guideline	N/A	N/A	5.00%	6.00%	10.00%
<b>The Corporation:</b>					
<b>March 31, 2014</b>	<b>11.26%</b>	<b>11.26%</b>	<b>10.24%</b>	<b>11.94%</b>	<b>12.93%</b>
March 31, 2013	13.48%	13.36%	12.23%	13.98%	15.06%
<b>The Bank:</b>					
<b>March 31, 2014</b>	<b>11.13%</b>	<b>11.13%</b>	<b>10.10%</b>	<b>11.76%</b>	<b>12.74%</b>
March 31, 2013	11.24%	11.12%	9.95%	11.37%	12.44%

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INTEREST RATE RISK

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

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

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

The Corporation has established interest rate floors on approximately \$140.756 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 \$87.245 million of the floor rate loan balances will reprice with a 100 basis point increase on the prime rate, with another \$47.722 million repricing in the next 100 basis point prime rate increase.

The Corporation also has \$47.411 million of securities providing for scheduled monthly principal and interest payments as well as unanticipated prepayments of principal. These cash flows are then reinvested into other earning assets at current market rates. The Corporation also has federal funds sold to correspondent banks as well as other interest-bearing deposits with correspondent banks. These funds are generally repriced on a daily basis.

The Corporation has \$230.475 million of transactional accounts, of which \$68.027 million consists of noninterest bearing demand deposit balances. Transaction account balances have increased significantly in the last year due in part to the Corporation's focus on these low costs accounts by developing new attractive products and increased sales efforts to municipalities, schools and businesses. These transactional account balances provide additional repricing flexibility in changing interest rate environments since they have no scheduled maturities and interest rates can be reset at any time.

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

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

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

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

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

The following is the Corporation's opportunities at March 31, 2014 (dollars in thousands):

	1-90 Days	91 - 365 Days	>1-5 Years	Over 5 Years	Total
<b>Interest-earning assets:</b>					
<b>Loans</b>	\$ 275,228	\$ 14,526	\$ 68,303	\$ 127,805	\$ 485,862
<b>Securities</b>	8	6,079	28,649	12,675	47,411
<b>Other (1)</b>	13			3,060	3,073
<b>Total interest-earning assets</b>	<b>275,249</b>	<b>20,605</b>	<b>96,952</b>	<b>143,540</b>	<b>536,346</b>
<b>Interest-bearing obligations:</b>					
<b>NOW, money market, savings, interest checking</b>	<b>162,448</b>				<b>162,448</b>
<b>Time deposits</b>	<b>29,008</b>	<b>74,457</b>	<b>74,029</b>	<b>194</b>	<b>177,688</b>
<b>Brokered CDs</b>	<b>2,239</b>	<b>10,605</b>	<b>54,703</b>		<b>67,547</b>
<b>Borrowings</b>		<b>10,000</b>	<b>28,000</b>	<b>852</b>	<b>38,852</b>
<b>Total interest-bearing obligations</b>	<b>193,695</b>	<b>95,062</b>	<b>156,732</b>	<b>1,046</b>	<b>446,535</b>
<b>Gap</b>	<b>\$ 81,554</b>	<b>\$ (74,457)</b>	<b>\$ (59,780)</b>	<b>\$ 142,494</b>	<b>\$ 89,811</b>
<b>Cumulative gap</b>	<b>\$ 81,554</b>	<b>\$ 7,097</b>	<b>\$ (52,683)</b>	<b>\$ 89,811</b>	

(1) Includes Federal Home Loan Bank Stock

The above analysis indicates that at March 31, 2014, the Corporation had a cumulative asset sensitivity gap position of \$7.097 million within the one-year time frame. The Corporation's cumulative asset sensitive gap suggests that if market interest rates were to increase in the next twelve months, the Corporation has the potential to earn more net interest income. Since more assets would reprice at higher rates than liabilities. Conversely, if market interest rates decrease in the next twelve months, the above gap position suggests the Corporation's net interest income would decrease. 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.

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At December 31, 2013, the Corporation had a cumulative liability sensitivity gap position of \$24.272 million within the one-year time frame.

The borrowings in the gap analysis include \$35.000 million of FHLB advances that have a weighted average maturity of 2.21 years and a weighted average rate of 1.79%.

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

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Evaluating the exposure to changes in interest rates includes assessing both the adequacy of the process used to control interest rate risk and the quantitative level of exposure. The Corporation's interest rate risk management process seeks to ensure that appropriate policies, procedures, management information systems, and internal controls are in place to maintain interest rate risk at prudent levels with consistency and continuity. In evaluating the quantitative level of interest rate risk, the Corporation assesses the existing and potential future effects of changes in interest rates on its financial condition, including capital adequacy, earnings, liquidity, and asset quality. In addition to changes in interest rates, the level of future net interest income is also dependent on a number of variables, including: the growth, composition and levels of loans, deposits, and other earning assets and interest-bearing obligations, and economic and competitive conditions; potential changes in lending, investing, and deposit strategies; customer preferences; and other factors.

FOREIGN EXCHANGE RISK

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

OFF-BALANCE-SHEET RISK

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

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

IMPACT OF INFLATION AND CHANGING PRICES

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and results of operations in historical dollars without considering the change in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of the Corporation's operations. Nearly all the assets and liabilities of the Corporation are financial, unlike industrial or commercial companies. As a result, the Corporation's performance is directly impacted by changes in interest rates, which are indirectly influenced by inflationary expectations. The



Corporation's ability to match the interest sensitivity of its financial assets to the interest sensitivity of its financial liabilities tends to minimize the effect of changes in interest rates on the Corporation's performance. Changes in interest rates do not necessarily move to the same extent as changes in the price of goods and services.

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ITEM 4 CONTROLS AND PROCEDURES

As of March 31, 2014, 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 March 31, 2014.

*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 March 31, 2014 that have materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

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PART II. OTHER INFORMATION

**Item 1. Legal Proceedings**

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

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

(a) Exhibits:

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

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SIGNATURES

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

MACKINAC FINANCIAL CORPORATION  
(Registrant)

Date: May 15, 2014

By: /s/ Paul D. Tobias  
PAUL D. TOBIAS,  
CHAIRMAN AND CHIEF EXECUTIVE OFFICER  
(principal executive officer)

By: /s/ Ernie R. Krueger  
ERNIE R. KRUEGER  
EVP/CHIEF FINANCIAL OFFICER  
(principal financial and accounting officer)