

ISABELLA BANK CORP  
Form 10-Q  
November 07, 2012  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**  
For the quarterly period ended September 30, 2012

or

.. **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**  
For the transition period from to

Commission File Number: 0-18415

**Isabella Bank Corporation**

(Exact name of registrant as specified in its charter)

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**Michigan**  
(State or other jurisdiction of  
incorporation or organization)

**38-2830092**  
(I.R.S. Employer  
identification No.)

**401 N. Main St, Mt. Pleasant, MI**  
(Address of principal executive offices)

**48858**  
(Zip code)

**(989) 772-9471**

(Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

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 period 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 (Section 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 the definitions of "accelerated filer", "large accelerated filer", and "smaller reporting company", in Rule 12b-2 of the Exchange Act (Check One).

Large accelerated filer  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock no par value, 7,620,399 as of October 19, 2012

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**ISABELLA BANK CORPORATION**  
**QUARTERLY REPORT ON FORM 10-Q**

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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1 Interim Condensed Consolidated Financial Statements (Unaudited)****INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS**

(Dollars in thousands)

|   | September 30<br>2012 | December 31<br>2011 |
|---|----------------------|---------------------|
| <b>ASSETS</b>   |                      |                     |
| Cash and cash equivalents   |                      |                     |
| Cash and demand deposits due from banks   | \$ 19,202            | \$ 24,514           |
| Interest bearing balances due from banks  | 5,462                | 4,076               |
| <b>Total cash and cash equivalents</b>  | <b>24,664</b>        | <b>28,590</b>       |
| Certificates of deposit held in other financial institutions                              | 5,675                | 8,924               |
| Trading securities  | 1,788                | 4,710               |
| Available-for-sale securities (amortized cost of \$452,536 in 2012 and \$414,614 in 2011) | 467,414              | 425,120             |
| Mortgage loans available-for-sale   | 2,820                | 3,205               |
| Loans   |                      |                     |
| Agricultural  | 83,439               | 74,645              |
| Commercial  | 369,366              | 365,714             |
| Consumer  | 33,515               | 31,572              |
| Residential real estate   | 280,431              | 278,360             |
| <b>Total loans</b>  | <b>766,751</b>       | <b>750,291</b>      |
| Less allowance for loan losses  | 12,062               | 12,375              |
| <b>Net loans</b>  | <b>754,689</b>       | <b>737,916</b>      |
| Premises and equipment  | 25,471               | 24,626              |
| Corporate owned life insurance  | 22,594               | 22,075              |
| Accrued interest receivable   | 6,565                | 5,848               |
| Equity securities without readily determinable fair values                                | 17,830               | 17,189              |
| Goodwill and other intangible assets  | 46,592               | 46,792              |
| Other assets  | 13,036               | 12,930              |
| <b>TOTAL ASSETS</b>   | <b>\$ 1,389,138</b>  | <b>\$ 1,337,925</b> |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |                      |                     |
| Deposits  |                      |                     |
| Noninterest bearing   | \$ 126,362           | \$ 119,072          |
| NOW accounts  | 174,350              | 163,653             |
| Certificates of deposit under \$100 and other savings                                     | 453,348              | 440,123             |
| Certificates of deposit over \$100  | 235,431              | 235,316             |
| <b>Total deposits</b>   | <b>989,491</b>       | <b>958,164</b>      |
| Borrowed funds (\$0 in 2012 and \$5,242 in 2011 at fair value)                            | 226,580              | 216,136             |
| Accrued interest payable and other liabilities  | 8,920                | 8,842               |
| <b>Total liabilities</b>  | <b>1,224,991</b>     | <b>1,183,142</b>    |
| Shareholders equity   |                      |                     |

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|  |                     |                     |
|--|---------------------|---------------------|
| Common stock – no par value 15,000,000 shares authorized; issued and outstanding 7,611,350 shares (including 25,644 shares held in the Rabbi Trust) in 2012 and 7,589,226 shares (including 16,585 shares held in the Rabbi Trust) in 2011 | 134,973             | 134,734             |
| Shares to be issued for deferred compensation obligations  | 4,925               | 4,524               |
| Retained earnings  | 18,178              | 13,036              |
| Accumulated other comprehensive income   | 6,071               | 2,489               |
| <b>Total shareholders' equity</b>  | <b>164,147</b>      | <b>154,783</b>      |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>  | <b>\$ 1,389,138</b> | <b>\$ 1,337,925</b> |

See notes to interim condensed consolidated financial statements.

**Table of Contents****INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

(Dollars in thousands except per share data)

|  | Common<br>Stock Shares<br>Outstanding | Common<br>Stock   | Shares to be<br>Issued for<br>Deferred<br>Compensation<br>Obligations | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>(Loss)<br>Income | Totals            |
|--|---------------------------------------|-------------------|---|----------------------|---|-------------------|
| <b>Balance, January 1, 2011</b>  | <b>7,550,074</b>                      | <b>\$ 133,592</b> | <b>\$ 4,682</b>   | <b>\$ 8,596</b>      | <b>\$ (1,709)</b>   | <b>\$ 145,161</b> |
| Comprehensive income   |                                       |                   |   | 7,499                | 6,608   | 14,107            |
| Issuance of common stock   | 90,049                                | 1,891             |   |                      |   | 1,891             |
| Common stock issued for deferred compensation obligations                                  | 14,842                                | 266               | (254)   |                      |   | 12                |
| Share based payment awards under equity compensation plan                                  |                                       |                   | 486   |                      |   | 486               |
| Common stock purchased for deferred compensation obligations                               |                                       | (356)             |   |                      |   | (356)             |
| Common stock repurchased pursuant to publicly announced repurchase plan                    | (76,708)                              | (1,391)           |   |                      |   | (1,391)           |
| Cash dividends (\$0.57 per share)  |                                       |                   |   | (4,331)              |   | (4,331)           |
| <b>Balance, September 30, 2011</b>   | <b>7,578,257</b>                      | <b>\$ 134,002</b> | <b>\$ 4,914</b>   | <b>\$ 11,764</b>     | <b>\$ 4,899</b>   | <b>\$ 155,579</b> |
| <b>Balance, January 1, 2012</b>  | <b>7,589,226</b>                      | <b>134,734</b>    | <b>4,524</b>  | <b>13,036</b>        | <b>2,489</b>  | <b>\$ 154,783</b> |
| Comprehensive income   |                                       |                   |   | 9,695                | 3,582   | 13,277            |
| Issuance of common stock   | 85,227                                | 2,025             |   |                      |   | 2,025             |
| Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations |                                       | 95                | (95)  |                      |   |                   |
| Share based payment awards under equity compensation plan                                  |                                       |                   | 496   |                      |   | 496               |
| Common stock purchased for deferred compensation obligations                               |                                       | (361)             |   |                      |   | (361)             |
| Common stock repurchased pursuant to publicly announced repurchase plan                    | (63,103)                              | (1,520)           |   |                      |   | (1,520)           |
| Cash dividends (\$0.60 per share)  |                                       |                   |   | (4,553)              |   | (4,553)           |
| <b>Balance, September 30, 2012</b>   | <b>7,611,350</b>                      | <b>\$ 134,973</b> | <b>\$ 4,925</b>   | <b>\$ 18,178</b>     | <b>\$ 6,071</b>   | <b>\$ 164,147</b> |

See notes to interim condensed consolidated financial statements.

**Table of Contents****INTERIM CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

(Dollars in thousands except per share data)

|  | Three Months Ended<br>September 30 |               | Nine Months Ended<br>September 30 |               |
|--|------------------------------------|---------------|-----------------------------------|---------------|
|  | 2012                               | 2011          | 2012                              | 2011          |
| <b>Interest income</b>                                     |                                    |               |                                   |               |
| Loans, including fees                                      | \$ 10,918                          | \$ 11,365     | \$ 32,707                         | \$ 34,190     |
| Investment securities                                      |                                    |               |                                   |               |
| Taxable  | 1,878                              | 1,800         | 5,755                             | 5,149         |
| Nontaxable   | 1,232                              | 1,201         | 3,652                             | 3,569         |
| Trading account securities                                 | 15                                 | 45            | 79                                | 143           |
| Federal funds sold and other                               | 121                                | 121           | 363                               | 388           |
| <b>Total interest income</b>                               | <b>14,164</b>                      | <b>14,532</b> | <b>42,556</b>                     | <b>43,439</b> |
| <b>Interest expense</b>                                    |                                    |               |                                   |               |
| Deposits   | 2,203                              | 2,725         | 7,083                             | 8,286         |
| Borrowings   | 1,036                              | 1,345         | 3,289                             | 3,938         |
| <b>Total interest expense</b>                              | <b>3,239</b>                       | <b>4,070</b>  | <b>10,372</b>                     | <b>12,224</b> |
| <b>Net interest income</b>                                 | <b>10,925</b>                      | <b>10,462</b> | <b>32,184</b>                     | <b>31,215</b> |
| Provision for loan losses                                  | 200                                | 963           | 1,100                             | 2,383         |
| <b>Net interest income after provision for loan losses</b> | <b>10,725</b>                      | <b>9,499</b>  | <b>31,084</b>                     | <b>28,832</b> |
| <b>Noninterest income</b>                                  |                                    |               |                                   |               |
| Service charges and fees                                   | 1,543                              | 1,341         | 4,800                             | 4,434         |
| Gain on sale of mortgage loans                             | 422                                | 111           | 1,080                             | 293           |
| Net loss on trading securities                             | (9)                                | (24)          | (41)                              | (51)          |
| Net gain on borrowings measured at fair value              |                                    | 42            | 33                                | 159           |
| Gain on sale of available-for-sale investment securities   | 116                                |               | 1,119                             |               |
| Other  | 687                                | 389           | 1,853                             | 950           |
| <b>Total noninterest income</b>                            | <b>2,759</b>                       | <b>1,859</b>  | <b>8,844</b>                      | <b>5,785</b>  |
| <b>Noninterest expenses</b>                                |                                    |               |                                   |               |
| Compensation and benefits                                  | 5,130                              | 4,814         | 15,663                            | 14,565        |
| Occupancy  | 649                                | 633           | 1,889                             | 1,892         |
| Furniture and equipment                                    | 1,113                              | 1,151         | 3,373                             | 3,384         |
| Other  | 2,236                              | 1,915         | 6,682                             | 6,038         |
| Available-for-sale impairment loss                         |                                    |               |                                   |               |
| Total other-than-temporary impairment loss                 |                                    |               | 486                               |               |
| Portion of loss reported in other comprehensive income     |                                    |               | (204)                             |               |
| Net available-for-sale impairment loss                     |                                    |               | 282                               |               |
| <b>Total noninterest expenses</b>                          | <b>9,128</b>                       | <b>8,513</b>  | <b>27,889</b>                     | <b>25,879</b> |
| <b>Income before federal income tax expense</b>            | <b>4,356</b>                       | <b>2,845</b>  | <b>12,039</b>                     | <b>8,738</b>  |
| Federal income tax expense                                 | 899                                | 334           | 2,344                             | 1,239         |

|                                       |                 |                 |                 |                 |
|---------------------------------------|-----------------|-----------------|-----------------|-----------------|
| <b>NET INCOME</b>                     | <b>\$ 3,457</b> | <b>\$ 2,511</b> | <b>\$ 9,695</b> | <b>\$ 7,499</b> |
| <b>Earnings per share</b>             |                 |                 |                 |                 |
| <b>Basic</b>                          | <b>\$ 0.45</b>  | <b>\$ 0.33</b>  | <b>\$ 1.28</b>  | <b>\$ 0.99</b>  |
| <b>Diluted</b>                        | <b>\$ 0.44</b>  | <b>\$ 0.32</b>  | <b>\$ 1.24</b>  | <b>\$ 0.97</b>  |
| <b>Cash dividends per basic share</b> | <b>\$ 0.20</b>  | <b>\$ 0.19</b>  | <b>\$ 0.60</b>  | <b>\$ 0.57</b>  |

See notes to interim condensed consolidated financial statements.



**Table of Contents****INTERIM CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(Dollars in thousands)

|   | Three Months Ended<br>September 30 |                 | Nine Months Ended<br>September 30 |                  |
|---|------------------------------------|-----------------|-----------------------------------|------------------|
|   | 2012                               | 2011            | 2012                              | 2011             |
| <b>Net income</b>   | <b>\$ 3,457</b>                    | <b>\$ 2,511</b> | <b>\$ 9,695</b>                   | <b>\$ 7,499</b>  |
| Unrealized holding gains on available-for-sale securities:                |                                    |                 |                                   |                  |
| Unrealized holding gains arising during the period                        | 2,990                              | 4,721           | 5,209                             | 10,050           |
| Reclassification adjustment for net realized gains included in net income | (116)                              |                 | (1,119)                           |                  |
| Reclassification adjustment for impairment loss included in net income    |                                    |                 | 282                               |                  |
| Net unrealized gains  | 2,874                              | 4,721           | 4,372                             | 10,050           |
| Tax effect  | (763)                              | (1,835)         | (790)                             | (3,442)          |
| Other comprehensive income, net of tax                                    | 2,111                              | 2,886           | 3,582                             | 6,608            |
| <b>COMPREHENSIVE INCOME</b>   | <b>\$ 5,568</b>                    | <b>\$ 5,397</b> | <b>\$ 13,277</b>                  | <b>\$ 14,107</b> |

See notes to interim condensed consolidated financial statements.

**Table of Contents****INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Dollars in thousands)

|   | Nine Months Ended<br>September 30 |                 |
|---|-----------------------------------|-----------------|
|   | 2012                              | 2011            |
| <b>OPERATING ACTIVITIES</b>   |                                   |                 |
| Net income  | \$ 9,695                          | \$ 7,499        |
| Reconciliation of net income to net cash provided by operations:            |                                   |                 |
| Provision for loan losses   | 1,100                             | 2,383           |
| Impairment of foreclosed assets   | 17                                | 45              |
| Depreciation  | 1,802                             | 1,909           |
| Amortization and impairment of originated mortgage servicing rights         | 582                               | 606             |
| Amortization of acquisition intangibles                                     | 200                               | 229             |
| Net amortization of available-for-sale securities                           | 1,683                             | 1,117           |
| Available-for-sale security impairment loss                                 | 282                               |                 |
| Gain on sale of available-for-sale securities                               | (1,119)                           |                 |
| Net unrealized losses on trading securities                                 | 41                                | 51              |
| Net gain on sale of mortgage loans  | (1,080)                           | (293)           |
| Net unrealized gains on borrowings measured at fair value                   | (33)                              | (159)           |
| Increase in cash value of corporate owned life insurance                    | (519)                             | (428)           |
| Share-based payment awards under equity compensation plan                   | 496                               | 486             |
| Origination of loans held for sale  | (69,503)                          | (31,225)        |
| Proceeds from loan sales  | 70,968                            | 29,724          |
| Net changes in operating assets and liabilities which provided (used) cash: |                                   |                 |
| Trading securities  | 2,881                             | 900             |
| Accrued interest receivable   | (717)                             | (1,067)         |
| Other assets  | (1,994)                           | 423             |
| Accrued interest payable and other liabilities                              | 78                                | 792             |
| <b>Net cash provided by operating activities</b>                            | <b>14,860</b>                     | <b>12,992</b>   |
| <b>INVESTING ACTIVITIES</b>   |                                   |                 |
| Net change in certificates of deposit held in other financial institutions  | 3,249                             | 6,159           |
| Activity in available-for-sale securities                                   |                                   |                 |
| Sales   | 40,677                            | 3,000           |
| Maturities and calls  | 58,598                            | 49,117          |
| Purchases   | (138,043)                         | (128,339)       |
| Loan principal originations, net  | (19,461)                          | (18,923)        |
| Proceeds from sales of foreclosed assets                                    | 1,446                             | 1,625           |
| Purchases of premises and equipment   | (2,647)                           | (1,576)         |
| Purchases of corporate owned life insurance                                 |                                   | (4,000)         |
| <b>Net cash used in investing activities</b>                                | <b>(56,181)</b>                   | <b>(92,937)</b> |

**Table of Contents****INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)**

(Dollars in thousands)

|   | Nine Months Ended<br>September 30 |                  |
|---|-----------------------------------|------------------|
|   | 2012                              | 2011             |
| <b>FINANCING ACTIVITIES</b>                                       |                                   |                  |
| Acceptances and withdrawals of deposits, net                      | 31,327                            | 65,102           |
| Increase in other borrowed funds                                  | 10,477                            | 22,130           |
| Cash dividends paid on common stock                               | (4,553)                           | (4,331)          |
| Proceeds from issuance of common stock                            | 2,025                             | 1,637            |
| Common stock repurchased  | (1,520)                           | (1,125)          |
| Common stock purchased for deferred compensation obligations      | (361)                             | (356)            |
| <b>Net cash provided by financing activities</b>                  | <b>37,395</b>                     | <b>83,057</b>    |
| <b>(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>           | <b>(3,926)</b>                    | <b>3,112</b>     |
| Cash and cash equivalents at beginning of period                  | 28,590                            | 18,109           |
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>                 | <b>\$ 24,664</b>                  | <b>\$ 21,221</b> |
| <b>SUPPLEMENTAL CASH FLOWS INFORMATION:</b>                       |                                   |                  |
| Interest paid   | \$ 10,526                         | \$ 12,292        |
| Federal income taxes paid   | 1,467                             | 672              |
| <b>SUPPLEMENTAL NONCASH INFORMATION:</b>                          |                                   |                  |
| Transfers of loans to foreclosed assets                           | \$ 1,588                          | \$ 1,681         |
| Common stock issued for deferred compensation obligations         |                                   | 254              |
| Common stock repurchased from the Rabbi Trust                     |                                   | (266)            |
| See notes to interim condensed consolidated financial statements. |                                   |                  |

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**NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Dollars in thousands except per share amounts)**

**NOTE 1 - BASIS OF PRESENTATION**

As used in these Notes as well as in the Management's Discussion and Analysis of Financial Condition and Results of Operations, references to Isabella, we, our, us, and similar terms refer to the consolidated entity consisting of Isabella Bank Corporation and its subsidiaries. Isabella Bank Corporation refers solely to the parent holding company, and Isabella Bank refers to Isabella Bank Corporation's subsidiary, Isabella Bank.

The acronyms and abbreviations identified below are used in the Notes to the Interim Condensed Consolidated Financial Statements as well as in the Management's Discussion and Analysis of Financial Condition and Results of Operations. You may find it helpful to refer back to this page as you read this report.

|  |   |
|--|---|
| AFS: Available-for-sale  | IFRS: International Financial Reporting Standards           |
| ALLL: Allowance for loan and lease losses  | IRR: Interest Rate Risk                                     |
| ASC: FASB Accounting Standards Codification  | JOBS Act: Jumpstart our Business Startups Act               |
| ASU: FASB Accounting Standards Update  | LIBOR: London Interbank Offered Rate                        |
| ATM: Automated Teller Machine  | Moody's: Moody's Investors Service, Inc                     |
| Directors Plan: Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors | N/A: Not applicable   |
| Dodd-Frank Act: Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010                        | N/M: Not meaningful   |
| FASB: Financial Accounting Standards Board   | OCI: Other comprehensive income (loss)                      |
| FDIC: Federal Deposit Insurance Corporation  | OMSR: Originated mortgage servicing rights                  |
| FFIEC: Federal Financial Institutions Examination Council  | OREO: Other real estate owned                               |
| FRB: Board of Governors of the Federal Reserve System  | OTTI: Other-than-temporary impairment                       |
| FHLB: Federal Home Loan Bank   | PBO: Projected Benefit Obligation                           |
| Freddie Mac: Federal Home Loan Mortgage Corporation  | Rabbi Trust: A trust established to fund the Directors Plan |
| FTE: Fully taxable equivalent  | SEC: U.S. Securities & Exchange Commission                  |
| GAAP: U.S. generally accepted accounting principles  | SOX: Sarbanes-Oxley Act of 2002                             |
|  | TDR: Troubled debt restructuring                            |
|  | XBRL: eXtensible Business Reporting Language                |

The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with GAAP for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In our opinion, all adjustments considered necessary for a fair presentation have been included. Operating results for the three and nine month periods ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. For further information, refer to the consolidated financial statements and footnotes thereto included in our annual report for the year ended December 31, 2011.

The accounting policies are materially the same as those discussed in Note 1 to the Consolidated Financial Statements included in our annual report for the year ended December 31, 2011.

**Table of Contents****NOTE 2 - COMPUTATION OF EARNINGS PER SHARE**

Basic earnings per share represents income available to common shareholders divided by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustments to income that would result from the assumed issuance. Potential common shares that may be issued relate solely to outstanding shares in the Directors Plan.

Earnings per common share have been computed based on the following:

|   | Three Months Ended<br>September 30 |                | Nine Months Ended<br>September 30 |                |
|---|------------------------------------|----------------|-----------------------------------|----------------|
|   | 2012                               | 2011           | 2012                              | 2011           |
| Average number of common shares outstanding for basic calculation                               | 7,600,443                          | 7,577,388      | 7,595,806                         | 7,568,551      |
| Average potential effect of shares in the Directors Plan (1)                                    | 206,233                            | 197,937        | 203,250                           | 195,360        |
| Average number of common shares outstanding used to calculate diluted earnings per common share | 7,806,676                          | 7,775,325      | 7,799,056                         | 7,763,911      |
| Net income  | \$ 3,457                           | \$ 2,511       | \$ 9,695                          | \$ 7,499       |
| <b>Earnings per share</b>   |                                    |                |                                   |                |
| <b>Basic</b>  | <b>\$ 0.45</b>                     | <b>\$ 0.33</b> | <b>\$ 1.28</b>                    | <b>\$ 0.99</b> |
| <b>Diluted</b>  | <b>\$ 0.44</b>                     | <b>\$ 0.32</b> | <b>\$ 1.24</b>                    | <b>\$ 0.97</b> |

(1) Exclusive of shares held in the Rabbi Trust

**NOTE 3 ACCOUNTING STANDARDS UPDATES****Recently Adopted Accounting Standards Updates***ASU No. 2011-03: Reconsideration of Effective Control for Repurchase Agreements*

In April 2011, ASU No. 2011-03 amended ASC Topic 310, *Transfers and Servicing* to eliminate from the assessment of effective control, the criteria calling for the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed upon terms, even in the event of the transferee's default. The assessment of effective control should instead focus on the transferor's contractual rights and obligations. The new authoritative guidance was effective for interim and annual periods beginning on or after December 15, 2011 and did not impact our consolidated financial statements.

*ASU No. 2011-04: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*

In May 2011, ASU No. 2011-04 amended ASC Topic 820, *Fair Value Measurement* to align fair value measurements and disclosures in GAAP and IFRS. The ASU changes the wording used to describe the requirements in GAAP for measuring fair value and disclosures about fair value.

The ASU clarifies the application of existing fair value measurements and disclosure requirements related to:

The application of highest and best use and valuation premise concepts.

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Measuring the fair value of an instrument classified in a reporting entity's stockholders' equity.

Disclosure about fair value measurements within Level 3 of the fair value hierarchy.

The ASU also changes particular principles or requirements for measuring fair value and disclosing information measuring fair value and disclosures related to:

Measuring the fair value of financial instruments that are managed within a portfolio.

Application of premiums and discounts in a fair value measurement.

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The new authoritative guidance was effective for interim and annual periods beginning on or after December 15, 2011 and did not have a financial impact but increased the level of disclosures related to fair value measurements in our interim condensed consolidated financial statements in 2012.

ASU No. 2011-05: Presentation of Comprehensive Income

In June 2011, ASU No. 2011-05 amended ASC Topic 220, Comprehensive Income to improve the comparability, consistency, and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. In addition, to increase the prominence of items reported in other comprehensive income, and to facilitate the convergence of GAAP and IFRS, the FASB eliminated the option to present components of other comprehensive income as part of the statement of changes in shareholders' equity.

The new authoritative guidance was effective for interim and annual periods beginning on or after December 15, 2011 and did not have an impact on our consolidated financial statements as we have historically elected to present a separate statement of comprehensive income.

**Pending Accounting Standards Updates**

ASU No. 2012-02: Intangibles - Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment

In August, ASU No. 2012-02 amended ASC Topic 350, Goodwill and Other to simplify the testing of intangible assets with indefinite lives. This update will allow for a qualitative assessment of intangible assets with indefinite lives to determine whether or not it is necessary to perform the impairment test described in ASC Topic 350. The new authoritative guidance is effective for fiscal years beginning after September 15, 2012 and is not expected to have any impact on our consolidated financial statements.

**NOTE 4 TRADING SECURITIES**

Trading securities, at fair value, consist of the following investments at:

|                                   | September 30<br>2012 | December 31<br>2011 |
|-----------------------------------|----------------------|---------------------|
| States and political subdivisions | \$ 1,788             | \$ 4,710            |

Included in the net trading losses of \$41 during the first nine months of 2012 were \$13 of net unrealized trading losses on securities that were held in our trading portfolio as of September 30, 2012. Included in the net trading losses of \$51 during the first nine months of 2011 were \$45 of net unrealized trading losses on securities that were held in the trading portfolio as of September 30, 2011.

**Table of Contents****NOTE 5 AVAILABLE-FOR-SALE SECURITIES**

The amortized cost and fair value of AFS securities, with gross unrealized gains and losses, are as follows at:

|                                     | Amortized<br>Cost | September 30, 2012           |                               | Fair<br>Value     |
|-------------------------------------|-------------------|------------------------------|-------------------------------|-------------------|
|                                     |                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |                   |
| Government sponsored enterprises    | \$ 1,925          | \$ 32                        | \$                            | \$ 1,957          |
| States and political subdivisions   | 176,576           | 9,394                        | 490                           | 185,480           |
| Auction rate money market preferred | 3,200             |                              | 429                           | 2,771             |
| Preferred stocks                    | 6,800             | 56                           | 496                           | 6,360             |
| Mortgage-backed securities          | 138,086           | 4,142                        |                               | 142,228           |
| Collateralized mortgage obligations | 125,949           | 2,773                        | 104                           | 128,618           |
| <b>Total</b>                        | <b>\$ 452,536</b> | <b>\$ 16,397</b>             | <b>\$ 1,519</b>               | <b>\$ 467,414</b> |

|                                     | Amortized<br>Cost | December 31, 2011            |                               | Fair<br>Value     |
|-------------------------------------|-------------------|------------------------------|-------------------------------|-------------------|
|                                     |                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |                   |
| Government sponsored enterprises    | \$ 395            | \$ 2                         | \$                            | \$ 397            |
| States and political subdivisions   | 166,832           | 8,157                        | 51                            | 174,938           |
| Auction rate money market preferred | 3,200             |                              | 1,151                         | 2,049             |
| Preferred stocks                    | 6,800             |                              | 1,767                         | 5,033             |
| Mortgage-backed securities          | 140,842           | 2,807                        | 47                            | 143,602           |
| Collateralized mortgage obligations | 96,545            | 2,556                        |                               | 99,101            |
| <b>Total</b>                        | <b>\$ 414,614</b> | <b>\$ 13,522</b>             | <b>\$ 3,016</b>               | <b>\$ 425,120</b> |

The amortized cost and fair value of AFS securities by contractual maturity at September 30, 2012 are as follows:

|                                     | Maturing                      |   |  |                       | Securities<br>With<br>Variable<br>Monthly<br>Payments<br>or<br>Continual<br>Call Dates | Total             |
|-------------------------------------|-------------------------------|---|--|-----------------------|--|-------------------|
|                                     | Due in<br>One Year<br>or Less | After One<br>Year But<br>Within<br>Five Years | After Five<br>Years But<br>Within<br>Ten Years | After<br>Ten<br>Years |  |                   |
| Government sponsored enterprises    | \$                            | \$  | \$ 72  | \$ 1,853              | \$   | \$ 1,925          |
| States and political subdivisions   | 7,300                         | 37,147  | 82,543   | 49,586                |  | 176,576           |
| Auction rate money market preferred |                               |   |  |                       | 3,200  | 3,200             |
| Preferred stocks                    |                               |   |  |                       | 6,800  | 6,800             |
| Mortgage-backed securities          |                               |   |  |                       | 138,086  | 138,086           |
| Collateralized mortgage obligations |                               |   |  |                       | 125,949  | 125,949           |
| <b>Total amortized cost</b>         | <b>\$ 7,300</b>               | <b>\$ 37,147</b>                              | <b>\$ 82,615</b>                               | <b>\$ 51,439</b>      | <b>\$ 274,035</b>  | <b>\$ 452,536</b> |
| <b>Fair value</b>                   | <b>\$ 7,302</b>               | <b>\$ 38,237</b>                              | <b>\$ 88,912</b>                               | <b>\$ 52,986</b>      | <b>\$ 279,977</b>  | <b>\$ 467,414</b> |



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Expected maturities for government sponsored enterprises and states and political subdivisions may differ from contractual maturities because issuers may have the right to call or prepay obligations.

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As auction rate money market preferred and preferred stocks have continual call dates, they are not reported by a specific maturity group. Because of their variable monthly payments, mortgage-backed securities and collateralized mortgage obligations are not reported by a specific maturity group.

A summary of the activity related to sales of AFS securities was as follows for the nine month period ended September 30, 2012:

|                                   |           |
|-----------------------------------|-----------|
| Proceeds from sales of securities | \$ 40,677 |
| Gross realized gains              | \$ 1,119  |
| Applicable income tax expense     | \$ 380    |

There were no sales of AFS securities in the first nine months of 2011. The cost basis used to determine the realized gains or losses of securities sold was the amortized cost of the individual investment security as of the trade date.

Information pertaining to AFS securities with gross unrealized losses at September 30, 2012 and December 31, 2011 aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

|   | September 30, 2012            |                  |                               |                 |                 |
|---|-------------------------------|------------------|-------------------------------|-----------------|-----------------|
|   | Less Than Twelve Months       |                  | Over Twelve Months            |                 | Total           |
|   | Gross<br>Unrealized<br>Losses | Fair<br>Value    | Gross<br>Unrealized<br>Losses | Fair<br>Value   |                 |
| States and political subdivisions                           | \$ 1                          | \$ 315           | \$ 489                        | \$ 2,410        | \$ 490          |
| Auction rate money market preferred                         |                               |                  | 429                           | 2,771           | 429             |
| Preferred stocks  |                               |                  | 496                           | 3,303           | 496             |
| Mortgage-backed securities                                  |                               |                  |                               |                 |                 |
| Collateralized mortgage obligations                         | 104                           | 15,001           |                               |                 | 104             |
| <b>Total</b>  | <b>\$ 105</b>                 | <b>\$ 15,316</b> | <b>\$ 1,414</b>               | <b>\$ 8,484</b> | <b>\$ 1,519</b> |
| <b>Number of securities in an unrealized loss position:</b> |                               | <b>4</b>         |                               | <b>6</b>        | <b>10</b>       |

|   | December 31, 2011             |                  |                               |                 |                 |
|---|-------------------------------|------------------|-------------------------------|-----------------|-----------------|
|   | Less Than Twelve Months       |                  | Over Twelve Months            |                 | Total           |
|   | Gross<br>Unrealized<br>Losses | Fair<br>Value    | Gross<br>Unrealized<br>Losses | Fair<br>Value   |                 |
| States and political subdivisions                           | \$ 51                         | \$ 1,410         | \$                            | \$              | \$ 51           |
| Auction rate money market preferred                         |                               |                  | 1,151                         | 2,049           | 1,151           |
| Preferred stocks  |                               |                  | 1,767                         | 5,033           | 1,767           |
| Mortgage-backed securities                                  | 47                            | 24,291           |                               |                 | 47              |
| <b>Total</b>  | <b>\$ 98</b>                  | <b>\$ 25,701</b> | <b>\$ 2,918</b>               | <b>\$ 7,082</b> | <b>\$ 3,016</b> |
| <b>Number of securities in an unrealized loss position:</b> |                               |                  | <b>6</b>                      | <b>6</b>        | <b>12</b>       |

As of September 30, 2012 and December 31, 2011, we conducted an analysis to determine whether any securities currently in an unrealized loss position should be other-than-temporarily impaired. Such analyses considered, among other factors, the following criteria:

Has the value of the investment declined more than what is deemed to be reasonable based on a risk and maturity adjusted discount rate?

Is the issuer's investment credit rating below investment grade?

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Is it probable that the issuer will be unable to pay the amount when due?

Is it more likely than not that we will have to sell the security before recovery of its cost basis?

Has the duration of the investment been extended?

As of September 30, 2012, we held an auction rate money market preferred security and preferred stocks which continued to be in an unrealized loss position as a result of the securities' interest rates, as they are currently lower than the offering rates of securities with similar characteristics. We determined that any declines in the fair value of these securities are the result of changes in interest rates and not risks related to the underlying credit quality of the security. Additionally, none of the issuers of these securities are deemed to be below investment grade, we do not intend to sell the securities in an unrealized loss position, and it is unlikely that we will have to sell the securities before recovery of their cost basis.

During the three month period ended March 31, 2012, we had one state issued student loan auction rate AFS investment security (which is included in states and political subdivisions) that was downgraded by Moody's from A3 to Caa3. As a result of this downgrade, we engaged the services of an independent investment valuation firm to estimate the amount of credit losses (if any) related to this particular issue as of March 31, 2012. The evaluation calculated a range of estimated credit losses utilizing two different bifurcation methods: 1) Estimated Cash Flow Method and 2) Credit Yield Analysis Method. The two methods were then weighted, with a higher weighting applied to the Estimated Cash Flow Method, to determine the estimated credit related impairment. As a result of this analysis we, recognized an OTTI of \$282 in earnings in the first quarter of 2012.

A summary of key valuation assumptions used in the aforementioned analysis as of March 31, 2012, follows:

|   |                                |
|---|--------------------------------|
|   | Discounted<br>Cash Flow Method |
| Ratings   |                                |
| Fitch   | Not Rated                      |
| Moody's   | Caa3                           |
| S&P   | A                              |
| Seniority   | Senior                         |
| Discount rate   | LIBOR + 6.35%                  |
|   | Credit Yield                   |
|   | Analysis Method                |
| Credit discount rate                                    | LIBOR + 4.00%                  |
| Average observed discounts based on closed transactions | 14.00%                         |

To test for additional impairment of this security during the three months ended September 30, 2012, we obtained another investment valuation (from the same firm engaged to perform the initial valuation as of March 31, 2012) as of September 30, 2012. Based on the results of this valuation, no additional OTTI was indicated as of September 30, 2012.

A rollforward of credit related impairment recognized in earnings on available-for-sale securities in the three and nine months ended September 30, 2012 was as follows:

|  | Three Months<br>Ended<br>September 30, 2012 | Nine Months<br>Ended<br>September 30, 2012 |
|--|---|--|
| Balance at beginning of period                                       | \$ 282                                      | \$   |
| Additions to credit losses for which no previous OTTI was recognized |   | 282  |

|                    |    |     |    |     |
|--------------------|----|-----|----|-----|
| September 30, 2012 | \$ | 282 | \$ | 282 |
|--------------------|----|-----|----|-----|

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There were no credit losses recognized in earnings on available-for-sale securities during 2011.

Based on our analysis using the above criteria, the fact that we have asserted that we do not have the intent to sell these securities in an unrealized loss position, and it is unlikely that we will have to sell the securities before recovery of their cost basis, we do not believe that the values of any other securities are other-than-temporarily impaired as of September 30, 2012 or December 31, 2011.

**NOTE 6 LOANS AND ALLOWANCE FOR LOAN LOSSES**

We grant commercial, agricultural, residential real estate, and consumer loans to customers situated primarily in Clare, Gratiot, Isabella, Mecosta, Midland, Montcalm, and Saginaw counties in Michigan. The ability of the borrowers to honor their repayment obligations is often dependent upon the real estate, agricultural, light manufacturing, retail, gaming and tourism, higher education, and general economic conditions of this region. Substantially all of the consumer and residential real estate loans are secured by various items of property, while commercial loans are secured primarily by real estate, business assets, and personal guarantees; a portion of loans are unsecured.

Loans that we have the intent and ability to hold in our portfolio are reported at their outstanding principal balance adjusted for any charge-offs, the ALLL, and any deferred fees or costs. Interest income on loans is accrued over the term of the loan based on the principal amount outstanding. Loan origination fees and certain direct loan origination costs are capitalized and recognized as a component of interest income over the term of the loan using the level yield method.

The accrual of interest on commercial, agricultural, and residential real estate loans is typically discontinued at the time the loan is 90 days or more past due unless the credit is well-secured and in the process of collection. Consumer loans are typically charged off no later than 180 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

For loans that are placed on nonaccrual status or charged off, all interest accrued in the current calendar year, but not collected, is reversed against interest income while interest accrued in prior calendar years, but not collected, is charged against the allowance for loan losses. The interest on these loans is accounted for on the cash basis, until qualifying for return to accrual status. Loans are typically returned to accrual status after six months of continuous performance. For impaired loans not classified as nonaccrual, interest income continues to be accrued over the term of the loan based on the principal amount outstanding.

Commercial and agricultural loans include loans for commercial real estate, commercial operating loans, farmland and agricultural production, and state and political subdivisions. Repayment of these loans is often dependent upon the successful operation and management of a business; thus, these loans generally involve greater risk than other types of lending. We minimize our risk by limiting the amount of loans to any one borrower to \$12,500. Borrowers with credit needs of more than \$12,500 are serviced through the use of loan participations with other commercial banks. Commercial and agricultural real estate loans generally require loan-to-value limits of less than 80%. Depending upon the type of loan, past credit history, and current operating results, we may require the borrower to pledge accounts receivable, inventory, and property and equipment. Personal guarantees are generally required from the owners of closely held corporations, partnerships, and sole proprietorships. In addition, we require annual financial statements, prepare cash flow analyses, and review credit reports as deemed necessary.

We offer adjustable rate mortgages, fixed rate balloon mortgages, construction loans, and fixed rate mortgage loans which typically have amortization periods up to a maximum of 30 years. Fixed rate loans with an amortization of greater than 15 years are generally sold upon origination to Freddie Mac. Fixed rate residential real estate loans with an amortization of 15 years or less may be held in our portfolio, held for future sale, or sold upon origination. We consider the direction of interest rates, the sensitivity of our balance sheet to changes in interest rates, and overall loan demand to determine whether or not to sell these loans to Freddie Mac.

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Our lending policies generally limit the maximum loan-to-value ratio on residential real estate loans to 95% of the lower of the appraised value of the property or the purchase price, with the condition that private mortgage insurance is required on loans with loan to value ratios in excess of 80%. Substantially all loans upon origination have a loan to value ratio of less than 80%. Underwriting criteria for residential real estate loans include: evaluation of the borrower's ability to make monthly payments, the value of the property securing the loan, ensuring the payment of principal, interest, taxes, and hazard insurance does not exceed 28% of a borrower's gross income, all debt servicing does not exceed 36% of income, acceptable credit reports, verification of employment, income, and financial information. Appraisals are performed by independent appraisers and reviewed internally. All mortgage loan requests are reviewed by our mortgage loan committee or through a secondary market automated underwriting system; loans in excess of \$400 require the approval of our Internal Loan Committee, the Board of Directors' Loan Committee, or the Board of Directors.

Consumer loans include automobile loans, secured and unsecured personal loans, and overdraft protection related loans. Loans are amortized generally for a period of up to 6 years. The underwriting emphasis is on a borrower's perceived intent and ability to pay rather than collateral value. No consumer loans are sold to the secondary market.

The ALLL is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the ALLL when we believe the uncollectibility of the loan balance is confirmed. Subsequent recoveries, if any, are credited to the ALLL.

The ALLL is evaluated on a regular basis and is based upon a periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The primary factors behind the determination of the level of the ALLL are specific allocations for impaired loans, historical loss percentages, as well as unallocated components. Specific allocations for impaired loans are primarily determined based on the difference between the net realizable value of the loan's underlying collateral or the net present value of the projected payment stream and our recorded investment. Historical loss allocations were calculated at the loan class and segment levels based on a migration analysis of the loan portfolio over the preceding four years. An unallocated component is maintained to cover uncertainties that we believe affect our estimate of probable losses based on qualitative factors. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A summary of changes in the ALLL and the recorded investment in loans by segments follows:

|                                  | Allowance for Loan Losses             |               |                            |               |               | Total            |
|----------------------------------|---------------------------------------|---------------|----------------------------|---------------|---------------|------------------|
|                                  | Three Months Ended September 30, 2012 |               |                            |               |               |                  |
|                                  | Commercial                            | Agricultural  | Residential<br>Real Estate | Consumer      | Unallocated   |                  |
| <b>Allowance for loan losses</b> |                                       |               |                            |               |               |                  |
| July 1, 2012                     | \$ 6,008                              | \$ 433        | \$ 3,669                   | \$ 667        | \$ 1,541      | \$ 12,318        |
| Loans charged off                | (271)                                 |               | (213)                      | (127)         |               | (611)            |
| Recoveries                       | 40                                    |               | 34                         | 81            |               | 155              |
| Provision for loan losses        | 1,132                                 | 6             | (356)                      | 91            | (673)         | 200              |
| <b>September 30, 2012</b>        | <b>\$ 6,909</b>                       | <b>\$ 439</b> | <b>\$ 3,134</b>            | <b>\$ 712</b> | <b>\$ 868</b> | <b>\$ 12,062</b> |

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|                                  | Allowance for Loan Losses            |               |                            |               |               |                  |
|----------------------------------|--------------------------------------|---------------|----------------------------|---------------|---------------|------------------|
|                                  | Nine Months Ended September 30, 2012 |               |                            |               |               |                  |
|                                  | Commercial                           | Agricultural  | Residential<br>Real Estate | Consumer      | Unallocated   | Total            |
| <b>Allowance for loan losses</b> |                                      |               |                            |               |               |                  |
| January 1, 2012                  | \$ 6,284                             | \$ 1,003      | \$ 2,980                   | \$ 633        | \$ 1,475      | \$ 12,375        |
| Loans charged off                | (957)                                |               | (566)                      | (364)         |               | (1,887)          |
| Recoveries                       | 168                                  |               | 95                         | 211           |               | 474              |
| Provision for loan losses        | 1,414                                | (564)         | 625                        | 232           | (607)         | 1,100            |
| <b>September 30, 2012</b>        | <b>\$ 6,909</b>                      | <b>\$ 439</b> | <b>\$ 3,134</b>            | <b>\$ 712</b> | <b>\$ 868</b> | <b>\$ 12,062</b> |

|                                       | Allowance for Loan Losses and Recorded Investment in Loans |                  |                            |                  |               |                   |
|---------------------------------------|--|------------------|----------------------------|------------------|---------------|-------------------|
|                                       | As of September 30, 2012                                   |                  |                            |                  |               |                   |
|                                       | Commercial   | Agricultural     | Residential<br>Real Estate | Consumer         | Unallocated   | Total             |
| <b>Allowance for loan losses</b>      |  |                  |                            |                  |               |                   |
| Individually evaluated for impairment | \$ 2,915   | \$               | \$ 1,354                   | \$               | \$            | \$ 4,269          |
| Collectively evaluated for impairment | 3,994  | 439              | 1,780                      | 712              | 868           | 7,793             |
| <b>Total</b>                          | <b>\$ 6,909</b>  | <b>\$ 439</b>    | <b>\$ 3,134</b>            | <b>\$ 712</b>    | <b>\$ 868</b> | <b>\$ 12,062</b>  |
| <b>Loans</b>                          |  |                  |                            |                  |               |                   |
| Individually evaluated for impairment | \$ 16,593  | \$ 2,281         | \$ 8,429                   | \$ 79            |               | \$ 27,382         |
| Collectively evaluated for impairment | 352,773  | 81,158           | 272,002                    | 33,436           |               | 739,369           |
| <b>Total</b>                          | <b>\$ 369,366</b>  | <b>\$ 83,439</b> | <b>\$ 280,431</b>          | <b>\$ 33,515</b> |               | <b>\$ 766,751</b> |

|                                  | Allowance for Loan Losses             |               |                            |               |                 |                  |
|----------------------------------|---------------------------------------|---------------|----------------------------|---------------|-----------------|------------------|
|                                  | Three Months Ended September 30, 2011 |               |                            |               |                 |                  |
|                                  | Commercial                            | Agricultural  | Residential<br>Real Estate | Consumer      | Unallocated     | Total            |
| <b>Allowance for loan losses</b> |                                       |               |                            |               |                 |                  |
| July 1, 2011                     | \$ 6,738                              | \$ 764        | \$ 2,885                   | \$ 660        | \$ 1,331        | \$ 12,378        |
| Loans charged off                | (215)                                 |               | (857)                      | (98)          |                 | (1,170)          |
| Recoveries                       | 75                                    | 1             | 39                         | 87            |                 | 202              |
| Provision for loan losses        | 116                                   | (331)         | 1,148                      | (3)           | 33              | 963              |
| <b>September 30, 2011</b>        | <b>\$ 6,714</b>                       | <b>\$ 434</b> | <b>\$ 3,215</b>            | <b>\$ 646</b> | <b>\$ 1,364</b> | <b>\$ 12,373</b> |



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|                                  | Allowance for Loan Losses            |               |                            |               |                 |                  |
|----------------------------------|--------------------------------------|---------------|----------------------------|---------------|-----------------|------------------|
|                                  | Nine Months Ended September 30, 2011 |               |                            |               |                 |                  |
|                                  | Commercial                           | Agricultural  | Residential<br>Real Estate | Consumer      | Unallocated     | Total            |
| <b>Allowance for loan losses</b> |                                      |               |                            |               |                 |                  |
| January 1, 2011                  | \$ 6,048                             | \$ 1,033      | \$ 3,198                   | \$ 605        | \$ 1,489        | \$ 12,373        |
| Loans charged off                | (1,084)                              | (1)           | (1,735)                    | (382)         |                 | (3,202)          |
| Recoveries                       | 421                                  | 1             | 142                        | 255           |                 | 819              |
| Provision for loan losses        | 1,329                                | (599)         | 1,610                      | 168           | (125)           | 2,383            |
| <b>September 30, 2011</b>        | <b>\$ 6,714</b>                      | <b>\$ 434</b> | <b>\$ 3,215</b>            | <b>\$ 646</b> | <b>\$ 1,364</b> | <b>\$ 12,373</b> |

|                                       | Allowance for Loan Losses and Recorded Investment in Loans |                  |                            |                  |                 |                   |
|---------------------------------------|--|------------------|----------------------------|------------------|-----------------|-------------------|
|                                       | As of December 31, 2011                                    |                  |                            |                  |                 |                   |
|                                       | Commercial   | Agricultural     | Residential<br>Real Estate | Consumer         | Unallocated     | Total             |
| <b>Allowance for loan losses</b>      |  |                  |                            |                  |                 |                   |
| Individually evaluated for impairment | \$ 2,152   | \$ 822           | \$ 1,146                   | \$               | \$              | \$ 4,120          |
| Collectively evaluated for impairment | 4,132  | 181              | 1,834                      | 633              | 1,475           | 8,255             |
| <b>Total</b>                          | <b>\$ 6,284</b>  | <b>\$ 1,003</b>  | <b>\$ 2,980</b>            | <b>\$ 633</b>    | <b>\$ 1,475</b> | <b>\$ 12,375</b>  |
| <b>Loans</b>                          |  |                  |                            |                  |                 |                   |
| Individually evaluated for impairment | \$ 14,097  | \$ 3,384         | \$ 7,664                   | \$ 105           |                 | \$ 25,250         |
| Collectively evaluated for impairment | 351,617  | 71,261           | 270,696                    | 31,467           |                 | 725,041           |
| <b>Total</b>                          | <b>\$ 365,714</b>  | <b>\$ 74,645</b> | <b>\$ 278,360</b>          | <b>\$ 31,572</b> |                 | <b>\$ 750,291</b> |

The following table displays the credit quality indicators for commercial and agricultural credit exposures based on internally assigned credit ratings as of:

| Rating                | September 30, 2012 |                     |                   |                  |                       |                  |
|-----------------------|--------------------|---------------------|-------------------|------------------|-----------------------|------------------|
|                       | Real Estate        | Commercial<br>Other | Total             | Real Estate      | Agricultural<br>Other | Total            |
|                       | 2 - High quality   | \$ 25,824           | \$ 16,871         | \$ 42,695        | \$ 2,591              | \$ 2,196         |
| 3 - High satisfactory | 82,108             | 26,977              | 109,085           | 16,293           | 9,615                 | 25,908           |
| 4 - Low satisfactory  | 126,649            | 47,965              | 174,614           | 25,073           | 20,704                | 45,777           |
| 5 - Special mention   | 13,224             | 2,271               | 15,495            | 961              | 2,751                 | 3,712            |
| 6 - Substandard       | 19,124             | 2,404               | 21,528            | 1,631            | 1,363                 | 2,994            |
| 7 - Vulnerable        | 2,783              | 2,358               | 5,141             |                  |                       |                  |
| 8 - Doubtful          | 785                | 23                  | 808               |                  | 261                   | 261              |
| <b>Total</b>          | <b>\$ 270,497</b>  | <b>\$ 98,869</b>    | <b>\$ 369,366</b> | <b>\$ 46,549</b> | <b>\$ 36,890</b>      | <b>\$ 83,439</b> |

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| Rating                | December 31, 2011 |                     |                   |                  |                       |                  |
|-----------------------|-------------------|---------------------|-------------------|------------------|-----------------------|------------------|
|                       | Real Estate       | Commercial<br>Other | Total             | Real Estate      | Agricultural<br>Other | Total            |
| 2 - High quality      | \$ 11,113         | \$ 11,013           | \$ 22,126         | \$ 3,583         | \$ 1,390              | \$ 4,973         |
| 3 - High satisfactory | 90,064            | 29,972              | 120,036           | 11,154           | 5,186                 | 16,340           |
| 4 - Low satisfactory  | 118,611           | 57,572              | 176,183           | 24,253           | 15,750                | 40,003           |
| 5 - Special mention   | 15,482            | 4,200               | 19,682            | 3,863            | 2,907                 | 6,770            |
| 6 - Substandard       | 19,017            | 4,819               | 23,836            | 1,640            | 4,314                 | 5,954            |
| 7 - Vulnerable        | 187               |                     | 187               |                  |                       |                  |
| 8 - Doubtful          | 3,621             | 43                  | 3,664             | 190              | 415                   | 605              |
| <b>Total</b>          | <b>\$ 258,095</b> | <b>\$ 107,619</b>   | <b>\$ 365,714</b> | <b>\$ 44,683</b> | <b>\$ 29,962</b>      | <b>\$ 74,645</b> |

Internally assigned risk ratings are reviewed, at a minimum, when loans are renewed or when management has knowledge of improvements or deterioration of the credit quality of individual credits. Descriptions of the internally assigned risk ratings for commercial and agricultural loans are as follows:

**1. EXCELLENT Substantially Risk Free**

Credit has strong financial condition and solid earnings history, characterized by:

High liquidity, strong cash flow, low leverage.

Unquestioned ability to meet all obligations when due.

Experienced management, with management succession in place.

Secured by cash.

**2. HIGH QUALITY Limited Risk**

Credit with sound financial condition and has a positive trend in earnings supplemented by:

Favorable liquidity and leverage ratios.

Ability to meet all obligations when due.

Management with successful track record.

Steady and satisfactory earnings history.

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If loan is secured, collateral is of high quality and readily marketable.

Access to alternative financing.

Well defined primary and secondary source of repayment.

If supported by guaranty, the financial strength and liquidity of the guarantor(s) are clearly evident.

### 3. **HIGH SATISFACTORY Reasonable Risk**

Credit with satisfactory financial condition and further characterized by:

Working capital adequate to support operations.

Cash flow sufficient to pay debts as scheduled.

Management experience and depth appear favorable.

Loan performing according to terms.

If loan is secured, collateral is acceptable and loan is fully protected.

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**4. LOW SATISFACTORY Acceptable Risk**

Credit with bankable risks, although some signs of weaknesses are shown:

Would include most start-up businesses.

Occasional instances of trade slowness or repayment delinquency may have been 10-30 days slow within the past year.

Management's abilities are apparent, yet unproven.

Weakness in primary source of repayment with adequate secondary source of repayment.

Loan structure generally in accordance with policy.

If secured, loan collateral coverage is marginal.

Adequate cash flow to service debt, but coverage is low.

**To be classified as less than satisfactory, only one of the following criteria must be met.**

**5. SPECIAL MENTION Criticized**

Credit constitutes an undue and unwarranted credit risk but not to the point of justifying a classification of substandard. The credit risk may be relatively minor yet constitute an unwarranted risk in light of the circumstances surrounding a specific loan:

Downward trend in sales, profit levels, and margins.

Impaired working capital position.

Cash flow is strained in order to meet debt repayment.

Loan delinquency (30-60 days) and overdrafts may occur.

Shrinking equity cushion.

Diminishing primary source of repayment and questionable secondary source.

Management abilities are questionable.

Weak industry conditions.

Litigation pending against the borrower.

Collateral or guaranty offers limited protection.

Negative debt service coverage, however the credit is well collateralized and payments are current.

**6. SUBSTANDARD Classified**

Credit where the borrower's current net worth, paying capacity, and value of the collateral pledged is inadequate. There is a distinct possibility that we will implement collection procedures if the loan deficiencies are not corrected. In addition, the following characteristics may apply:

Sustained losses have severely eroded the equity and cash flow.

Deteriorating liquidity.

Serious management problems or internal fraud.

Original repayment terms liberalized.

Likelihood of bankruptcy.

Inability to access other funding sources.

Reliance on secondary source of repayment.

Litigation filed against borrower.

Collateral provides little or no value.

Requires excessive attention of the loan officer.

Borrower is uncooperative with loan officer.

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**7. VULNERABLE Classified**

Credit is considered Substandard and warrants placing on nonaccrual. Risk of loss is being evaluated and exit strategy options are under review. Other characteristics that may apply:

Insufficient cash flow to service debt.

Minimal or no payments being received.

Limited options available to avoid the collection process.

Transition status, expect action will take place to collect loan without immediate progress being made.

**8. DOUBTFUL Workout**

Credit has all the weaknesses inherent in a Substandard loan with the added characteristic that collection and/or liquidation is pending. The possibility of a loss is extremely high, but its classification as a loss is deferred until liquidation procedures are completed, or reasonably estimable. Other characteristics that may apply:

Normal operations are severely diminished or have ceased.

Seriously impaired cash flow.

Original repayment terms materially altered.

Secondary source of repayment is inadequate.

Survivability as a going concern is impossible.

Collection process has begun.

Bankruptcy petition has been filed.

Judgments have been filed.

Portion of the loan balance has been charged-off.

9. **LOSS Charge off**

Credits are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification is for charged off loans but does not mean that the asset has absolutely no recovery or salvage value. These loans are further characterized by:

Liquidation or reorganization under bankruptcy, with poor prospects of collection.

Fraudulently overstated assets and/or earnings.

Collateral has marginal or no value.

Debtor cannot be located.

Over 120 days delinquent.

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Our primary credit quality indicators for residential real estate and consumer loans is the individual loans past due aging. The following tables summarize the past due and current loans as of:

|                                      | <b>September 30, 2012</b>          |                    |                 |                               |                   |                   |
|--------------------------------------|------------------------------------|--------------------|-----------------|-------------------------------|-------------------|-------------------|
|                                      | Accruing Interest<br>and Past Due: |                    |                 | Total                         |                   |                   |
|                                      | 30-89<br>Days                      | 90 Days<br>or More | Nonaccrual      | Past Due<br>and<br>Nonaccrual | Current           | Total             |
| <b>Commercial</b>                    |                                    |                    |                 |                               |                   |                   |
| Commercial real estate               | \$ 4,100                           | \$ 86              | \$ 2,939        | \$ 7,125                      | \$ 263,372        | \$ 270,497        |
| Commercial other                     | 680                                | 114                | 2,369           | 3,163                         | 95,706            | 98,869            |
| <b>Total commercial</b>              | <b>4,780</b>                       | <b>200</b>         | <b>5,308</b>    | <b>10,288</b>                 | <b>359,078</b>    | <b>369,366</b>    |
| <b>Agricultural</b>                  |                                    |                    |                 |                               |                   |                   |
| Agricultural real estate             | 36                                 | 91                 |                 | 127                           | 46,422            | 46,549            |
| Agricultural other                   | 328                                |                    | 261             | 589                           | 36,301            | 36,890            |
| <b>Total agricultural</b>            | <b>364</b>                         | <b>91</b>          | <b>261</b>      | <b>716</b>                    | <b>82,723</b>     | <b>83,439</b>     |
| <b>Residential real estate</b>       |                                    |                    |                 |                               |                   |                   |
| Senior liens                         | 2,824                              | 177                | 1,239           | 4,240                         | 218,895           | 223,135           |
| Junior liens                         | 184                                |                    | 32              | 216                           | 17,233            | 17,449            |
| Home equity lines of credit          | 238                                |                    | 185             | 423                           | 39,424            | 39,847            |
| <b>Total residential real estate</b> | <b>3,246</b>                       | <b>177</b>         | <b>1,456</b>    | <b>4,879</b>                  | <b>275,552</b>    | <b>280,431</b>    |
| <b>Consumer</b>                      |                                    |                    |                 |                               |                   |                   |
| Secured                              | 220                                |                    |                 | 220                           | 27,938            | 28,158            |
| Unsecured                            | 64                                 |                    |                 | 64                            | 5,293             | 5,357             |
| <b>Total consumer</b>                | <b>284</b>                         |                    |                 | <b>284</b>                    | <b>33,231</b>     | <b>33,515</b>     |
| <b>Total</b>                         | <b>\$ 8,674</b>                    | <b>\$ 468</b>      | <b>\$ 7,025</b> | <b>\$ 16,167</b>              | <b>\$ 750,584</b> | <b>\$ 766,751</b> |

|                          | <b>December 31, 2011</b>           |                    |              |                               |                |                |
|--------------------------|------------------------------------|--------------------|--------------|-------------------------------|----------------|----------------|
|                          | Accruing Interest<br>and Past Due: |                    |              | Total                         |                |                |
|                          | 30-89<br>Days                      | 90 Days<br>or More | Nonaccrual   | Past Due<br>and<br>Nonaccrual | Current        | Total          |
| <b>Commercial</b>        |                                    |                    |              |                               |                |                |
| Commercial real estate   | \$ 1,721                           | \$ 364             | \$ 4,176     | \$ 6,261                      | \$ 251,834     | \$ 258,095     |
| Commercial other         | 426                                | 3                  | 25           | 454                           | 107,165        | 107,619        |
| <b>Total commercial</b>  | <b>2,147</b>                       | <b>367</b>         | <b>4,201</b> | <b>6,715</b>                  | <b>358,999</b> | <b>365,714</b> |
| <b>Agricultural</b>      |                                    |                    |              |                               |                |                |
| Agricultural real estate |                                    | 99                 | 189          | 288                           | 44,395         | 44,683         |
| Agricultural other       | 2                                  |                    | 415          | 417                           | 29,545         | 29,962         |



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|                                      |                 |               |                 |                  |                   |                   |
|--------------------------------------|-----------------|---------------|-----------------|------------------|-------------------|-------------------|
| Total agricultural                   | 2               | 99            | 604             | 705              | 73,940            | 74,645            |
| <b>Residential real estate</b>       |                 |               |                 |                  |                   |                   |
| Senior liens                         | 3,004           | 124           | 1,292           | 4,420            | 213,181           | 217,601           |
| Junior liens                         | 235             | 40            | 94              | 369              | 20,877            | 21,246            |
| Home equity lines of credit          | 185             | 125           | 198             | 508              | 39,005            | 39,513            |
| <b>Total residential real estate</b> | <b>3,424</b>    | <b>289</b>    | <b>1,584</b>    | <b>5,297</b>     | <b>273,063</b>    | <b>278,360</b>    |
| <b>Consumer</b>                      |                 |               |                 |                  |                   |                   |
| Secured                              | 158             | 5             |                 | 163              | 26,011            | 26,174            |
| Unsecured                            | 23              |               |                 | 23               | 5,375             | 5,398             |
| <b>Total consumer</b>                | <b>181</b>      | <b>5</b>      |                 | <b>186</b>       | <b>31,386</b>     | <b>31,572</b>     |
| <b>Total</b>                         | <b>\$ 5,754</b> | <b>\$ 760</b> | <b>\$ 6,389</b> | <b>\$ 12,903</b> | <b>\$ 737,388</b> | <b>\$ 750,291</b> |

**Table of Contents****Impaired Loans**

Loans may be classified as impaired if they meet one or more of the following criteria:

1. There has been a chargeoff of its principal balance (in whole or in part);
2. The loan has been classified as a Troubled Debt Restructuring (TDR); or
3. The loan is in nonaccrual status.

Impairment is measured on a loan by loan basis for commercial, commercial real estate, agricultural, or agricultural real estate loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral, less cost to sell, if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment.

Interest income is recognized on impaired loans in nonaccrual status on the cash basis, but only after all principal has been collected. For impaired loans not in nonaccrual status, interest income is recognized daily as earned according to the terms of the loan agreement.

The following is a summary of information pertaining to impaired loans as of and for the periods ended:

|   | September 30, 2012     |                                |                        | December 31, 2011      |                                |                        |
|---|------------------------|--------------------------------|------------------------|------------------------|--------------------------------|------------------------|
|   | Outstanding<br>Balance | Unpaid<br>Principal<br>Balance | Valuation<br>Allowance | Outstanding<br>Balance | Unpaid<br>Principal<br>Balance | Valuation<br>Allowance |
| <b>Impaired loans with a valuation allowance</b>          |                        |                                |                        |                        |                                |                        |
| Commercial real estate                                    | \$ 6,392               | \$ 6,673                       | \$ 2,259               | \$ 5,014               | \$ 5,142                       | \$ 1,881               |
| Commercial other  | 3,047                  | 3,047                          | 656                    | 734                    | 734                            | 271                    |
| Agricultural other  |                        |                                |                        | 2,689                  | 2,689                          | 822                    |
| Residential real estate senior liens                      | 8,089                  | 9,237                          | 1,326                  | 7,271                  | 8,827                          | 1,111                  |
| Residential real estate junior liens                      | 152                    | 198                            | 28                     | 195                    | 260                            | 35                     |
| <b>Total impaired loans with a valuation allowance</b>    | <b>\$ 17,680</b>       | <b>\$ 19,155</b>               | <b>\$ 4,269</b>        | <b>\$ 15,903</b>       | <b>\$ 17,652</b>               | <b>\$ 4,120</b>        |
| <b>Impaired loans without a valuation allowance</b>       |                        |                                |                        |                        |                                |                        |
| Commercial real estate                                    | \$ 5,356               | \$ 6,128                       |                        | \$ 7,984               | \$ 10,570                      |                        |
| Commercial other  | 1,798                  | 1,908                          |                        | 365                    | 460                            |                        |
| Agricultural real estate                                  |                        |                                |                        | 190                    | 190                            |                        |
| Agricultural other  | 2,281                  | 2,401                          |                        | 505                    | 625                            |                        |
| Residential real estate senior liens                      | 3                      | 65                             |                        |                        |                                |                        |
| Home equity lines of credit                               | 185                    | 485                            |                        | 198                    | 498                            |                        |
| Consumer secured  | 79                     | 88                             |                        | 105                    | 114                            |                        |
| <b>Total impaired loans without a valuation allowance</b> | <b>\$ 9,702</b>        | <b>\$ 11,075</b>               |                        | <b>\$ 9,347</b>        | <b>\$ 12,457</b>               |                        |
| <b>Impaired loans</b>                                     |                        |                                |                        |                        |                                |                        |
| Commercial  | \$ 16,593              | \$ 17,756                      | \$ 2,915               | \$ 14,097              | \$ 16,906                      | \$ 2,152               |
| Agricultural  | 2,281                  | 2,401                          |                        | 3,384                  | 3,504                          | 822                    |
| Residential real estate                                   | 8,429                  | 9,985                          | 1,354                  | 7,664                  | 9,585                          | 1,146                  |
| Consumer  | 79                     | 88                             |                        | 105                    | 114                            |                        |

|                             |                  |                  |                 |                  |                  |                 |
|-----------------------------|------------------|------------------|-----------------|------------------|------------------|-----------------|
| <b>Total impaired loans</b> | <b>\$ 27,382</b> | <b>\$ 30,230</b> | <b>\$ 4,269</b> | <b>\$ 25,250</b> | <b>\$ 30,109</b> | <b>\$ 4,120</b> |
|-----------------------------|------------------|------------------|-----------------|------------------|------------------|-----------------|

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|   | Three Months Ended<br>September 30, 2012 |                                  | Nine Months Ended<br>September 30, 2012 |                                  |
|---|--|----------------------------------|---|----------------------------------|
|   | Average<br>Outstanding<br>Balance        | Interest<br>Income<br>Recognized | Average<br>Outstanding<br>Balance       | Interest<br>Income<br>Recognized |
| <b>Impaired loans with a valuation allowance</b>          |  |                                  |   |                                  |
| Commercial real estate                                    | \$ 6,260                                 | \$ 106                           | \$ 6,197                                | \$ 287                           |
| Commercial other  | 1,996                                    | 67                               | 1,183                                   | 95                               |
| Agricultural other  | 1,023                                    |                                  | 1,878                                   | 73                               |
| Residential real estate senior liens                      | 7,992                                    | 86                               | 7,802                                   | 261                              |
| Residential real estate junior liens                      | 158                                      | 3                                | 174                                     | 7                                |
| <b>Total impaired loans with a valuation allowance</b>    | <b>\$ 17,429</b>                         | <b>\$ 262</b>                    | <b>\$ 17,234</b>                        | <b>\$ 723</b>                    |
| <b>Impaired loans without a valuation allowance</b>       |  |                                  |   |                                  |
| Commercial real estate                                    | \$ 5,651                                 | \$ 72                            | \$ 6,749                                | \$ 251                           |
| Commercial other  | 2,026                                    | 15                               | 1,860                                   | 80                               |
| Agricultural real estate                                  | 179                                      |                                  | 214                                     |                                  |
| Agricultural other  | 1,417                                    | 34                               | 869                                     | 41                               |
| Residential real estate senior liens                      | 2  | 2                                | 1                                       | 2                                |
| Home equity lines of credit                               | 188                                      | 6                                | 194                                     | 14                               |
| Consumer secured  | 81                                       | 2                                | 90                                      | 5                                |
| <b>Total impaired loans without a valuation allowance</b> | <b>\$ 9,544</b>                          | <b>\$ 131</b>                    | <b>\$ 9,977</b>                         | <b>\$ 393</b>                    |
| <b>Impaired loans</b>                                     |  |                                  |   |                                  |
| Commercial  | \$ 15,933                                | \$ 260                           | \$ 15,989                               | \$ 713                           |
| Agricultural  | 2,619                                    | 34                               | 2,961                                   | 114                              |
| Residential real estate                                   | 8,340                                    | 97                               | 8,171                                   | 284                              |
| Consumer  | 81                                       | 2                                | 90                                      | 5                                |
| <b>Total impaired loans</b>                               | <b>\$ 26,973</b>                         | <b>\$ 393</b>                    | <b>\$ 27,211</b>                        | <b>\$ 1,116</b>                  |

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|   | Three Months Ended<br>September 30, 2011 |                                  | Nine Months Ended<br>September 30, 2011 |                                  |
|---|--|----------------------------------|---|----------------------------------|
|   | Average<br>Outstanding<br>Balance        | Interest<br>Income<br>Recognized | Average<br>Outstanding<br>Balance       | Interest<br>Income<br>Recognized |
| <b>Impaired loans with a valuation allowance</b>          |  |                                  |   |                                  |
| Commercial real estate                                    | \$ 4,770                                 | \$ 130                           | \$ 4,402                                | \$ 250                           |
| Commercial other  | 586                                      | 16                               | 577                                     | 16                               |
| Agricultural real estate                                  | 58                                       | 3                                | 58                                      | 3                                |
| Agricultural other  | 720                                      | (38)                             | 1,140                                   | 4                                |
| Residential real estate senior liens                      | 6,174                                    | 115                              | 5,621                                   | 221                              |
| Residential real estate junior liens                      | 179                                      | 1                                | 165                                     | 5                                |
| <b>Total impaired loans with a valuation allowance</b>    | <b>\$ 12,487</b>                         | <b>\$ 227</b>                    | <b>\$ 11,963</b>                        | <b>\$ 499</b>                    |
| <b>Impaired loans without a valuation allowance</b>       |  |                                  |   |                                  |
| Commercial real estate                                    | \$ 5,743                                 | \$ 124                           | \$ 3,878                                | \$ 219                           |
| Commercial other  | 1,941                                    | 37                               | 1,076                                   | 124                              |
| Agricultural real estate                                  | 207                                      | 2                                | 112                                     | 1                                |
| Agricultural other  | 2,411                                    | 112                              | 1,770                                   | 151                              |
| Residential real estate senior liens                      |  | 1                                | 201                                     | 1                                |
| Home equity lines of credit                               | 100                                      | 10                               | 100                                     | 10                               |
| Consumer secured  | 50                                       | 2                                | 61                                      | 5                                |
| <b>Total impaired loans without a valuation allowance</b> | <b>\$ 10,452</b>                         | <b>\$ 288</b>                    | <b>\$ 7,198</b>                         | <b>\$ 511</b>                    |
| <b>Impaired loans</b>                                     |  |                                  |   |                                  |
| Commercial  | \$ 13,040                                | \$ 307                           | \$ 9,933                                | \$ 609                           |
| Agricultural  | 3,396                                    | 79                               | 3,080                                   | 159                              |
| Residential real estate                                   | 6,453                                    | 127                              | 6,087                                   | 237                              |
| Consumer  | 50                                       | 2                                | 61                                      | 5                                |
| <b>Total impaired loans</b>                               | <b>\$ 22,939</b>                         | <b>\$ 515</b>                    | <b>\$ 19,161</b>                        | <b>\$ 1,010</b>                  |

Impaired loans, which include TDR s, had \$173 and \$68 of unfunded commitments under lines of credit as of September 30, 2012 and 2011, respectively.

**Table of Contents****Troubled Debt Restructurings**

Loan modifications are considered to be TDR s when a concession has been granted to a borrower who is experiencing financial difficulties.

Typical concessions granted include, but are not limited to:

1. Agreeing to interest rates below prevailing market rates for debt with similar risk characteristics.
2. Extending the amortization period beyond typical lending guidelines for debt with similar risk characteristics.
3. Forbearance of principal.
4. Forbearance of accrued interest.

To determine if a borrower is experiencing financial difficulties, we consider if:

1. The borrower is currently in default on any of their debt.
2. The borrower will likely default on any of their debt if the concession is not granted.
3. The borrower s cash flow is insufficient to service all of their debt if the concession is not granted.
4. The borrower has declared, or is in the process of declaring, bankruptcy.
5. The borrower is unlikely to continue as a going concern (if the entity is a business).

The following is a summary of information pertaining to TDR s for the three and nine month periods ended September 30, 2012:

|                                      | Loans Restructured in the Three Month<br>Period ended September 30, 2012 |  |   | Loans Restructured in the Nine Month<br>Period ended September 30, 2012 |  |   |
|--------------------------------------|--|--|---|---|--|---|
|                                      | Number<br>of<br>Loans  | Pre-<br>Modification<br>Recorded<br>Investment | Post-<br>Modification<br>Recorded<br>Investment | Number<br>of<br>Loans   | Pre-<br>Modification<br>Recorded<br>Investment | Post-<br>Modification<br>Recorded<br>Investment |
| Commercial other                     | 1  | \$ 178   | \$ 178  | 27  | \$ 5,069                                       | \$ 5,069  |
| Agricultural other                   |  |  |   | 6   | 561  | 561   |
| Residential real estate senior liens |  |  |   | 12  | 1,405  | 1,405   |
| Residential real estate junior liens | 1  | 22   | 22  | 1   | 22   | 22  |
| <b>Total</b>                         | <b>2</b>   | <b>\$ 200</b>                                  | <b>\$ 200</b>                                   | <b>46</b>   | <b>\$ 7,057</b>                                | <b>\$ 7,057</b>                                 |



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|                                      | Loans Restructured in the Three Month<br>Period ended September 30, 2011 |  |   | Loans Restructured in the Nine Month<br>Period ended September 30, 2011 |  |   |
|--------------------------------------|--|--|---|---|--|---|
|                                      | Number<br>of<br>Loans  | Pre-<br>Modification<br>Recorded<br>Investment | Post-<br>Modification<br>Recorded<br>Investment | Number<br>of<br>Loans   | Pre-<br>Modification<br>Recorded<br>Investment | Post-<br>Modification<br>Recorded<br>Investment |
| <b>Commercial</b>                    |  |  |   |   |  |   |
| Commercial real estate               | 1  | \$ 408   | \$ 408  | 1   | \$ 408   | \$ 408  |
| Commercial other                     | 21   | 4,069  | 3,737   | 42  | 12,143   | 11,700  |
| <b>Total commercial</b>              | <b>22</b>  | <b>4,477</b>                                   | <b>4,145</b>                                    | <b>43</b>   | <b>12,551</b>                                  | <b>12,108</b>                                   |
| Agricultural other                   | 3  | 143  | 143   | 11  | 1,481  | 1,481   |
| Residential real estate senior liens | 3  | 165  | 165   | 23  | 2,454  | 2,424   |
| Consumer secured                     | 3  | 34   | 34  | 5   | 50   | 50  |
| <b>Total</b>                         | <b>31</b>  | <b>\$ 4,819</b>                                | <b>\$ 4,487</b>                                 | <b>82</b>   | <b>\$ 16,536</b>                               | <b>\$ 16,063</b>                                |

|                                      | Loans Restructured in the Three Month<br>Period Ended September 30, 2012       |  |  |  | Loans Restructured in the Nine Month<br>Period Ended September 30, 2012        |  |  |  |
|--------------------------------------|--|--|--|--|--|--|--|--|
|                                      | Below Market<br>Interest Rate<br>and<br>Extension of<br>Amortization<br>Period |  | Below Market<br>Interest Rate<br>and<br>Extension of<br>Amortization<br>Period |  | Below Market<br>Interest Rate<br>and<br>Extension of<br>Amortization<br>Period |  | Below Market<br>Interest Rate<br>and<br>Extension of<br>Amortization<br>Period |  |
|                                      | Number<br>of<br>Loans  | Pre-<br>Modification<br>Recorded<br>Investment | Number<br>of<br>Loans  | Pre-<br>Modification<br>Recorded<br>Investment | Number<br>of<br>Loans  | Pre-<br>Modification<br>Recorded<br>Investment | Number<br>of<br>Loans  | Pre-<br>Modification<br>Recorded<br>Investment |
| Commercial other                     | 1  | \$ 178   |  | \$   | 25   | \$ 4,924                                       | 2  | \$ 145   |
| Agricultural other                   |  |  |  |  | 6  | 561  |  |  |
| Residential real estate senior liens |  |  |  |  | 4  | 324  | 8  | 1,081  |
| Residential real estate junior liens |  |  | 1  | 22   |  |  | 1  | 22   |
| <b>Total</b>                         | <b>1</b>   | <b>\$ 178</b>                                  | <b>1</b>   | <b>\$ 22</b>                                   | <b>35</b>  | <b>\$ 5,809</b>                                | <b>11</b>  | <b>\$ 1,248</b>                                |



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|                                      | Loans Restructured in the Three Month<br>Period Ended September 30, 2011 |  |                                     |  |   |  |
|--------------------------------------|--|--|-------------------------------------|--|---|--|
|                                      | Below Market<br>Interest Rate  |  | Extension of<br>Amortization Period |  | Below Market<br>Interest Rate<br>and<br>Extension of<br>Amortization Period |  |
|                                      | Number<br>of<br>Loans  | Pre-<br>Modification<br>Recorded<br>Investment | Number<br>of<br>Loans               | Pre-<br>Modification<br>Recorded<br>Investment | Number<br>of<br>Loans   | Pre-<br>Modification<br>Recorded<br>Investment |
| <b>Commercial</b>                    |  |  |                                     |  |   |  |
| Commercial real estate               | 1  | \$ 408   |                                     | \$   |   | \$   |
| Commercial other                     | 21   | 4,069  |                                     |  |   |  |
| <b>Total commercial</b>              | <b>22</b>  | <b>4,477</b>                                   |                                     |  |   |  |
| Agricultural other                   | 3  | 143  |                                     |  |   |  |
| Residential real estate senior liens | 1  | 85   | 1                                   | 7  | 1   | 73   |
| Consumer secured                     | 3  | 34   |                                     |  |   |  |
| <b>Total</b>                         | <b>29</b>  | <b>\$ 4,739</b>                                | <b>1</b>                            | <b>\$ 7</b>                                    | <b>1</b>  | <b>\$ 73</b>                                   |

|                                      | Loans Restructured in the Nine Month<br>Period Ended September 30, 2012 |  |                                     |  |   |  |
|--------------------------------------|---|--|-------------------------------------|--|---|--|
|                                      | Below Market<br>Interest Rate   |  | Extension of<br>Amortization Period |  | Below Market<br>Interest Rate<br>and<br>Extension of<br>Amortization Period |  |
|                                      | Number<br>of<br>Loans   | Pre-<br>Modification<br>Recorded<br>Investment | Number<br>of<br>Loans               | Pre-<br>Modification<br>Recorded<br>Investment | Number<br>of<br>Loans   | Pre-<br>Modification<br>Recorded<br>Investment |
| <b>Commercial</b>                    |   |  |                                     |  |   |  |
| Commercial real estate               | 1   | \$ 408   |                                     | \$   |   | \$   |
| Commercial other                     | 38  | 9,500  | 3                                   | 913  | 1   | 1,730  |
| <b>Total commercial</b>              | <b>39</b>   | <b>9,908</b>                                   | <b>3</b>                            | <b>913</b>                                     | <b>1</b>  | <b>1,730</b>                                   |
| Agricultural other                   | 11  | 1,481  |                                     |  |   |  |
| Residential real estate senior liens | 18  | 2,083  | 2                                   | 57   | 3   | 314  |
| Consumer secured                     | 5   | 50   |                                     |  |   |  |
| <b>Total</b>                         | <b>73</b>   | <b>\$ 13,522</b>                               | <b>5</b>                            | <b>\$ 970</b>                                  | <b>4</b>  | <b>\$ 2,044</b>                                |

We did not restructure any loans through the forbearance of principal or accrued interest in the three or nine month periods ended September 30, 2012 or 2011.

Based on our historical loss experience, losses associated with TDR s are not significantly different than other impaired loans within the same loan segment. As such, TDR s, including TDR s that have been modified in the past 12 months that subsequently defaulted, are analyzed in the same manner as other impaired loans within their respective loan segment.



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Following is a summary of loans that defaulted in the three and nine month periods ended September 30, 2012, which were modified within 12 months prior to the default date:

|                                      | Three Months Ended September 30, 2012 |                                 |                                  |                                  | Nine Months Ended September 30, 2012 |                                 |                                  |                                  |
|--------------------------------------|---------------------------------------|---------------------------------|----------------------------------|----------------------------------|--------------------------------------|---------------------------------|----------------------------------|----------------------------------|
|                                      | Number of Loans                       | Pre-Default Recorded Investment | Charge Off Recorded Upon Default | Post-Default Recorded Investment | Number of Loans                      | Pre-Default Recorded Investment | Charge Off Recorded Upon Default | Post-Default Recorded Investment |
| Commercial other                     | 2                                     | \$ 50                           | \$ 25                            | \$ 25                            | 3                                    | \$ 132                          | \$ 66                            | \$ 66                            |
| Residential real estate senior liens |                                       |                                 |                                  |                                  | 1                                    | 47                              | 43                               | 4                                |
| Consumer secured                     | 1                                     | 8                               | 8                                |                                  | 1                                    | 8                               | 8                                |                                  |
| <b>Total</b>                         | <b>3</b>                              | <b>\$ 58</b>                    | <b>\$ 33</b>                     | <b>\$ 25</b>                     | <b>5</b>                             | <b>\$ 187</b>                   | <b>\$ 117</b>                    | <b>\$ 70</b>                     |

We had no loans that defaulted during the first nine months of 2011, which were modified within 12 months prior to the default date.

The following is a summary of TDR loan balances as of:

|                              | September 30<br>2012 | December 31<br>2011 |
|------------------------------|----------------------|---------------------|
| Troubled debt restructurings | \$ 21,061            | \$ 18,756           |

**NOTE 7 EQUITY SECURITIES WITHOUT READILY DETERMINABLE FAIR VALUES**

Included in equity securities without readily determinable fair values are restricted securities, which are carried at cost, and investments in nonconsolidated entities accounted for under the equity method of accounting.

Equity securities without readily determinable fair values consist of the following as of:

|  | September 30<br>2012 | December 31<br>2011 |
|--|----------------------|---------------------|
| Federal Home Loan Bank Stock                 | \$ 7,700             | \$ 7,380            |
| Investment in Corporate Settlement Solutions | 6,932                | 6,611               |
| Federal Reserve Bank Stock                   | 1,879                | 1,879               |
| Investment in Valley Financial Corporation   | 1,000                | 1,000               |
| Other  | 319                  | 319                 |
| <b>Total</b>                                 | <b>\$ 17,830</b>     | <b>\$ 17,189</b>    |

**NOTE 8 BORROWED FUNDS**

Borrowed funds consist of the following obligations as of:

|  | September 30, 2012 |       | December 31, 2011 |       |
|--|--------------------|-------|-------------------|-------|
|  | Amount             | Rate  | Amount            | Rate  |
| Federal Home Loan Bank advances  | \$ 152,000         | 2.15% | \$ 142,242        | 3.16% |
| Securities sold under agreements to repurchase without stated maturity dates | 57,927             | 0.20% | 57,198            | 0.25% |
| Securities sold under agreements to repurchase with stated maturity dates    | 16,653             | 3.51% | 16,696            | 3.51% |

|              |                   |              |                   |              |
|--------------|-------------------|--------------|-------------------|--------------|
| <b>Total</b> | <b>\$ 226,580</b> | <b>1.75%</b> | <b>\$ 216,136</b> | <b>2.42%</b> |
|--------------|-------------------|--------------|-------------------|--------------|

The FHLB advances are collateralized by a blanket lien on all qualified 1-4 family residential real estate loans and certain mortgage-backed securities and collateralized mortgage obligations. Advances are also secured by our holdings of FHLB stock. We had the ability to borrow up to an additional \$117,035 based on assets currently pledged as collateral as of September 30, 2012. During the first quarter of 2012, we reduced funding costs by modifying the terms of \$60,000 of FHLB advances.

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The following table lists the maturity and weighted average interest rates of FHLB advances as of:

|   | September 30<br>2012 |              | December 31<br>2011 |              |
|---|----------------------|--------------|---------------------|--------------|
|   | Amount               | Rate         | Amount              | Rate         |
| Fixed rate advances due 2012                  | \$                   |              | \$ 17,000           | 2.97%        |
| One year putable fixed rate advances due 2012 | 5,000                | 3.48%        | 15,000              | 4.10%        |
| Variable rate advances due 2012               | 5,000                | 0.50%        |                     |              |
| Fixed rate advances due 2013                  |                      |              | 5,242               | 4.14%        |
| One year putable fixed rate advances due 2013 |                      |              | 5,000               | 3.15%        |
| Fixed rate advances due 2014                  |                      |              | 25,000              | 3.16%        |
| Fixed rate advances due 2015                  | 42,000               | 1.12%        | 45,000              | 3.30%        |
| Fixed rate advances due 2016                  | 10,000               | 2.15%        | 10,000              | 2.15%        |
| Fixed rate advances due 2017                  | 40,000               | 2.15%        | 20,000              | 2.56%        |
| Fixed rate advances due 2018                  | 20,000               | 2.86%        |                     |              |
| Fixed rate advances due 2019                  | 20,000               | 3.73%        |                     |              |
| Fixed rate advances due 2020                  | 10,000               | 1.98%        |                     |              |
| <b>Total</b>                                  | <b>\$ 152,000</b>    | <b>2.15%</b> | <b>\$ 142,242</b>   | <b>3.16%</b> |

Securities sold under agreements to repurchase are classified as secured borrowings. Securities sold under agreements to repurchase without stated maturity dates generally mature within one to four days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction. The securities underlying the agreements have a carrying value and a fair value of \$112,873 and \$99,869 at September 30, 2012 and December 31, 2011, respectively. Such securities remain under our control. We may be required to provide additional collateral based on the fair value of underlying securities.

The following table provides a summary of short term borrowings for the three and nine month periods ended September 30:

|  | Three Months Ended September 30 |                                 |                           |                                 |  |  |
|--|---------------------------------|---------------------------------|---------------------------|---------------------------------|--|--|
|  | 2012                            |                                 | 2011                      |                                 | Weighted Average Interest Rate                   |  |
|  | Maximum Month-End Balance       | Quarter to Date Average Balance | Maximum Month-End Balance | Quarter to Date Average Balance | Weighted Average Interest Rate During the Period | Weighted Average Interest Rate During the Period |
| Securities sold under agreements to repurchase without stated maturity dates | \$ 58,471                       | \$ 57,983                       | \$ 49,583                 | \$ 47,871                       | 0.20%  | 0.25%  |
| Federal funds purchased  | 15,000                          | 5,848                           | 18,300                    | 2,563                           | 0.46%  | 0.46%  |

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|  | Nine Months Ended September 30 |                                 |  |                           |           |  |
|--|--------------------------------|---------------------------------|--|---------------------------|-----------|--|
|  | 2012                           |                                 | Weighted<br>Average<br>Interest Rate<br>During the<br>Period | 2011                      |           | Weighted<br>Average<br>Interest Rate<br>During the<br>Period |
| Maximum<br>Month-End<br>Balance  | YTD<br>Average<br>Balance      | Maximum<br>Month-End<br>Balance |  | YTD<br>Average<br>Balance |           |  |
| Securities sold under agreements to repurchase without stated maturity dates | \$ 58,584                      | \$ 55,721                       | 0.20%  | \$ 49,583                 | \$ 42,515 | 0.25%  |
| Federal funds purchased  | 17,900                         | 4,327                           | 0.41%  | 18,300                    | 2,776     | 0.51%  |

We had pledged certificates of deposit held in other financial institutions, trading securities, available-for-sale securities, and 1-4 family residential real estate loans in the following amounts at:

|   | September 30<br>2012 | December 31<br>2011 |
|---|----------------------|---------------------|
| Pledged to secure borrowed funds  | \$ 308,797           | \$ 292,092          |
| Pledged to secure repurchase agreements   | 112,873              | 99,869              |
| Pledged for public deposits and for other purposes necessary or required by law | 23,480               | 26,761              |
| <b>Total</b>  | <b>\$ 445,150</b>    | <b>\$ 418,722</b>   |

We had no investment securities that are restricted to be pledged for specific purposes.

**NOTE 9 OTHER NONINTEREST EXPENSES**

A summary of expenses included in other noninterest expenses are as follows for the three and nine month periods ended:

|                                 | Three Months Ended<br>September 30 |                 | Nine Months Ended<br>September 30 |                 |
|---------------------------------|------------------------------------|-----------------|-----------------------------------|-----------------|
|                                 | 2012                               | 2011            | 2012                              | 2011            |
| Marketing and donations         | \$ 610                             | \$ 228          | \$ 1,639                          | \$ 978          |
| FDIC insurance premiums         | 218                                | 209             | 646                               | 874             |
| Directors fees                  | 235                                | 203             | 654                               | 620             |
| Audit fees                      | 179                                | 195             | 509                               | 518             |
| Education and travel            | 112                                | 102             | 378                               | 306             |
| Printing and supplies           | 91                                 | 108             | 310                               | 297             |
| Postage and freight             | 105                                | 103             | 300                               | 299             |
| Foreclosed asset and collection | 21                                 | 143             | 100                               | 420             |
| Consulting fees                 | 92                                 | 63              | 350                               | 163             |
| Amortization of deposit premium | 67                                 | 77              | 200                               | 229             |
| Legal fees                      | 50                                 | 82              | 193                               | 198             |
| Other Losses                    | 80                                 | 23              | 217                               | 34              |
| All other                       | 376                                | 379             | 1,186                             | 1,102           |
| <b>Total</b>                    | <b>\$ 2,236</b>                    | <b>\$ 1,915</b> | <b>\$ 6,682</b>                   | <b>\$ 6,038</b> |

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The reconciliation of the provision for federal income taxes and the amount computed at the federal statutory tax rate of 34% of income before federal income tax expense is as follows for the three and nine month periods ended September 30:

|   | Three Months Ended<br>September 30 |               | Nine Months Ended<br>September 30 |                 |
|---|------------------------------------|---------------|-----------------------------------|-----------------|
|   | 2012                               | 2011          | 2012                              | 2011            |
| Income taxes at 34% statutory rate            | \$ 1,481                           | \$ 967        | \$ 4,093                          | \$ 2,971        |
| Effect of nontaxable income                   |                                    |               |                                   |                 |
| Interest income on tax exempt municipal bonds | (391)                              | (389)         | (1,170)                           | (1,157)         |
| Earnings on corporate owned life insurance    | (58)                               | (48)          | (176)                             | (146)           |
| Other   | (147)                              | (204)         | (439)                             | (460)           |
| Total effect of nontaxable income             | (596)                              | (641)         | (1,785)                           | (1,763)         |
| Effect of nondeductible expenses              | 14                                 | 8             | 36                                | 31              |
| <b>Federal income tax expense</b>             | <b>\$ 899</b>                      | <b>\$ 334</b> | <b>\$ 2,344</b>                   | <b>\$ 1,239</b> |

Included in OCI for the three and nine month periods ended September 30, 2012 and 2011 are changes in unrealized holding gains, related to auction rate money market preferred and preferred stocks. For federal income tax purposes, these securities are considered equity investments. As such, no deferred federal income taxes related to unrealized holding gains or losses are expected or recorded.

A summary of OCI follows for the three and nine month periods ended September 30:

|   | September 30, 2012   |                                   |                 | September 30, 2011   |                                   |                 |
|---|--|-----------------------------------|-----------------|--|-----------------------------------|-----------------|
|   | Auction<br>Rate<br>Money<br>Market<br>Preferreds<br>and<br>Preferred<br>Stocks | All<br>Other<br>AFS<br>Securities | Total           | Auction<br>Rate<br>Money<br>Market<br>Preferreds<br>and<br>Preferred<br>Stocks | All<br>Other<br>AFS<br>Securities | Total           |
| Unrealized gains (losses) arising during the period                       | \$ 630   | \$ 2,360                          | \$ 2,990        | \$ (675)   | \$ 5,396                          | \$ 4,721        |
| Reclassification adjustment for net realized gains included in net income |  | (116)                             | (116)           |  |                                   |                 |
| Net unrealized gains  | 630  | 2,244                             | 2,874           | (675)  | 5,396                             | 4,721           |
| Tax effect  |  | (763)                             | (763)           |  | (1,835)                           | (1,835)         |
| <b>Other comprehensive income (loss), net of tax</b>                      | <b>\$ 630</b>  | <b>\$ 1,481</b>                   | <b>\$ 2,111</b> | <b>\$ (675)</b>  | <b>\$ 3,561</b>                   | <b>\$ 2,886</b> |

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|   | Nine Months Ended  |                                   |                 |  |                                   |                 |
|---|--|-----------------------------------|-----------------|--|-----------------------------------|-----------------|
|   | September 30, 2012   |                                   |                 | September 30, 2011   |                                   |                 |
|   | Auction<br>Rate<br>Money<br>Market<br>Preferreds<br>and<br>Preferred<br>Stocks | All<br>Other<br>AFS<br>Securities | Total           | Auction<br>Rate<br>Money<br>Market<br>Preferreds<br>and<br>Preferred<br>Stocks | All<br>Other<br>AFS<br>Securities | Total           |
| Unrealized gains arising during the period                                | \$ 2,049   | \$ 3,160                          | \$ 5,209        | \$ (72)  | \$ 10,122                         | \$ 10,050       |
| Reclassification adjustment for net realized gains included in net income |  | (1,119)                           | (1,119)         |  |                                   |                 |
| Reclassification adjustment for impairment loss included in net income    |  | 282                               | 282             |  |                                   |                 |
| Net unrealized gains  | 2,049  | 2,323                             | 4,372           | (72)   | 10,122                            | 10,050          |
| Tax effect  |  | (790)                             | (790)           |  | (3,442)                           | (3,442)         |
| <b>Other comprehensive income, net of tax</b>                             | <b>\$ 2,049</b>  | <b>\$ 1,533</b>                   | <b>\$ 3,582</b> | <b>\$ (72)</b>   | <b>\$ 6,680</b>                   | <b>\$ 6,608</b> |

**NOTE 11 DEFINED BENEFIT PENSION PLAN**

We maintain a noncontributory defined benefit pension plan, which was curtailed effective March 1, 2007. As a result of the curtailment, future salary increases are no longer considered and plan benefits are based on years of service and the employees' five highest consecutive years of compensation out of the last ten years of service through March 1, 2007. We contributed \$709 to the pension plan during the nine month period ended September 30, 2012 and contributed \$140 to the plan in the nine month period ended September 30, 2011. We anticipate contributing \$41 to the plan in the fourth quarter of 2012.

Following are the components of net periodic benefit cost for the three and nine month periods ended September 30:

|   | Three Months Ended   |                      | Nine Months Ended    |                      |
|---|----------------------|----------------------|----------------------|----------------------|
|   | September 30<br>2012 | September 30<br>2011 | September 30<br>2012 | September 30<br>2011 |
| Interest cost on PBO                            | \$ 118               | \$ 126               | \$ 353               | \$ 380               |
| Expected return on plan assets                  | (127)                | (131)                | (381)                | (392)                |
| Amortization of unrecognized actuarial net loss | 73                   | 38                   | 219                  | 115                  |
| <b>Net periodic benefit cost</b>                | <b>\$ 64</b>         | <b>\$ 33</b>         | <b>\$ 191</b>        | <b>\$ 103</b>        |

**NOTE 12 FAIR VALUE**

Following is a description of the valuation methodologies, key inputs, and an indication of the level of the fair value hierarchy in which the assets or liabilities are classified.

*Cash and demand deposits due from banks:* The carrying amounts of cash and short term investments, including Federal funds sold, approximate fair values. As such, we classify cash and demand deposits due from banks as Level 1.

*Certificates of deposit held in other financial institutions:* Interest bearing balances held in unaffiliated financial institutions include certificates of deposit and other short term interest bearing balances that mature within 3 years. Fair value is determined using prices for similar assets with similar characteristics. As such, we classify certificates of deposits held in other financial institutions as Level 2.

*Investment securities:* Investment securities are recorded at fair value on a recurring basis. Level 1 fair value measurement is based upon quoted prices for identical instruments. Level 2 fair value measurement is based upon quoted prices for similar instruments. If quoted prices are not available, fair values are measured using independent pricing models or other model based valuation techniques.





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such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss and liquidity assumptions. The values for Level 1 and Level 2 investment securities are generally obtained from an independent third party. On a quarterly basis, we compare the values provided to alternative pricing sources.

Due to the limited trading activity of certain auction rate money market preferred securities and preferred stocks, we measured these securities using Level 3 inputs as of September 30, 2012. As the markets for these securities normalized and established regular trading patterns, we measured preferred stocks utilizing Level 1 inputs and an auction rate money market preferred security utilizing Level 2 inputs as of December 31, 2011 and continued to measure at these levels as of September 30, 2012.

The table below represents the activity in auction rate money market preferred available-for-sale investment securities measured with Level 3 inputs on a recurring basis for the:

|                                       | Three Months<br>Ended<br>September 30, 2011 | Nine Months Ended<br>September 30,<br>2011 |
|---------------------------------------|---|--|
| Level 3 inputs at beginning of period | \$ 2,834                                    | \$ 2,865                                   |
| Net unrealized losses                 | (371)                                       | (402)                                      |
| Level 3 inputs September 30           | \$ 2,463                                    | \$ 2,463                                   |

The table below represents the activity in preferred stock available-for-sale investment securities measured with Level 3 inputs on a recurring basis for the:

|                                       | Three Months<br>Ended<br>September 30, 2011 | Nine Months Ended<br>September 30,<br>2011 |
|---------------------------------------|---|--|
| Level 3 inputs at beginning of period | \$ 7,570                                    | \$ 6,936                                   |
| Net unrealized (losses) gains         | (304)                                       | 330  |
| Level 3 inputs September 30           | \$ 7,266                                    | \$ 7,266                                   |

We had no financial instruments measured with Level 3 inputs on a recurring basis during 2012.

*Mortgage loans available-for-sale:* Mortgage loans available-for-sale are carried at the lower of cost or fair value. The fair value of mortgage loans available-for-sale are based on what price secondary markets are currently offering for portfolios with similar characteristics. As such, we classify loans subjected to nonrecurring fair value adjustments as Level 2.

*Loans:* For variable rate loans with no significant change in credit risk, fair values are based on carrying values. Fair values for fixed rate loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The resulting amounts are adjusted to estimate the effect of changes in the credit quality of borrowers since the loans were originated.

We do not record loans at fair value on a recurring basis. However, from time to time, loans are classified as impaired and a specific allowance for loan losses may be established. Loans for which it is probable that payment of interest and principal will be significantly different than the contractual terms of the original loan agreement are considered impaired. Once a loan is identified as impaired, we measure the estimated impairment. The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value, or discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans.

We review the net realizable values of the underlying collateral for collateral dependent impaired loans on at least a quarterly basis for all loan types. To determine the collateral value, management utilizes independent appraisals, broker price opinions, or internal evaluations. These valuations are reviewed to determine whether an additional discount should be applied given the age of market



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information that may have been considered as well as other factors such as costs to carry and sell an asset if it is determined that the collateral will be liquidated in connection with the ultimate settlement of the loan. We use these valuations to determine if any charge offs or specific reserves are necessary. We may obtain new valuations in certain circumstances, including when there has been significant deterioration in the condition of the collateral, if the foreclosure process has begun, or if the existing valuation is deemed to be outdated.

Impaired loans where an allowance is established based on the net realizable value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraisal value, we record the loan as nonrecurring Level 2. When a current appraised value is not available or we determine the fair value of collateral is further impaired below the appraised value, the impaired loan is classified as nonrecurring Level 3.

The table below lists the quantitative information about impaired loans measured utilizing Level 3 fair value measurements as of September 30, 2012:

| Valuation Techniques              | Fair Value | Unobservable Input         | Range           |
|-----------------------------------|------------|----------------------------|-----------------|
| <b>Discounted cash flow</b>       | \$ 6,889   | Duration of cash flows     | 17 - 120 Months |
|                                   |            | Reduction in interest rate |                 |
|                                   |            | from original loan terms   | 2.13% - 3.38%   |
|                                   |            | Discount applied to        |                 |
|                                   |            | collateral appraisal:      |                 |
|                                   |            | Real Estate                | 20% -30%        |
|                                   |            | Equipment                  | 50%             |
| <b>Discounted appraisal value</b> | \$ 16,224  | Livestock                  | 50%             |
|                                   |            | Cash crop inventory        | 50%             |
|                                   |            | Other inventory            | 75%             |
|                                   |            | Accounts receivable        | 75%             |

*Accrued interest:* The carrying amounts of accrued interest approximate fair value. As such, we classify accrued interest as Level 1.

*Goodwill and other intangible assets:* Acquisition intangibles and goodwill are evaluated for potential impairment on at least an annual basis. Goodwill is typically qualitatively evaluated to determine if it is more likely than not that the carrying balance is impaired. If it is determined that the carrying balance of goodwill is more likely than not to be impaired, we perform a cash flow valuation to determine the extent of the potential impairment. Acquisition intangibles are tested for impairment with a cash flow valuation. This valuation method requires a significant degree of judgment. In the event the projected undiscounted net operating cash flows for these intangible assets are less than the carrying value, the asset is recorded at fair value as determined by the valuation model. If the testing resulted in impairment, we would classify goodwill and other acquisition intangibles subjected to nonrecurring fair value adjustments as Level 3. During 2012 and 2011 there were no impairments recorded on goodwill and other acquisition intangibles.

*Equity securities without readily determinable fair values:* We have investments in equity securities without readily determinable fair values as well as investments in joint ventures. The assets are individually reviewed for impairment on an annual basis, or more frequently if an indication of impairment exists, by comparing the carrying value to the estimated fair value. The lack of an independent source to validate fair value estimates, including the impact of future capital calls and transfer restrictions, is an inherent limitation in the valuation process. We classify nonmarketable equity securities and investments in joint ventures subjected to nonrecurring fair value adjustments as Level 3. During 2012 and 2011, there were no impairments recorded on equity securities without readily determinable fair values.

*Foreclosed assets:* Upon transfer from the loan portfolio, foreclosed assets are adjusted to and subsequently carried at the lower of carrying value or fair value less costs to sell. Net realizable value is based upon independent market prices, appraised values of the collateral, or management's estimation of the value of the collateral and as such, we classify foreclosed assets as a nonrecurring Level 2. When the net realizable value of the collateral is further impaired below the appraised value but there is no observable market price, we record the foreclosed asset as nonrecurring Level 3.



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*Originated mortgage servicing rights:* OMSR is subject to impairment testing. A valuation model, which utilizes a discounted cash flow analysis using interest rates and prepayment speed assumptions currently quoted for comparable instruments and a discount rate determined by management, is used for impairment testing. If the valuation model reflects a value less than the carrying value, originated mortgage servicing rights are adjusted to fair value through a valuation allowance as determined by the model. As such, we classify loan servicing rights subject to nonrecurring fair value adjustments as Level 2.

*Deposits:* The fair value of demand, savings, and money market deposits are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts), and are classified as Level 1. Fair values for variable rate certificates of deposit approximate their recorded carrying value. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits. As such, certificates of deposit are classified as Level 2.

*Borrowed funds:* The carrying amounts of federal funds purchased, borrowings under overnight repurchase agreements, and other short-term borrowings maturing within ninety days approximate their fair values. The fair values of other borrowed funds are estimated using discounted cash flow analyses based on current incremental borrowing arrangements.

We elected to measure a portion of borrowed funds at fair value as of December 31, 2011. These borrowings were recorded at fair value on a recurring basis, with the fair value measurement estimated using discounted cash flow analysis based on current incremental borrowing rates for similar types of borrowing arrangements. Changes in the fair value of these borrowings are included in noninterest income. As such, other borrowed funds are classified as Level 2.

The activity in borrowings which the Corporation had elected to carry at fair value was as follows:

|  | Three Months Ended<br>September 30 |                 | Nine Months Ended<br>September 30 |                 |
|--|------------------------------------|-----------------|-----------------------------------|-----------------|
|  | 2012                               | 2011            | 2012                              | 2011            |
| Borrowings carried at fair value beginning of year   | \$                                 | \$ 5,306        | \$ 5,242                          | \$ 10,423       |
| Paydowns and maturities                              |                                    |                 | (5,209)                           | (5,000)         |
| Net unrealized change in fair value                  |                                    | (42)            | (33)                              | (159)           |
| <b>Borrowings carried at fair value September 30</b> | <b>\$</b>                          | <b>\$ 5,264</b> | <b>\$</b>                         | <b>\$ 5,264</b> |
| <b>Unpaid principal balance September 30</b>         | <b>\$</b>                          | <b>\$ 5,000</b> | <b>\$</b>                         | <b>\$ 5,000</b> |

*Commitments to extend credit, standby letters of credit and undisbursed loans:* Fair values for off balance sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into consideration the remaining terms of the agreements and the counterparties' credit standings. As we do not charge fees for lending commitments outstanding, as it is not practicable to estimate the fair value of these instruments.

The preceding methods described may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, although we believe our valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement.

**Estimated Fair Values of Financial Instruments Not Recorded at Fair Value in their Entirety on a Recurring Basis**

Disclosure of the estimated fair values of financial instruments, which differ from carrying values, often requires the use of estimates. In cases where quoted market values in an active market are not available, we use present value techniques and other valuation methods to estimate the fair values of our financial instruments. These valuation methods require considerable judgment and the resulting estimates of fair value can be significantly affected by the assumptions made and methods used.

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The carrying amount and estimated fair value of financial instruments not recorded at fair value in their entirety on a recurring basis on our consolidated balance sheets are as follows as of:

|  | Carrying Value | Estimated Fair Value | September 30, 2012 |           |           |
|--|----------------|----------------------|--------------------|-----------|-----------|
|  |                |                      | (Level 1)          | (Level 2) | (Level 3) |
| <b>ASSETS</b>  |                |                      |                    |           |           |
| Cash and demand deposits due from banks                        | \$ 24,664      | \$ 24,664            | \$ 24,664          | \$        | \$        |
| Certificates of deposit held in other financial institutions   | 5,675          | 5,691                |                    | 5,691     |           |
| Mortgage loans available-for-sale                              | 2,820          | 2,856                |                    | 2,856     |           |
| Total loans  | 766,751        | 780,793              |                    | 753,411   | 27,382    |
| Less allowance for loan losses                                 | (12,062)       | (12,062)             |                    | (7,793)   | (4,269)   |
| Net loans  | 754,689        | 768,731              |                    | 745,618   | 23,113    |
| Accrued interest receivable                                    | 6,565          | 6,565                | 6,565              |           |           |
| Equity securities without readily determinable fair values (1) | 17,830         | 17,830               |                    |           |           |
| Originated mortgage servicing rights                           | 2,290          | 2,290                |                    | 2,290     |           |
| <b>LIABILITIES</b>   |                |                      |                    |           |           |
| Deposits without stated maturities                             | 522,642        | 522,642              | 522,642            |           |           |
| Deposits with stated maturities                                | 466,849        | 475,526              |                    | 475,526   |           |
| Borrowed funds   | 226,580        | 234,229              |                    | 234,229   |           |
| Accrued interest payable                                       | 813            | 813                  | 813                |           |           |

|  | Carrying Value | Estimated Fair Value | December 31, 2011 |           |           |
|--|----------------|----------------------|-------------------|-----------|-----------|
|  |                |                      | (Level 1)         | (Level 2) | (Level 3) |
| <b>ASSETS</b>  |                |                      |                   |           |           |
| Cash and demand deposits due from banks                        | \$ 28,590      | \$ 28,590            | \$ 28,590         | \$ -      | \$ -      |
| Certificates of deposit held in other financial institutions   | 8,924          | 8,977                | -                 | 8,977     | -         |
| Mortgage loans available-for-sale                              | 3,205          | 3,252                |                   | 3,252     |           |
| Total loans  | 750,291        | 769,177              |                   | 743,927   | 25,250    |
| Less allowance for loan losses                                 | (12,375)       | (12,375)             |                   | (8,255)   | (4,120)   |
| Net loans  | 737,916        | 756,802              |                   | 735,672   | 21,130    |
| Accrued interest receivable                                    | 5,848          | 5,848                | 5,848             |           |           |
| Equity securities without readily determinable fair values (1) | 17,189         | 17,189               |                   |           |           |
| Originated mortgage servicing rights                           | 2,374          | 2,374                |                   | 2,374     |           |
| <b>LIABILITIES</b>   |                |                      |                   |           |           |
| Deposits without stated maturities                             | 476,627        | 476,627              | 476,627           |           |           |
| Deposits with stated maturities                                | 481,537        | 499,644              |                   | 499,644   |           |
| Borrowed funds   | 210,894        | 222,538              |                   | 222,538   |           |
| Accrued interest payable                                       | 967            | 967                  | 967               |           |           |

- (1) Due to the characteristics of equity securities without readily determinable fair values, they are not disclosed under a specific fair value hierarchy.

**Table of Contents****Financial Instruments Recorded at Fair Value**

The table below presents the recorded amount of assets and liabilities measured at fair value on:

| Description  | Total   | September 30, 2012 |           |           | Total   | December 31, 2011 |           |           |
|--|---------|--------------------|-----------|-----------|---------|-------------------|-----------|-----------|
|  |         | (Level 1)          | (Level 2) | (Level 3) |         | (Level 1)         | (Level 2) | (Level 3) |
| <b>Recurring items</b>                                   |         |                    |           |           |         |                   |           |           |
| Trading securities                                       |         |                    |           |           |         |                   |           |           |
| States and political subdivisions                        | 1,788   |                    | 1,788     |           | 4,710   |                   | 4,710     |           |
| Available-for-sale investment securities                 |         |                    |           |           |         |                   |           |           |
| Government sponsored enterprises                         | 1,957   |                    | 1,957     |           | 397     |                   | 397       |           |
| States and political subdivisions                        | 185,480 |                    | 185,480   |           | 174,938 |                   | 174,938   |           |
| Auction rate money market preferred                      | 2,771   |                    | 2,771     |           | 2,049   |                   | 2,049     |           |
| Preferred stocks   | 6,360   | 6,360              |           |           | 5,033   | 5,033             |           |           |
| Mortgage-backed securities                               | 142,228 |                    | 142,228   |           | 143,602 |                   | 143,602   |           |
| Collateralized mortgage obligations                      | 128,618 |                    | 128,618   |           | 99,101  |                   | 99,101    |           |
| Total available-for-sale investment securities           | 467,414 | 6,360              | 461,054   |           | 425,120 | 5,033             | 420,087   |           |
| Borrowed funds   |         |                    |           |           | 5,242   |                   | 5,242     |           |
| <b>Nonrecurring items</b>                                |         |                    |           |           |         |                   |           |           |
| Impaired loans (net of the allowance for loan losses)    |         |                    |           |           |         |                   |           |           |
|  | 23,113  |                    |           | 23,113    | 21,130  |                   |           | 21,130    |
| Originated mortgage servicing rights                     | 2,290   |                    | 2,290     |           | 2,374   |                   | 2,374     |           |
| Foreclosed assets  | 2,001   |                    | 2,001     |           | 1,876   |                   | 1,876     |           |
|  | 496,606 | 6,360              | 467,133   | 23,113    | 460,452 | 5,033             | 434,289   | 21,130    |
| Percent of assets and liabilities measured at fair value |         | 1.28%              | 94.07%    | 4.65%     |         | 1.09%             | 94.32%    | 4.59%     |

The changes in fair value of assets and liabilities recorded at fair value through earnings on a recurring basis and changes in assets and liabilities recorded at fair value on a nonrecurring basis, for which an impairment, or reduction of an impairment, was recognized in the three and nine month periods ended September 30, 2012 and 2011, are summarized as follows:

| Description                          | Three Months Ended September 30 |                          |              |                            |                          |              |
|--------------------------------------|---------------------------------|--------------------------|--------------|----------------------------|--------------------------|--------------|
|                                      | 2012                            |                          |              | 2011                       |                          |              |
|                                      | Trading Gains and (Losses)      | Other Gains and (Losses) | Total        | Trading Gains and (Losses) | Other Gains and (Losses) | Total        |
| <b>Recurring Items</b>               |                                 |                          |              |                            |                          |              |
| Trading securities                   | (9)                             |                          | (9)          | (24)                       |                          | (24)         |
| Borrowed funds                       |                                 |                          |              |                            | 42                       | 42           |
| <b>Nonrecurring Items</b>            |                                 |                          |              |                            |                          |              |
| Foreclosed assets                    |                                 |                          |              |                            | (10)                     | (10)         |
| Originated mortgage servicing rights |                                 | (98)                     | (98)         |                            | (296)                    | (296)        |
| <b>Total</b>                         | <b>(9)</b>                      | <b>(98)</b>              | <b>(107)</b> | <b>(24)</b>                | <b>(264)</b>             | <b>(288)</b> |





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| Description                          | Nine Months Ended September 30 |                             |             |                   |                             |              |
|--------------------------------------|--------------------------------|-----------------------------|-------------|-------------------|-----------------------------|--------------|
|                                      | 2012                           |                             |             | 2011              |                             |              |
|                                      | Trading<br>Losses              | Other Gains<br>and (Losses) | Total       | Trading<br>Losses | Other Gains<br>and (Losses) | Total        |
| <b>Recurring items</b>               |                                |                             |             |                   |                             |              |
| Trading securities                   | (41)                           |                             | (41)        | (51)              |                             | (51)         |
| Borrowed funds                       |                                | 33                          | 33          |                   | 159                         | 159          |
| <b>Nonrecurring items</b>            |                                |                             |             |                   |                             |              |
| Foreclosed assets                    |                                | (17)                        | (17)        |                   | (45)                        | (45)         |
| Originated mortgage servicing rights |                                | (56)                        | (56)        |                   | (314)                       | (314)        |
| <b>Total</b>                         | <b>(41)</b>                    | <b>(40)</b>                 | <b>(81)</b> | <b>(51)</b>       | <b>(200)</b>                | <b>(251)</b> |

**NOTE 13 OPERATING SEGMENTS**

Our reportable segments are based on legal entities that account for at least 10% of net operating results. The operations of Isabella Bank as of September 30, 2012 and 2011 and each of the three and nine month periods then ended, represented 90% or more of our consolidated total assets and operating results. As such, no additional segment reporting is presented.

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### **Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations**

#### **ISABELLA BANK CORPORATION FINANCIAL REVIEW**

(All dollars in thousands, except per share data)

This section reviews the financial condition and results of operations of Isabella Bank Corporation and its subsidiaries for the three and nine month periods ended September 30, 2012 and 2011. This analysis should be read in conjunction with our 2011 annual report and with the unaudited interim condensed consolidated financial statements and notes, beginning on page 3 of this report. A comprehensive list of acronyms and abbreviations used throughout this discussion is included in Note 1 Basis of Presentation of our interim condensed consolidated financial statements.

#### **Executive Summary**

Despite the challenges of the current economic environment and increased regulatory compliance costs, we are pleased to report our highest quarterly earnings ever and we anticipate that the year ending December 31, 2012 will be our strongest year. There continues to be slight improvements in the local, regional, and national economies, but a large degree of economic uncertainty remains. Our continued success throughout these challenging times is a direct result of our unwavering focus on community banking principles, prudent underwriting standards, and long term sustainable growth. This focus has enabled us to continue to meet the needs of the communities we serve which translates into increased shareholder value.

As we continue to look to build upon our continued success and our desire to expand into complementary markets, we are excited about the prospects of our new Freeland, Michigan office which was opened in October 2012. The new location will complement our existing office locations, increase our brand awareness in the Freeland area, and provide additional shareholder value for years to come.

#### **Recent Legislation**

The Health Care and Education Act of 2010, the Patient Protection and Affordable Care Act, the Dodd-Frank Act, and the JOBS Act, have already and are expected to continue to have a significant impact on the Corporation's operating results in future periods. While the legislation has been passed for these acts, much of the regulations have yet to be written. As such, the extent of the potential impact on our operations has yet to be determined. Of these three acts, the Dodd-Frank Act has had, and is likely to have, the most significant impact. This particular Act made sweeping changes in the regulation of financial institutions aimed at strengthening the operation of the financial services sector. As a result of the implementation of some of the provisions, we have had increases in compensation costs and this trend is expected to continue.

In June 2012, the FFIEC proposed new capital requirements for all financial institutions. In general, the proposal adds a new capital standard of equity capital to assets and increases the minimum capital ratios to be considered well capitalized. While these proposals are not yet final, they could significantly impact our capital requirements, which could impact our ability to pay dividends.

**Table of Contents****RESULTS OF OPERATIONS****Selected Financial Data**

The following table outlines the results of operations and provides certain performance measures for:

|   | Three Months Ended<br>September 30 |            | Nine Months Ended<br>September 30 |            |
|---|------------------------------------|------------|-----------------------------------|------------|
|   | 2012                               | 2011       | 2012                              | 2011       |
| <b>INCOME STATEMENT DATA</b>                        |                                    |            |                                   |            |
| Interest income                                     | \$ 14,164                          | \$ 14,532  | \$ 42,556                         | \$ 43,439  |
| Interest expense                                    | 3,239                              | 4,070      | 10,372                            | 12,224     |
| Net interest income                                 | 10,925                             | 10,462     | 32,184                            | 31,215     |
| Provision for loan losses                           | 200                                | 963        | 1,100                             | 2,383      |
| Noninterest income                                  | 2,759                              | 1,859      | 8,844                             | 5,785      |
| Noninterest expenses                                | 9,128                              | 8,513      | 27,889                            | 25,879     |
| Federal income tax expense                          | 899                                | 334        | 2,344                             | 1,239      |
| Net Income  | \$ 3,457                           | \$ 2,511   | \$ 9,695                          | \$ 7,499   |
| <b>PER SHARE</b>                                    |                                    |            |                                   |            |
| Basic earnings                                      | \$ 0.45                            | \$ 0.33    | \$ 1.28                           | \$ 0.99    |
| Diluted earnings                                    | 0.44                               | 0.32       | 1.24                              | 0.97       |
| Dividends   | 0.20                               | 0.19       | 0.60                              | 0.57       |
| Market value*                                       | 22.50                              | 18.75      | 22.50                             | 18.75      |
| Tangible book value*                                | 14.65                              | 13.70      | 14.65                             | 13.70      |
| <b>BALANCE SHEET DATA</b>                           |                                    |            |                                   |            |
| <b>At end of period</b>                             |                                    |            |                                   |            |
| Loans   | \$ 766,751                         | \$ 750,163 | \$ 766,751                        | \$ 750,163 |
| Total assets  | 1,389,138                          | 1,324,093  | 1,389,138                         | 1,324,093  |
| Deposits  | 989,491                            | 942,441    | 989,491                           | 942,441    |
| Shareholders' equity                                | 164,147                            | 155,579    | 164,147                           | 155,579    |
| <b>Average balance</b>                              |                                    |            |                                   |            |
| Loans   | \$ 761,069                         | \$ 746,856 | \$ 751,071                        | \$ 741,308 |
| Total assets  | 1,391,955                          | 1,299,179  | 1,372,433                         | 1,272,848  |
| Deposits  | 988,136                            | 932,508    | 979,934                           | 920,290    |
| Shareholders' equity                                | 152,537                            | 146,514    | 154,428                           | 146,271    |
| <b>PERFORMANCE RATIOS</b>                           |                                    |            |                                   |            |
| Return on average total assets (annualized)         | 0.99%                              | 0.77%      | 0.94%                             | 0.79%      |
| Return on average shareholders' equity (annualized) | 9.07%                              | 6.86%      | 8.37%                             | 6.84%      |
| Return on average tangible equity (annualized)      | 12.56%                             | 9.97%      | 11.96%                            | 10.08%     |
| Net interest margin yield (FTE annualized)          | 3.73%                              | 3.85%      | 3.72%                             | 3.90%      |
| Loan to deposit*                                    | 77.49%                             | 79.60%     | 77.49%                            | 79.60%     |
| Nonperforming loans to total loans*                 | 0.98%                              | 0.81%      | 0.98%                             | 0.81%      |
| Nonperforming assets to total assets*               | 0.68%                              | 0.61%      | 0.68%                             | 0.61%      |
| ALLL to nonperforming loans*                        | 160.98%                            | 199.24%    | 160.98%                           | 199.24%    |
| <b>CAPITAL RATIOS</b>                               |                                    |            |                                   |            |
| Shareholders' equity to assets*                     | 11.82%                             | 11.75%     | 11.82%                            | 11.75%     |
| Tier 1 capital to average assets*                   | 8.27%                              | 8.10%      | 8.27%                             | 8.10%      |
| Tier 1 risk-based capital*                          | 13.35%                             | 12.43%     | 13.35%                            | 12.43%     |
| Total risk-based capital*                           | 14.60%                             | 13.68%     | 14.60%                            | 13.68%     |

\* At end of period

**Table of Contents****Net Interest Income**

Net interest income is our primary source of income. Interest income includes loan fees of \$846 and \$2,302 for the three and nine month periods ended September 30, 2012, respectively, as compared to \$534 and \$1,755 during the same periods in 2011. For analytical purposes, net interest income is adjusted to an FTE basis by adding the income tax savings from interest on tax exempt loans and securities, thus making year to year comparisons more meaningful.

**AVERAGE BALANCES, INTEREST RATE, AND NET INTEREST INCOME**

The following schedules present the daily average amount outstanding for each major category of interest earning assets, nonearning assets, interest bearing liabilities, and noninterest bearing liabilities. This schedule also presents an analysis of interest income and interest expense for the periods indicated. All interest income is reported on a FTE basis using a 34% tax rate. Nonaccruing loans, for the purpose of the following computations, are included in the average loan amounts outstanding. FRB and FHLB restricted equity holdings are included in accrued income and other assets.

The following table displays the results for the three month periods ended September 30:

|  | Average<br>Balance  | 2012<br>Tax<br>Equivalent<br>Interest | Average<br>Yield /<br>Rate | Average<br>Balance  | 2011<br>Tax<br>Equivalent<br>Interest | Average<br>Yield /<br>Rate |
|--|---------------------|---------------------------------------|----------------------------|---------------------|---------------------------------------|----------------------------|
| <b>INTEREST EARNING ASSETS</b>                   |                     |                                       |                            |                     |                                       |                            |
| Loans  | \$ 761,069          | \$ 10,918                             | 5.74%                      | \$ 746,856          | \$ 11,365                             | 6.09%                      |
| Taxable investment securities                    | 316,639             | 1,878                                 | 2.37%                      | 243,123             | 1,800                                 | 2.96%                      |
| Nontaxable investment securities                 | 149,390             | 2,006                                 | 5.37%                      | 135,433             | 1,961                                 | 5.79%                      |
| Trading account securities                       | 1,862               | 23                                    | 4.94%                      | 4,905               | 68                                    | 5.55%                      |
| Other  | 26,367              | 121                                   | 1.84%                      | 38,412              | 121                                   | 1.26%                      |
| <b>Total earning assets</b>                      | <b>1,255,327</b>    | <b>14,946</b>                         | <b>4.76%</b>               | <b>1,168,729</b>    | <b>15,315</b>                         | <b>5.24%</b>               |
| <b>NONEARNING ASSETS</b>                         |                     |                                       |                            |                     |                                       |                            |
| Allowance for loan losses                        | (12,484)            |                                       |                            | (12,496)            |                                       |                            |
| Cash and demand deposits due from banks          | 19,483              |                                       |                            | 20,459              |                                       |                            |
| Premises and equipment                           | 25,290              |                                       |                            | 24,361              |                                       |                            |
| Accrued income and other assets                  | 104,339             |                                       |                            | 98,126              |                                       |                            |
| <b>Total assets</b>                              | <b>\$ 1,391,955</b> |                                       |                            | <b>\$ 1,299,179</b> |                                       |                            |
| <b>INTEREST BEARING LIABILITIES</b>              |                     |                                       |                            |                     |                                       |                            |
| Interest bearing demand deposits                 | \$ 172,931          | 52                                    | 0.12%                      | \$ 155,385          | 49                                    | 0.13%                      |
| Savings deposits                                 | 218,028             | 110                                   | 0.20%                      | 192,457             | 117                                   | 0.24%                      |
| Time deposits                                    | 472,873             | 2,041                                 | 1.73%                      | 469,791             | 2,559                                 | 2.18%                      |
| Borrowed funds                                   | 232,231             | 1,036                                 | 1.78%                      | 202,451             | 1,345                                 | 2.66%                      |
| <b>Total interest bearing liabilities</b>        | <b>1,096,063</b>    | <b>3,239</b>                          | <b>1.18%</b>               | <b>1,020,084</b>    | <b>4,070</b>                          | <b>1.60%</b>               |
| <b>NONINTEREST BEARING LIABILITIES</b>           |                     |                                       |                            |                     |                                       |                            |
| Demand deposits                                  | 124,304             |                                       |                            | 114,875             |                                       |                            |
| Other  | 19,051              |                                       |                            | 17,706              |                                       |                            |
| Shareholders equity                              | 152,537             |                                       |                            | 146,514             |                                       |                            |
| <b>Total liabilities and shareholders equity</b> | <b>\$ 1,391,955</b> |                                       |                            | <b>\$ 1,299,179</b> |                                       |                            |
| <b>Net interest income (FTE)</b>                 |                     | <b>\$ 11,707</b>                      |                            |                     | <b>\$ 11,245</b>                      |                            |

**Net yield on interest earning assets (FTE)**

**3.73%**

**3.85%**

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The following table displays the results for the nine month periods ended September 30:

|   | Average<br>Balance  | 2012<br>Tax<br>Equivalent<br>Interest | Average<br>Yield /<br>Rate | Average<br>Balance  | 2011<br>Tax<br>Equivalent<br>Interest | Average<br>Yield /<br>Rate |
|---|---------------------|---------------------------------------|----------------------------|---------------------|---------------------------------------|----------------------------|
| <b>INTEREST EARNING ASSETS</b>                    |                     |                                       |                            |                     |                                       |                            |
| Loans   | \$ 751,071          | \$ 32,707                             | 5.81%                      | \$ 741,308          | \$ 34,190                             | 6.15%                      |
| Taxable investment securities                     | 306,006             | 5,755                                 | 2.51%                      | 226,104             | 5,149                                 | 3.04%                      |
| Nontaxable investment securities                  | 144,170             | 5,956                                 | 5.51%                      | 134,948             | 5,830                                 | 5.76%                      |
| Trading account securities                        | 2,925               | 120                                   | 5.47%                      | 5,174               | 217                                   | 5.59%                      |
| Other   | 33,619              | 363                                   | 1.44%                      | 38,407              | 388                                   | 1.35%                      |
| <b>Total earning assets</b>                       | <b>1,237,791</b>    | <b>44,901</b>                         | <b>4.84%</b>               | <b>1,145,941</b>    | <b>45,774</b>                         | <b>5.33%</b>               |
| <b>NONEARNING ASSETS</b>                          |                     |                                       |                            |                     |                                       |                            |
| Allowance for loan losses                         | (12,559)            |                                       |                            | (12,544)            |                                       |                            |
| Cash and demand deposits due from banks           | 19,455              |                                       |                            | 20,111              |                                       |                            |
| Premises and equipment                            | 25,079              |                                       |                            | 24,335              |                                       |                            |
| Accrued income and other assets                   | 102,667             |                                       |                            | 95,005              |                                       |                            |
| <b>Total assets</b>                               | <b>\$ 1,372,433</b> |                                       |                            | <b>\$ 1,272,848</b> |                                       |                            |
| <b>INTEREST BEARING LIABILITIES</b>               |                     |                                       |                            |                     |                                       |                            |
| Interest bearing demand deposits                  | \$ 171,079          | 156                                   | 0.12%                      | \$ 152,436          | 142                                   | 0.12%                      |
| Savings deposits                                  | 212,040             | 341                                   | 0.21%                      | 192,820             | 363                                   | 0.25%                      |
| Time deposits                                     | 476,186             | 6,586                                 | 1.84%                      | 463,950             | 7,781                                 | 2.24%                      |
| Borrowed funds                                    | 223,668             | 3,289                                 | 1.96%                      | 193,021             | 3,938                                 | 2.72%                      |
| <b>Total interest bearing liabilities</b>         | <b>1,082,973</b>    | <b>10,372</b>                         | <b>1.28%</b>               | <b>1,002,227</b>    | <b>12,224</b>                         | <b>1.63%</b>               |
| <b>NONINTEREST BEARING LIABILITIES</b>            |                     |                                       |                            |                     |                                       |                            |
| Demand deposits                                   | 120,629             |                                       |                            | 111,084             |                                       |                            |
| Other   | 14,403              |                                       |                            | 13,266              |                                       |                            |
| Shareholders equity                               | 154,428             |                                       |                            | 146,271             |                                       |                            |
| <b>Total liabilities and shareholders equity</b>  | <b>\$ 1,372,433</b> |                                       |                            | <b>\$ 1,272,848</b> |                                       |                            |
| <b>Net interest income (FTE)</b>                  |                     | <b>\$ 34,529</b>                      |                            |                     | <b>\$ 33,550</b>                      |                            |
| <b>Net yield on interest earning assets (FTE)</b> |                     |                                       | <b>3.72%</b>               |                     |                                       | <b>3.90%</b>               |



**Table of Contents****VOLUME AND RATE VARIANCE ANALYSIS**

The following table sets forth the effect of volume and rate changes on interest income and expense for the periods indicated. For the purpose of this table, changes in interest due to volume and rate were determined as follows:

Volume Variance change in volume multiplied by the previous year's rate.

Rate Variance change in the FTE rate multiplied by the previous year's volume.

The change in interest due to both volume and rate has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.

|  | Three Months Ended<br>September 30, 2012 Compared to<br>September 30, 2011 |                 |               | Nine Months Ended<br>September 30, 2012 Compared to<br>September 30, 2011 |                 |               |
|--|--|-----------------|---------------|---|-----------------|---------------|
|  | Volume   | Rate            | Net           | Volume  | Rate            | Net           |
| <b>CHANGES IN INTEREST INCOME</b>          |  |                 |               |   |                 |               |
| Loans                                      | \$ 213   | \$ (660)        | \$ (447)      | \$ 446  | \$ (1,929)      | \$ (1,483)    |
| Taxable investment securities              | 479  | (401)           | 78            | 1,607   | (1,001)         | 606           |
| Nontaxable investment securities           | 193  | (148)           | 45            | 388   | (265)           | 123           |
| Trading account securities                 | (38)   | (7)             | (45)          | (92)  | (5)             | (97)          |
| Other                                      | (45)   | 45              |               | (51)  | 26              | (25)          |
| Total changes in interest income           | 802  | (1,171)         | (369)         | 2,298   | (3,174)         | (876)         |
| <b>CHANGES IN INTEREST EXPENSE</b>         |  |                 |               |   |                 |               |
| Interest bearing demand deposits           | 5  | (2)             | 3             | 17  | (3)             | 14            |
| Savings deposits                           | 14   | (21)            | (7)           | 34  | (56)            | (22)          |
| Time deposits                              | 17   | (535)           | (518)         | 201   | (1,396)         | (1,195)       |
| Borrowed funds                             | 178  | (487)           | (309)         | 562   | (1,211)         | (649)         |
| Total changes in interest expense          | 214  | (1,045)         | (831)         | 814   | (2,666)         | (1,852)       |
| <b>Net change in interest margin (FTE)</b> | <b>\$ 588</b>  | <b>\$ (126)</b> | <b>\$ 462</b> | <b>\$ 1,484</b>   | <b>\$ (508)</b> | <b>\$ 976</b> |

Our net yield on interest earning assets has leveled off in spite of the persistent low interest rate environment and soft loan demand. This is a direct result of our restructuring of \$60,000 of FHLB advances in the first quarter of 2012, which is anticipated to reduce interest expense by approximately \$450 for 2012.

Given that the historically low interest rate environment is expected to continue for the foreseeable future, the net yield on interest earning assets is likely to decline in future periods. This anticipated decline will be driven by continued reduction in rates earned on loans without a corresponding decline in funding rates. Any additional interest income will be contingent upon increases in volume, which will increase the speed of the rate reductions on interest earning assets.

**Table of Contents****Allowance for Loan Losses**

The viability of any financial institution is ultimately determined by its management of credit risk. Loans outstanding represent our single largest concentration of risk. The ALLL is our estimation of probable losses inherent in the existing loan portfolio. We allocate the ALLL throughout the loan portfolio based on our assessment of the underlying risks associated with each loan segment. Our assessments include allocations based on specific impairment allocations, historical losses, internally assigned credit ratings, and past due and nonaccrual balances. A portion of the ALLL is not allocated to any one loan segment, but is instead a reflection of other qualitative risks within the loan portfolio.

The following tables summarize our charge off and recovery activity for the:

|   | Three Months Ended<br>September 30 |                  | Nine Months Ended<br>September 30 |                  |
|---|------------------------------------|------------------|-----------------------------------|------------------|
|   | 2012                               | 2011             | 2012                              | 2011             |
| Allowance for loan losses at beginning of period                  | \$ 12,318                          | \$ 12,378        | \$ 12,375                         | \$ 12,373        |
| Loans charged off   |                                    |                  |                                   |                  |
| Commercial and agricultural                                       | 271                                | 215              | 957                               | 1,085            |
| Residential real estate   | 213                                | 857              | 566                               | 1,735            |
| Consumer  | 127                                | 98               | 364                               | 382              |
| <b>Total loans charged off</b>                                    | <b>611</b>                         | <b>1,170</b>     | <b>1,887</b>                      | <b>3,202</b>     |
| Recoveries  |                                    |                  |                                   |                  |
| Commercial and agricultural                                       | 40                                 | 76               | 168                               | 422              |
| Residential real estate   | 34                                 | 39               | 95                                | 142              |
| Consumer  | 81                                 | 87               | 211                               | 255              |
| <b>Total recoveries</b>   | <b>155</b>                         | <b>202</b>       | <b>474</b>                        | <b>819</b>       |
| Provision for loan losses   | 200                                | 963              | 1,100                             | 2,383            |
| <b>Allowance for loan losses at end of period</b>                 | <b>\$ 12,062</b>                   | <b>\$ 12,373</b> | <b>\$ 12,062</b>                  | <b>\$ 12,373</b> |
| Net loans charged off   | \$ 456                             | \$ 968           | \$ 1,413                          | \$ 2,383         |
| Average loans outstanding   | 761,069                            | 746,856          | 751,071                           | 741,308          |
| <b>Net loans charged off to average loans outstanding</b>         | <b>0.06%</b>                       | <b>0.13%</b>     | <b>0.19%</b>                      | <b>0.32%</b>     |
| Total amount of loans outstanding at end of period                | \$ 766,751                         | \$ 750,163       | \$ 766,751                        | \$ 750,163       |
| <b>Allowance for loan losses as a % of loans at end of period</b> | <b>1.57%</b>                       | <b>1.65%</b>     | <b>1.57%</b>                      | <b>1.65%</b>     |

As shown in the preceding table, the level of net chargeoffs continues to decline. This trend has allowed us to reduce our provision, which has led to a decline in the ALLL in both amount and as a percentage of loans. For further discussion on the allocation of the ALLL, see Note 6 Loans and Allowance for Loan Losses to our interim condensed consolidated financial statements.

**Table of Contents****Loans Past Due and Loans in Nonaccrual Status**

Increases in past due and nonaccrual loans can have a significant impact on the allowance for loan losses. To determine the potential impact, and corresponding estimated losses, we analyze our historical loss trends on loans past due 30-89 days, 90 days or more, and nonaccrual loans. Loans past due and in nonaccrual status have increased over prior periods. Part of the increase in accruing loans past due 30-89 days from year end was related to one loan that had a balance of \$1,302 as of September 30, 2012. This loan was also past due 30-89 days as of June 30, 2012. We will continue to closely monitor this loan for indicators of additional deterioration. The increase in nonaccrual loans was primarily the result of the addition of one loan in the three month period ended September 30, 2012 (for further discussion see nonperforming assets below).

A summary of loans past due and in nonaccrual status, including the composition of the ending balance of nonaccrual loans by type, is included in Note 6 Loans and Allowance for Loan Losses of our interim condensed consolidated financial statements.

**Troubled Debt Restructurings**

We have taken a proactive approach to avoid foreclosures on borrowers who are willing to work with us in modifying their loans, thus making them more affordable. While this approach has allowed certain borrowers to develop a payment structure that will allow them to continue making payments in lieu of foreclosure, it has contributed to a significant increase in the level of loans classified as TDR. The implementation of ASU No. 2011-02 *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring* has also contributed to the increased level of TDRs. The modifications have been extremely successful for us and our customers as very few of the modified loans have resulted in foreclosures. Troubled debt restructurings that have been placed in nonaccrual status may be placed back on accrual status after six months of continued performance.

The following table summarizes our troubled debt restructurings component of impaired loans as of:

|   | September 30, 2012 |                 |                  | December 31, 2011 |                 |                  | Total Change    |
|---|--------------------|-----------------|------------------|-------------------|-----------------|------------------|-----------------|
|   | Accruing Interest  | Nonaccrual      | Total            | Accruing Interest | Nonaccrual      | Total            |                 |
| Current                                   | \$ 17,637          | \$ 1,551        | \$ 19,188        | \$ 16,125         | \$ 514          | \$ 16,639        | \$ 2,549        |
| Past due 30-89 days                       | 594                | 1,017           | 1,611            | 1,614             | 429             | 2,043            | (432)           |
| Past due 90 days or more                  | 30                 | 232             | 262              |                   | 74              | 74               | 188             |
| <b>Total troubled debt restructurings</b> | <b>\$ 18,261</b>   | <b>\$ 2,800</b> | <b>\$ 21,061</b> | <b>\$ 17,739</b>  | <b>\$ 1,017</b> | <b>\$ 18,756</b> | <b>\$ 2,305</b> |

Additional disclosures about TDRs are included in Note 6 Loans and Allowance for Loan Losses of our interim condensed consolidated financial statements.

**Table of Contents****Nonperforming Assets**

The following table summarizes our nonperforming assets as of:

|  | September 30<br>2012 | December 31<br>2011 |
|--|----------------------|---------------------|
| Nonaccrual loans                                   | \$ 7,025             | \$ 6,389            |
| Accruing loans past due 90 days or more            | 468                  | 760                 |
| <b>Total nonperforming loans</b>                   | <b>7,493</b>         | <b>7,149</b>        |
| OREO   | 1,986                | 1,867               |
| Repossessed assets                                 | 15                   | 9                   |
| <b>Total nonperforming assets</b>                  | <b>\$ 9,494</b>      | <b>\$ 9,025</b>     |
| <b>Nonperforming loans as a % of total loans</b>   | <b>0.98%</b>         | <b>0.95%</b>        |
| <b>Nonperforming assets as a % of total assets</b> | <b>0.68%</b>         | <b>0.67%</b>        |

Loans are placed in nonaccrual status when the foreclosure process has begun, generally after a loan is 90 days past due, unless they are well secured and in the process of collection. Upon transferring the loans to nonaccrual status, an evaluation to determine the net realizable value of the underlying collateral is performed. This evaluation is used to help determine if any charge offs are necessary. Loans may be placed back on accrual status after six months of continued performance.

Included in the nonaccrual loan balances above were credits currently classified as troubled debt restructurings as of:

|                             | September 30<br>2012 | December 31<br>2011 |
|-----------------------------|----------------------|---------------------|
| Commercial and agricultural | \$ 2,608             | \$ 520              |
| Residential real estate     | 192                  | 497                 |
| <b>Total</b>                | <b>\$2,800</b>       | <b>\$1,017</b>      |

The following table lists individually significant commercial and agricultural loan relationships in nonaccrual status as of September 30, 2012 and December 31, 2011. To be classified as individually significant, the recorded investment in nonaccrual loans to each borrower must have exceeded \$1,000 as of the end of either period.

|                                    | September 30, 2012     |                        | December 31, 2011      |                        |
|------------------------------------|------------------------|------------------------|------------------------|------------------------|
|                                    | Outstanding<br>Balance | Specific<br>Allocation | Outstanding<br>Balance | Specific<br>Allocation |
| Borrower 1                         | \$ 1,096               | \$ 175                 | \$                     | \$                     |
| Borrower 2                         | 997                    | A                      | 1,014                  | A                      |
| Borrower 3                         |                        |                        | 1,900                  | B                      |
| Borrower 4                         | 2,107                  | 390                    |                        |                        |
| Other not individually significant | 1,369                  |                        | 1,891                  |                        |
| <b>Total</b>                       | <b>\$ 5,569</b>        |                        | <b>\$ 4,805</b>        |                        |

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- A** - No specific allocation as the net realizable value of the loan's underlying collateral value exceeded the loan's carrying balance.
  - B** - No specific allocation established for this loan as it was charged down to reflect the current market value of the real estate. This loan was subsequently transferred to OREO and sold in the second quarter of 2012.
- There were no other individually significant credits included in nonaccrual loans as of September 30, 2012 or December 31, 2011.

Additional disclosures about nonaccrual loans are included in Note 6 Loans and Allowance for Loan Losses of our interim condensed consolidated financial statements.

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We continue to devote considerable attention to identifying impaired loans and adjusting the net carrying value of these loans to their current net realizable values through the establishment of a specific reserve or the recording of a chargeoff. We believe that all loans deemed to be impaired have been recognized.

We believe that the level of the ALLL is appropriate as of September 30, 2012 and we will continue to closely monitor overall credit quality and our policies and procedures related to the analysis of the ALLL to ensure that the allowance for loan losses remains appropriate.

**NONINTEREST INCOME AND EXPENSES****Noninterest Income**

Noninterest income consists of service charges and fee income, gains from the sale of mortgage loans, gains and losses on trading securities and borrowings measured at fair value, gains from the sale of investment securities, and other. Significant account balances are highlighted in the accompanying tables with additional descriptions of significant fluctuations:

|   | Three Months Ended September 30 |                 |               |                |
|---|---------------------------------|-----------------|---------------|----------------|
|   | 2012                            | 2011            | Change        |                |
|   |                                 |                 | \$            | %              |
| <b>Service charges and fees</b>                                 |                                 |                 |               |                |
| NSF and overdraft fees  | \$ 628                          | \$ 653          | \$ (25)       | -3.8%          |
| ATM and debit card fees   | 473                             | 455             | 18            | 4.0%           |
| Trust fees  | 279                             | 253             | 26            | 10.3%          |
| Freddie Mac servicing fee                                       | 185                             | 188             | (3)           | -1.6%          |
| Service charges on deposit accounts                             | 80                              | 84              | (4)           | -4.8%          |
| Net originated mortgage servicing rights loss                   | (135)                           | (325)           | 190           | N/M            |
| All other   | 33                              | 33              |               | 0.0%           |
| <b>Total service charges and fees</b>                           | <b>1,543</b>                    | <b>1,341</b>    | <b>202</b>    | <b>15.1%</b>   |
| <b>Gain on sale of mortgage loans</b>                           | <b>422</b>                      | <b>111</b>      | <b>311</b>    | <b>280.2%</b>  |
| <b>Net loss on trading securities</b>                           | <b>(9)</b>                      | <b>(24)</b>     | <b>15</b>     | <b>N/M</b>     |
| <b>Net gain on borrowings measured at fair value</b>            |                                 | <b>42</b>       | <b>(42)</b>   | <b>-100.0%</b> |
| <b>Gain on sale of available-for-sale investment securities</b> | <b>116</b>                      |                 | <b>116</b>    | <b>N/M</b>     |
| <b>Other</b>  |                                 |                 |               |                |
| Earnings on corporate owned life insurance policies             | 171                             | 141             | 30            | 21.3%          |
| Brokerage and advisory fees                                     | 143                             | 122             | 21            | 17.2%          |
| Income from investment in Corporate Settlement Solutions        | 198                             | 3               | 195           | N/M            |
| Gain on sale of OREO  | 75                              | 32              | 43            | 134.4%         |
| All other   | 100                             | 91              | 9             | 9.9%           |
| <b>Total other</b>  | <b>687</b>                      | <b>389</b>      | <b>298</b>    | <b>76.6%</b>   |
| <b>Total noninterest income</b>                                 | <b>\$ 2,759</b>                 | <b>\$ 1,859</b> | <b>\$ 900</b> | <b>48.4%</b>   |

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|   | Nine Months Ended September 30 |                 |                 |               |
|---|--------------------------------|-----------------|-----------------|---------------|
|   | 2012                           | 2011            | Change          | %             |
|   |                                |                 | \$              |               |
| <b>Service charges and fees</b>                                 |                                |                 |                 |               |
| NSF and overdraft fees  | \$ 1,783                       | \$ 1,875        | \$ (92)         | -4.9%         |
| ATM and debit card fees   | 1,407                          | 1,299           | 108             | 8.3%          |
| Trust fees  | 795                            | 741             | 54              | 7.3%          |
| Freddie Mac servicing fee                                       | 563                            | 544             | 19              | 3.5%          |
| Service charges on deposit accounts                             | 238                            | 242             | (4)             | -1.7%         |
| Net originated mortgage servicing rights loss                   | (85)                           | (375)           | 290             | N/M           |
| All other   | 99                             | 108             | (9)             | -8.3%         |
| <b>Total service charges and fees</b>                           | <b>4,800</b>                   | <b>4,434</b>    | <b>366</b>      | <b>8.3%</b>   |
| <b>Gain on sale of mortgage loans</b>                           | <b>1,080</b>                   | <b>293</b>      | <b>787</b>      | <b>268.6%</b> |
| <b>Net loss on trading securities</b>                           | <b>(41)</b>                    | <b>(51)</b>     | <b>10</b>       | <b>N/M</b>    |
| <b>Net gain on borrowings measured at fair value</b>            | <b>33</b>                      | <b>159</b>      | <b>(126)</b>    | <b>-79.2%</b> |
| <b>Gain on sale of available-for-sale investment securities</b> | <b>1,119</b>                   |                 | <b>1,119</b>    | <b>N/M</b>    |
| <b>Other</b>  |                                |                 |                 |               |
| Earnings on corporate owned life insurance policies             | 519                            | 428             | 91              | 21.3%         |
| Brokerage and advisory fees                                     | 410                            | 405             | 5               | 1.2%          |
| Income (Loss) from investment in Corporate Settlement Solutions | 397                            | (281)           | 678             | N/M           |
| Gain on sale of OREO  | 206                            | 73              | 133             | 182.2%        |
| All other   | 321                            | 325             | (4)             | -1.2%         |
| <b>Total other</b>  | <b>1,853</b>                   | <b>950</b>      | <b>903</b>      | <b>95.1%</b>  |
| <b>Total noninterest income</b>                                 | <b>\$ 8,844</b>                | <b>\$ 5,785</b> | <b>\$ 3,059</b> | <b>52.9%</b>  |

Significant changes in noninterest income are detailed below:

We continuously analyze various fees related to deposit accounts including service charges and NSF and overdraft fees. Based on these analyses, we make any necessary adjustments to ensure that our fee structure is within the range of our competitors, while at the same time making sure that the fees remain fair to deposit customers. NSF and overdraft fees represent the largest single component of service charges and fees. While we have experienced significant increases in deposit accounts, NSF and overdraft fees have declined. This decline has been the result of reduced overdraft activity by our customers as well as changes in banking regulations. We expect this downward trend to continue into the foreseeable future.

As customers have continued to increase their dependence on ATM and debit cards, we have seen a corresponding increase in fees. We do not anticipate significant changes to our ATM and debit fee structure; however, we do expect that these fees will continue to increase as the usage of debit cards increases.

In recent periods, we have invested considerable efforts to increase our market share in trust and brokerage and advisory services. These efforts have translated into increases in revenues and we expect this trend to continue in future periods.

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The recent decline in offering rates on residential real estate loans has led to a significant increase in the level of refinancing activity. This increase in activity has resulted in substantial increases in the gain on sale of mortgage loans, while contributing to fluctuations in the value of our OMSR portfolio. This increased refinancing activity has also contributed to the increase in income from Corporate Settlement. We anticipate this trend to continue for the remainder of 2012.

Fluctuations in the gains and losses related to trading securities and borrowings measured at fair value are caused by interest rate variances. As we do not anticipate any significant changes to interest rates in the foreseeable future, and therefore we do not anticipate any large fluctuations in future periods.

We are continually analyzing our available-for-sale investment portfolio for potential sale opportunities that will improve our long term profitability. During the first quarter of 2012, we identified several pools of mortgage-backed securities with significant unrealized gains. As the interest rates of the underlying mortgages were significantly higher than the current offering rates for similar mortgages, we elected to realize these gains through the sales of such securities as the investments would have likely been paid off in the near term through refinancing activity. In the third quarter of 2012, we elected to sell some additional mortgage-backed securities as their current prepayment characteristics had resulted in less than acceptable yields. We do not anticipate any further significant investment sales during the remainder of 2012.

Earnings on corporate owned life insurance policies have increased from 2011 as a result of the purchase of an additional \$4,000 in policies in the third quarter of 2011. Earnings are expected to approximate current levels for the remainder of 2012.

As market conditions have improved, we have been able to sell some of our OREO properties at gains. As property values and the facts and circumstances surrounding each property vary, this amount will fluctuate from period to period. We do not anticipate any assets currently included in OREO generating significant gains or losses in future periods.

The fluctuation in all other income is spread throughout various categories, none of which are individually significant. We do not anticipate any significant fluctuations from current levels for the remainder of 2012.



**Table of Contents****Noninterest Expenses**

Noninterest expenses include compensation and benefits, occupancy, furniture and equipment, available-for-sale security impairment loss, and other expenses. Significant account balances are highlighted in the accompanying tables with additional descriptions of significant fluctuations:

|  | Three Months Ended September 30 |                 |               |              |
|--|---------------------------------|-----------------|---------------|--------------|
|  | 2012                            | 2011            | \$ Change     | %            |
| <b>Compensation and benefits</b>       |                                 |                 |               |              |
| Compensation                           | \$ 3,810                        | \$ 3,567        | \$ 243        | 6.8%         |
| Benefits                               | 1,320                           | 1,247           | 73            | 5.9%         |
| <b>Total compensation and benefits</b> | <b>5,130</b>                    | <b>4,814</b>    | <b>316</b>    | <b>6.6%</b>  |
| <b>Occupancy</b>                       |                                 |                 |               |              |
| Outside services                       | 147                             | 147             |               | 0.0%         |
| Depreciation                           | 156                             | 153             | 3             | 2.0%         |
| Property taxes                         | 129                             | 121             | 8             | 6.6%         |
| Utilities                              | 125                             | 122             | 3             | 2.5%         |
| Building repairs                       | 70                              | 70              |               | 0.0%         |
| All other                              | 22                              | 20              | 2             | 10.0%        |
| <b>Total occupancy</b>                 | <b>649</b>                      | <b>633</b>      | <b>16</b>     | <b>2.5%</b>  |
| <b>Furniture and equipment</b>         |                                 |                 |               |              |
| Computer / service contracts           | 455                             | 504             | (49)          | -9.7%        |
| Depreciation                           | 451                             | 474             | (23)          | -4.9%        |
| ATM and debit card fees                | 177                             | 161             | 16            | 9.9%         |
| All other                              | 30                              | 12              | 18            | 150.0%       |
| <b>Total furniture and equipment</b>   | <b>1,113</b>                    | <b>1,151</b>    | <b>(38)</b>   | <b>-3.3%</b> |
| <b>Other</b>                           |                                 |                 |               |              |
| Marketing and donations                | 610                             | 228             | 382           | 167.5%       |
| FDIC insurance premiums                | 218                             | 209             | 9             | 4.3%         |
| Directors fees                         | 235                             | 203             | 32            | 15.8%        |
| Audit fees                             | 179                             | 195             | (16)          | -8.2%        |
| Education and travel                   | 112                             | 102             | 10            | 9.8%         |
| Printing and supplies                  | 91                              | 108             | (17)          | -15.7%       |
| Postage and freight                    | 105                             | 103             | 2             | 1.9%         |
| Foreclosed asset and collection        | 21                              | 143             | (122)         | -85.3%       |
| Consulting fees                        | 92                              | 63              | 29            | 46.0%        |
| Amortization of deposit premium        | 67                              | 77              | (10)          | -13.0%       |
| Legal fees                             | 50                              | 82              | (32)          | -39.0%       |
| Other losses                           | 80                              | 23              | 57            | N/M          |
| All other                              | 376                             | 379             | (3)           | -0.8%        |
| <b>Total other</b>                     | <b>2,236</b>                    | <b>1,915</b>    | <b>321</b>    | <b>16.8%</b> |
| <b>Total noninterest expenses</b>      | <b>\$ 9,128</b>                 | <b>\$ 8,513</b> | <b>\$ 615</b> | <b>7.2%</b>  |

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|  | Nine Months Ended September 30 |                  |                 |              |
|--|--------------------------------|------------------|-----------------|--------------|
|  | 2012                           | 2011             | Change<br>\$    | %            |
| <b>Compensation and benefits</b>                   |                                |                  |                 |              |
| Compensation                                       | \$ 11,458                      | \$ 10,636        | \$ 822          | 7.7%         |
| Benefits   | 4,205                          | 3,929            | 276             | 7.0%         |
| <b>Total compensation and benefits</b>             | <b>15,663</b>                  | <b>14,565</b>    | <b>1,098</b>    | <b>7.5%</b>  |
| <b>Occupancy</b>                                   |                                |                  |                 |              |
| Outside services                                   | 447                            | 454              | (7)             | -1.5%        |
| Depreciation                                       | 465                            | 451              | 14              | 3.1%         |
| Property taxes                                     | 388                            | 379              | 9               | 2.4%         |
| Utilities  | 349                            | 355              | (6)             | -1.7%        |
| Building repairs                                   | 177                            | 189              | (12)            | -6.3%        |
| All other  | 63                             | 64               | (1)             | -1.6%        |
| <b>Total occupancy</b>                             | <b>1,889</b>                   | <b>1,892</b>     | <b>(3)</b>      | <b>-0.2%</b> |
| <b>Furniture and equipment</b>                     |                                |                  |                 |              |
| Computer / service contracts                       | 1,469                          | 1,429            | 40              | 2.8%         |
| Depreciation                                       | 1,337                          | 1,458            | (121)           | -8.3%        |
| ATM and debit card fees                            | 507                            | 457              | 50              | 10.9%        |
| All other  | 60                             | 40               | 20              | 50.0%        |
| <b>Total furniture and equipment</b>               | <b>3,373</b>                   | <b>3,384</b>     | <b>(11)</b>     | <b>-0.3%</b> |
| <b>Available-for-sale security impairment loss</b> | <b>282</b>                     |                  | <b>282</b>      | <b>N/M</b>   |
| <b>Other</b>                                       |                                |                  |                 |              |
| Marketing and donations                            | 1,639                          | 978              | 661             | 67.6%        |
| FDIC insurance premiums                            | 646                            | 874              | (228)           | -26.1%       |
| Directors fees                                     | 654                            | 620              | 34              | 5.5%         |
| Audit fees   | 509                            | 518              | (9)             | -1.7%        |
| Education and travel                               | 378                            | 306              | 72              | 23.5%        |
| Printing and supplies                              | 310                            | 297              | 13              | 4.4%         |
| Postage and freight                                | 300                            | 299              | 1               | 0.3%         |
| Foreclosed asset and collection                    | 100                            | 420              | (320)           | -76.2%       |
| Consulting fees                                    | 350                            | 163              | 187             | 114.7%       |
| Amortization of deposit premium                    | 200                            | 229              | (29)            | -12.7%       |
| Legal fees   | 193                            | 198              | (5)             | -2.5%        |
| Other losses                                       | 217                            | 34               | 183             | N/M          |
| All other  | 1,186                          | 1,102            | 84              | 7.6%         |
| <b>Total other</b>                                 | <b>6,682</b>                   | <b>6,038</b>     | <b>644</b>      | <b>10.7%</b> |
| <b>Total noninterest expenses</b>                  | <b>\$ 27,889</b>               | <b>\$ 25,879</b> | <b>\$ 2,010</b> | <b>7.8%</b>  |

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Significant changes in noninterest expenses are detailed below:

The increase in compensation, and corresponding increases in employee benefits, is due to annual merit increases and our continued growth as well as additional staff additions to help comply with the Dodd Frank Act and other recently passed regulations.

As noted above, our customers have continued to increase their dependence on ATM and debit cards. This increased usage has resulted in a corresponding increase in fees that we pay to various service providers. We expect that these fees will continue to increase as the usage of debit cards increases.

We have long been a strong supporter of the various communities, schools, and charities in the markets we serve. In the 1996, we established a foundation that is generally funded from non-recurring revenue sources. The foundation allows us to make long term to organizations that benefit our communities. Donation expenses related to the foundation were \$850 and \$250 for the nine months ended September 30, 2012 and 2011, respectively.

FDIC insurance premiums declined in the third quarter of 2011 due to a change in the premium calculation. Since that time, premiums have increased as we have continued to grow our balance sheet. There are no significant changes to the premium calculation expected for the remainder of 2012.

The increase in consulting fees is primarily related to consulting services employed to review the FHLB advance restructure (see Volume and Rate Variance Analysis , above). They also increased due to the engagement of consultants to review our loan prepayment and deposit decay assumptions as well as to review various information technology projects. Consulting fees are anticipated to approximate current levels for the remainder of 2012.

As a result of decreases in foreclosure and repossession activity, we have seen significant declines in foreclosed asset and collection expenses. These expenses have also declined as we have been able to recover expenses through our collection efforts. These collection efforts have actually led to a net negative expense for the current quarter as we have been able to recover expenses incurred in previous periods. Foreclosed asset and collection expenses are expected to decline for the remainder of 2012.

During the first quarter of 2012, we recorded a credit impairment on an AFS investment security through earnings due to a bond being downgraded by Moody's to Caa3. We will continue to monitor the investment portfolio throughout the year for other potential other-than-temporary impairments. For further discussion, see Note 5 Available-For-Sale Securities to the interim condensed consolidated financial statements.

Other losses have increased significantly in 2012 primarily as a result of losses incurred related to a fraudulent wire transfer as well as losses related to repurchase of a loan that was previously sold to a third party. We do not anticipate any significant other losses in the remainder of 2012.

The fluctuations in all other expenses are spread throughout various categories, none of which are individually significant.

**Table of Contents****ANALYSIS OF CHANGES IN FINANCIAL CONDITION**

|  | September 30<br>2012 | December 31<br>2011 | \$ Change        | % Change<br>(unannualized) |
|--|----------------------|---------------------|------------------|----------------------------|
| <b>ASSETS</b>  |                      |                     |                  |                            |
| Cash and cash equivalents                                    | \$ 24,664            | \$ 28,590           | \$ (3,926)       | -13.73%                    |
| Certificates of deposit held in other financial institutions | 5,675                | 8,924               | (3,249)          | -36.41%                    |
| Trading securities   | 1,788                | 4,710               | (2,922)          | -62.04%                    |
| Available-for-sale securities                                | 467,414              | 425,120             | 42,294           | 9.95%                      |
| Mortgage loans available-for-sale                            | 2,820                | 3,205               | (385)            | -12.01%                    |
| Loans  | 766,751              | 750,291             | 16,460           | 2.19%                      |
| Allowance for loan losses                                    | (12,062)             | (12,375)            | 313              | N/M                        |
| Premises and equipment                                       | 25,471               | 24,626              | 845              | 3.43%                      |
| Corporate owned life insurance                               | 22,594               | 22,075              | 519              | 2.35%                      |
| Accrued interest receivable                                  | 6,565                | 5,848               | 717              | 12.26%                     |
| Equity securities without readily determinable fair values   | 17,830               | 17,189              | 641              | 3.73%                      |
| Goodwill and other intangible assets                         | 46,592               | 46,792              | (200)            | -0.43%                     |
| Other assets   | 13,036               | 12,930              | 106              | 0.82%                      |
| <b>TOTAL ASSETS</b>  | <b>\$ 1,389,138</b>  | <b>\$ 1,337,925</b> | <b>\$ 51,213</b> | <b>3.83%</b>               |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>                   |                      |                     |                  |                            |
| <b>Liabilities</b>   |                      |                     |                  |                            |
| Deposits   | \$ 989,491           | \$ 958,164          | \$ 31,327        | 3.27%                      |
| Borrowed funds   | 226,580              | 216,136             | 10,444           | 4.83%                      |
| Accrued interest payable and other liabilities               | 8,920                | 8,842               | 78               | 0.88%                      |
| <b>Total liabilities</b>                                     | <b>1,224,991</b>     | <b>1,183,142</b>    | <b>41,849</b>    | <b>3.54%</b>               |
| <b>Shareholders equity</b>                                   | <b>164,147</b>       | <b>154,783</b>      | <b>9,364</b>     | <b>6.05%</b>               |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>             | <b>\$ 1,389,138</b>  | <b>\$ 1,337,925</b> | <b>\$ 51,213</b> | <b>3.83%</b>               |

As shown above, we were able to grow our balance sheet since December 31, 2011. The growth in deposits was supplemented by an increase in borrowed funds. As loan growth continues to be relatively soft, the additional funding provided by the growth in loans and deposits were deployed into available-for-sale investment securities to generate additional net interest income. We anticipate that loan growth will continue to be a challenge and that deposit growth will approximate current levels over the remainder of the year.

The following table outlines the changes in the loan portfolio:

|                         | September 30<br>2012 | December 31<br>2011 | \$ Change        | % Change<br>(unannualized) |
|-------------------------|----------------------|---------------------|------------------|----------------------------|
| Agricultural            | \$ 83,439            | \$ 74,645           | \$ 8,794         | 11.78%                     |
| Commercial              | 369,366              | 365,714             | 3,652            | 1.00%                      |
| Consumer                | 33,515               | 31,572              | 1,943            | 6.15%                      |
| Residential real estate | 280,431              | 278,360             | 2,071            | 0.74%                      |
| <b>Total</b>            | <b>\$ 766,751</b>    | <b>\$ 750,291</b>   | <b>\$ 16,460</b> | <b>2.19%</b>               |

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The following table outlines the changes in the deposit portfolio:

|                                     | September 30<br>2012 | December 31<br>2011 | \$ Change        | % Change<br>(unannualized) |
|-------------------------------------|----------------------|---------------------|------------------|----------------------------|
| Noninterest bearing demand deposits | \$ 126,362           | \$ 119,072          | \$ 7,290         | 6.12%                      |
| Interest bearing demand deposits    | 174,350              | 163,653             | 10,697           | 6.54%                      |
| Savings deposits                    | 221,930              | 193,902             | 28,028           | 14.45%                     |
| Certificates of deposit             | 374,445              | 395,777             | (21,332)         | -5.39%                     |
| Brokered certificates of deposit    | 59,871               | 54,326              | 5,545            | 10.21%                     |
| Internet certificates of deposit    | 32,533               | 31,434              | 1,099            | 3.50%                      |
| <b>Total</b>                        | <b>\$ 989,491</b>    | <b>\$ 958,164</b>   | <b>\$ 31,327</b> | <b>3.27%</b>               |

Borrowed funds consist of the following obligations as of:

|  | September 30, 2012 |              | December 31, 2011 |              |
|--|--------------------|--------------|-------------------|--------------|
|  | Amount             | Rate         | Amount            | Rate         |
| Federal Home Loan Bank advances  | \$ 152,000         | 2.15%        | \$ 142,242        | 3.16%        |
| Securities sold under agreements to repurchase without stated maturity dates | 57,927             | 0.20%        | 57,198            | 0.25%        |
| Securities sold under agreements to repurchase with stated maturity dates    | 16,653             | 3.51%        | 16,696            | 3.51%        |
| <b>Total</b>   | <b>\$ 226,580</b>  | <b>1.75%</b> | <b>\$ 216,136</b> | <b>2.42%</b> |

The FHLB advances are collateralized by a blanket lien on all qualified 1-4 family residential real estate loans and certain mortgage-backed securities and collateralized mortgage obligations. Advances are also secured by FHLB stock. We had the ability to borrow up to an additional \$117,035 based on assets currently pledged as collateral as of September 30, 2012. During the first quarter of 2012, we reduced funding costs by modifying the terms of \$60,000 of FHLB advances. This modification strategy extended the duration of our interest bearing liabilities and will reduce interest expense by approximately \$450 for 2012.

The following table lists the maturity and weighted average interest rates of FHLB advances as of:

|   | September 30<br>2012 |              | December 31<br>2011 |              |
|---|----------------------|--------------|---------------------|--------------|
|   | Amount               | Rate         | Amount              | Rate         |
| Fixed rate advances due 2012                  | \$ 5,000             | 3.48%        | \$ 17,000           | 2.97%        |
| One year putable fixed rate advances due 2012 | 5,000                | 0.50%        | 15,000              | 4.10%        |
| Variable rate advances due 2012               |                      |              |                     |              |
| Fixed rate advances due 2013                  |                      |              | 5,242               | 4.14%        |
| One year putable fixed rate advances due 2013 |                      |              | 5,000               | 3.15%        |
| Fixed rate advances due 2014                  |                      |              | 25,000              | 3.16%        |
| Fixed rate advances due 2015                  | 42,000               | 1.12%        | 45,000              | 3.30%        |
| Fixed rate advances due 2016                  | 10,000               | 2.15%        | 10,000              | 2.15%        |
| Fixed rate advances due 2017                  | 40,000               | 2.15%        | 20,000              | 2.56%        |
| Fixed rate advances due 2018                  | 20,000               | 2.86%        |                     |              |
| Fixed rate advances due 2019                  | 20,000               | 3.73%        |                     |              |
| Fixed rate advances due 2020                  | 10,000               | 1.98%        |                     |              |
| <b>Total</b>                                  | <b>\$ 152,000</b>    | <b>2.15%</b> | <b>\$ 142,242</b>   | <b>3.16%</b> |



**Table of Contents****Capital**

Capital consists solely of common stock, retained earnings, and accumulated other comprehensive income. We are currently authorized to raise capital through dividend reinvestment, employee and director stock purchases, and shareholder stock purchases. Pursuant to these authorizations, we issued 85,227 shares or \$2,025 of common stock during the first nine months of 2012, as compared to 89,898 shares or \$1,633 of common stock during the same period in 2011. We also offer the Directors Plan which allows participants to purchase stock units, in lieu of cash payments. Pursuant to this plan, we increased shareholders' equity by \$496 and \$486 during the nine month periods ended September 30, 2012 and 2011, respectively.

We have approved a publicly announced common stock repurchase plan. During the first nine months of 2012 and 2011, pursuant to this plan, we repurchased 63,103 shares of common stock at an average price of \$24.09 and 76,708 shares of common stock at an average price of \$18.13, respectively. As of September 30, 2012, we were authorized to repurchase up to an additional 105,893 shares of common stock.

There are no significant regulatory constraints placed on our capital. The FRB's current recommended minimum primary capital to assets requirement is 6.0%. Our primary capital to adjusted average assets, which consists of shareholders' equity plus the allowance for loan losses less acquisition intangibles, was 8.27% as of September 30, 2012.

The FRB has established a minimum risk based capital standard. Under this standard, a framework has been established that assigns risk weights to each category of on and off balance sheet items to arrive at risk adjusted total assets. Regulatory capital is divided by the risk adjusted assets with the resulting ratio compared to the minimum standard to determine whether a corporation has adequate capital. The minimum standard is 8%, of which at least 4% must consist of equity capital net of goodwill. The following table sets forth the percentages required under the Risk Based Capital guidelines and our values as of:

|                      | September 30<br>2012 | December 31<br>2011 | Required     |
|----------------------|----------------------|---------------------|--------------|
| Equity Capital       | 13.35%               | 12.92%              | 4.00%        |
| Secondary Capital    | 1.25%                | 1.25%               | 4.00%        |
| <b>Total Capital</b> | <b>14.60%</b>        | <b>14.17%</b>       | <b>8.00%</b> |

Secondary capital includes only the allowance for loan losses. The percentage for the secondary capital under the required column is the maximum amount allowed from all sources.

The FRB and FDIC also prescribe minimum capital requirements for Isabella Bank. At September 30, 2012, the Bank exceeded these minimum capital requirements. Recently passed legislation will likely increase the required level of capital for banks. This increase in capital levels may have an adverse impact on our ability to grow and pay dividends.

**Liquidity**

Liquidity is monitored regularly by our Market Risk Committee, which consists of members of senior management. The committee reviews projected cash flows, key ratios, and liquidity available from both primary and secondary sources.

Our primary sources of liquidity are cash and demand deposits due from banks, certificates of deposit held in other financial institutions, trading securities, and available-for-sale securities. These categories totaled \$499,541 or 36.0% of assets as of September 30, 2012 as compared to \$467,344 or 34.9% as of December 31, 2011. Liquidity is important for financial institutions because of their need to meet loan funding commitments, depositor withdrawal requests, and various other commitments including expansion of operations, investment opportunities, and payment of cash dividends. Liquidity varies on a daily basis as a result of customer activity.

Our primary source of funds is deposit accounts. We also have the ability to borrow from the FHLB, the FRB, and through various correspondent banks as federal funds purchased. These funding methods typically carry a higher interest rate than traditional market deposit accounts. Some borrowed funds, including FHLB Advances, FRB Discount Window Advances, and repurchase agreements, require us to pledge assets, typically in the form of certificates of deposits held in other financial institutions, investment securities, or loans as collateral. We had the ability to borrow up to an additional \$117,035 based on the assets currently pledged as collateral.





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The following table summarizes our sources and uses of cash for the nine month periods ended September 30:

|  | 2012             | 2011             | \$<br>Variance  |
|--|------------------|------------------|-----------------|
| Net cash provided by operating activities        | \$ 14,860        | \$ 12,992        | \$ 1,868        |
| Net cash used in investing activities            | (56,181)         | (92,937)         | 36,756          |
| Net cash provided by financing activities        | 37,395           | 83,057           | (45,662)        |
| (Decrease) increase in cash and cash equivalents | (3,926)          | 3,112            | (7,038)         |
| Cash and cash equivalents January 1              | 28,590           | 18,109           | 10,481          |
| <b>Cash and cash equivalents September 30</b>    | <b>\$ 24,664</b> | <b>\$ 21,221</b> | <b>\$ 3,443</b> |

**Market Risk**

Our primary market risks are interest rate risk and liquidity risk. We have no significant foreign exchange risk and do not utilize interest rate swaps or derivatives, except for interest rate locks and forward loan commitments, in the management of IRR. Any changes in foreign exchange rates or commodity prices would have an insignificant impact on our interest income and cash flows.

IRR is the exposure of our net interest income to changes in interest rates. IRR results from the difference in the maturity or repricing frequency of a financial institution's interest earning assets and its interest bearing liabilities. IRR is the fundamental method in which financial institutions earn income and create shareholder value. Excessive exposure to IRR could pose a significant risk to our earnings and capital.

The FRB, our primary Federal regulator, has adopted a policy requiring us to effectively manage the various risks that can have a material impact on our safety and soundness. The risks include credit, interest rate, liquidity, operational, and reputational. We have policies, procedures and internal controls for measuring and managing these risks. Specifically, the IRR policy and procedures include defining acceptable types and terms of investments and funding sources, liquidity requirements, limits on investments in long term assets, limiting the mismatch in repricing opportunity of assets and liabilities, and the frequency of measuring and reporting to our Board of Directors.

The primary technique to measure interest rate risk is simulation analysis. Simulation analysis forecasts the effects on the balance sheet structure and net interest income under a variety of scenarios that incorporate changes in interest rates, the shape of yield curves, interest rate relationships, and loan prepayments. These forecasts are compared against net interest income projected in a stable interest rate environment. While many assets and liabilities reprice either at maturity or in accordance with their contractual terms, several balance sheet components demonstrate characteristics that require an evaluation to more accurately reflect their repricing behavior. Key assumptions in the simulation analysis include prepayments on loans, probable calls of investment securities, changes in market conditions, loan volumes and loan pricing, deposit sensitivity and customer preferences. These assumptions are inherently uncertain as they are subject to fluctuation and revision in a dynamic environment. As a result, the simulation analysis cannot precisely forecast the impact of rising and falling interest rates on net interest income. Actual results will differ from simulated results due to many other factors, including changes in balance sheet components, interest rate changes, changes in market conditions, and management strategies.

Our interest rate sensitivity is estimated by first forecasting the next twelve months of net interest income under an assumed environment of a constant balance sheet and constant market interest rates (base case). We then compare the results of various simulation analyses to the base case. At September 30, 2012, we projected the change in net interest income during the next twelve months assuming market interest rates were to immediately decrease by 100 basis points and increase by 100, 200, 300, and 400 basis points in a parallel fashion over the entire yield curve during the same time period. We did not project scenarios showing decreases in interest rates beyond 100 basis points as this is considered extremely unlikely given prevailing interest rate levels. These projections were based on our assets and liabilities remaining static over the next twelve months, while factoring in probable calls and prepayments of certain investment securities and real estate residential and consumer loans. While it is extremely unlikely that interest rates would immediately increase at these levels, we feel that these extreme scenarios help us identify potential gaps and mismatches in the repricing characteristics of assets and liabilities. We regularly monitor our forecasted net interest income sensitivity to ensure that it remains within established limits.

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The following table summarizes our interest rate sensitivity as of:

|  | September 30, 2012 |   |       |        |        |        |
|--|--------------------|---|-------|--------|--------|--------|
|  | -100               | 0 | 100   | 200    | 300    | 400    |
| Immediate basis point change assumption (short-term rates) | -100               | 0 | 100   | 200    | 300    | 400    |
| Percent change in net income vs. constant rates            | -1.45%             |   | 0.28% | -1.79% | -2.54% | -3.72% |

  

|  | September 30, 2011 |   |       |       |        |     |
|--|--------------------|---|-------|-------|--------|-----|
|  | -100               | 0 | 100   | 200   | 300    | 400 |
| Immediate basis point change assumption (short-term rates) | -100               | 0 | 100   | 200   | 300    | 400 |
| Percent change in net income vs. constant rates            | -2.22%             |   | 1.09% | 0.26% | -1.88% | N/A |

A 400 basis point increase was not applicable as of September 30, 2011 as we were not utilizing this scenario as part of our interest rate sensitivity analysis at that time.

The secondary method to measure interest rate risk is gap analysis. Gap analysis measures the cash flows and/or the earliest repricing of our interest bearing assets and liabilities. This analysis is useful for measuring trends in the repricing characteristics of the balance sheet. Significant assumptions are required in this process because of the imbedded repricing options contained in assets and liabilities. A substantial portion of our assets are invested in loans and investment securities with issuer call options. Residential real estate and consumer loans have imbedded options that allow the borrower to repay the balance prior to maturity without penalty, while commercial and agricultural loans have prepayment penalties. The amount of prepayments is dependent upon many factors, including the interest rate of a given loan in comparison to the current interest rate for residential real estate loans, the level of sales of used homes, and the overall availability of credit in the market place. Generally, a decrease in interest rates will result in an increase in cash flows from these assets. A significant portion of our securities are callable or have prepayment options. The call and prepayment options are more likely to be exercised in a period of decreasing interest rates. Investment securities, other than those that are callable, do not have any significant embedded options. Savings and NOW accounts may generally be withdrawn on request without prior notice. The timing of cash flows from these deposits is estimated based on historical experience. Time deposits have penalties that discourage early withdrawals.

The following tables provide information about assets and liabilities that are sensitive to changes in interest rates as of September 30, 2012 and December 31, 2011. The principal amounts of assets and time deposits maturing were calculated based on the contractual maturity dates. Savings and NOW accounts are based on management's estimate of their future cash flows. During the third quarter of 2012, we engaged the services of a third party to analyze our historical loan prepayment speeds and non-contractual deposit decay rates. These analyses were prompted by the Office of Thrift Supervision's discontinuation of publishing its various benchmarks for various loan prepayment speeds and deposit decay rates, which we had previously used for certain loan and deposit accounts (including as of December 31, 2011). As a result of implementing the results of these analyses, the estimated lives of our non-contractual deposit accounts significantly increased, which in turn significantly impacted the corresponding estimated cash flows for these accounts in the following table. We have reviewed the results of the analyses in detail and feel that it reasonably reflects the prepayment speeds and decay rates of our loan and deposit portfolios.

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|                                      | (dollars in thousands) |            |           |                    |            |            |            | Fair Value |
|--------------------------------------|------------------------|------------|-----------|--------------------|------------|------------|------------|------------|
|                                      | 2013                   | 2014       | 2015      | September 30, 2012 |            | Thereafter | Total      |            |
|                                      |                        |            |           | 2016               | 2017       |            |            |            |
| <b>Rate sensitive assets</b>         |                        |            |           |                    |            |            |            |            |
| Other interest bearing assets        | \$ 9,572               | \$ 1,325   | \$ 240    | \$                 | \$         | \$         | \$ 11,137  | \$ 11,153  |
| Average interest rates               | 0.82%                  | 1.14%      | 1.25%     |                    |            |            | 0.87%      |            |
| Trading securities                   | \$ 1,050               | \$ 738     | \$        | \$                 | \$         | \$         | \$ 1,788   | \$ 1,788   |
| Average interest rates               | 2.64%                  | 2.81%      |           |                    |            |            | 2.71%      |            |
| Fixed interest rate securities       | \$ 124,653             | \$ 66,580  | \$ 53,645 | \$ 38,084          | \$ 37,954  | \$ 146,498 | \$ 467,414 | \$ 467,414 |
| Average interest rates               | 2.46%                  | 2.46%      | 2.67%     | 2.75%              | 3.06%      | 2.65%      | 2.62%      |            |
| Fixed interest rate loans (1)        | \$ 139,585             | \$ 95,994  | \$ 88,688 | \$ 88,337          | \$ 104,694 | \$ 77,042  | \$ 594,340 | \$ 608,382 |
| Average interest rates               | 5.93%                  | 5.67%      | 5.77%     | 5.35%              | 4.70%      | 4.78%      | 5.41%      |            |
| Variable interest rate loans (1)     | \$ 69,647              | \$ 26,793  | \$ 29,299 | \$ 14,862          | \$ 21,910  | \$ 9,900   | \$ 172,411 | \$ 172,411 |
| Average interest rates               | 4.70%                  | 3.89%      | 3.71%     | 3.71%              | 3.38%      | 3.99%      | 4.11%      |            |
| <b>Rate sensitive liabilities</b>    |                        |            |           |                    |            |            |            |            |
| Borrowed funds                       | \$ 68,448              | \$ 5,225   | \$ 32,907 | \$ 30,000          | \$ 40,000  | \$ 50,000  | \$ 226,580 | \$ 234,229 |
| Average interest rates               | 0.44%                  | 4.43%      | 1.13%     | 2.19%              | 2.15%      | 3.03%      | 1.74%      |            |
| Savings and NOW accounts             | \$ 34,756              | \$ 31,593  | \$ 28,396 | \$ 25,549          | \$ 23,013  | \$ 252,973 | \$ 396,280 | \$ 396,280 |
| Average interest rates               | 0.18%                  | 0.18%      | 0.17%     | 0.17%              | 0.17%      | 0.16%      | 0.17%      |            |
| Fixed interest rate time deposits    | \$ 215,522             | \$ 67,291  | \$ 67,215 | \$ 51,449          | \$ 44,352  | \$ 19,867  | \$ 465,696 | \$ 474,373 |
| Average interest rates               | 1.24%                  | 1.94%      | 2.10%     | 2.21%              | 1.87%      | 1.62%      | 1.65%      |            |
| Variable interest rate time deposits | \$ 784                 | \$ 369     | \$        | \$                 | \$         | \$         | \$ 1,153   | \$ 1,153   |
| Average interest rates               | 0.46%                  | 0.45%      |           |                    |            |            | 0.46%      |            |
|                                      | December 31, 2011      |            |           |                    |            |            |            | Fair Value |
|                                      | 2012                   | 2013       | 2014      | 2015               | 2016       | Thereafter | Total      |            |
| <b>Rate sensitive assets</b>         |                        |            |           |                    |            |            |            |            |
| Other interest bearing assets        | \$ 8,775               | \$ 4,125   | \$ 100    | \$                 | \$         | \$         | \$ 13,000  | \$ 13,053  |
| Average interest rates               | 1.18%                  | 1.33%      | 0.35%     |                    |            |            | 1.22%      |            |
| Trading securities                   | \$ 3,156               | \$ 1,031   | \$ 523    | \$                 | \$         | \$         | \$ 4,710   | \$ 4,710   |
| Average interest rates               | 3.34%                  | 2.48%      | 2.49%     |                    |            |            | 3.06%      |            |
| Fixed interest rate securities       | \$ 104,559             | \$ 61,421  | \$ 48,659 | \$ 37,777          | \$ 35,108  | \$ 137,596 | \$ 425,120 | \$ 425,120 |
| Average interest rates               | 2.98%                  | 2.84%      | 2.91%     | 2.93%              | 3.21%      | 3.01%      | 2.98%      |            |
| Fixed interest rate loans (1)        | \$ 141,867             | \$ 140,390 | \$ 90,852 | \$ 75,690          | \$ 76,985  | \$ 61,854  | \$ 587,638 | \$ 606,524 |
| Average interest rates               | 6.24%                  | 6.08%      | 5.94%     | 5.99%              | 5.40%      | 5.15%      | 5.90%      |            |
| Variable interest rate loans (1)     | \$ 70,783              | \$ 25,267  | \$ 20,803 | \$ 18,853          | \$ 11,631  | \$ 15,316  | \$ 162,653 | \$ 162,653 |
| Average interest rates               | 5.87%                  | 3.97%      | 4.05%     | 3.68%              | 4.00%      | 3.98%      | 4.78%      |            |
| <b>Rate sensitive liabilities</b>    |                        |            |           |                    |            |            |            |            |
| Borrowed funds                       | \$ 89,869              | \$ 15,000  | \$ 25,869 | \$ 45,398          | \$ 20,000  | \$ 20,000  | \$ 216,136 | \$ 227,780 |
| Average interest rates               | 1.42%                  | 3.93%      | 3.13%     | 3.30%              | 2.67%      | 2.56%      | 2.41%      |            |
| Savings and NOW accounts             | \$ 120,850             | \$ 78,313  | \$ 51,291 | \$ 34,006          | \$ 22,803  | \$ 50,292  | \$ 357,555 | \$ 357,555 |
| Average interest rates               | 0.20%                  | 0.19%      | 0.18%     | 0.17%              | 0.15%      | 0.15%      | 0.18%      |            |
| Fixed interest rate time deposits    | \$ 264,147             | \$ 62,883  | \$ 46,802 | \$ 55,493          | \$ 43,601  | \$ 7,052   | \$ 479,978 | \$ 498,085 |
| Average interest rates               | 1.61%                  | 2.67%      | 2.33%     | 2.56%              | 2.41%      | 1.48%      | 2.00%      |            |
| Variable interest rate time deposits | \$ 1,152               | \$ 407     | \$        | \$                 | \$         | \$         | \$ 1,559   | \$ 1,559   |
| Average interest rates               | 0.67%                  | 0.69%      |           |                    |            |            | 0.68%      |            |

(1) The fair value reported is exclusive of the allocation of the allowance for loan losses.

We do not believe that there has been a material change in the nature or categories of our primary market risk exposure, or the particular markets that present the primary risk of loss. As of the date of this report, we do not know of or expect there to be any material change in the general nature of our primary market risk exposure in the near term. The methods by which we manage primary market risk exposure, as described in our Annual Report on Form 10-K for the year ended December 31, 2011, have not changed materially during 2012. As of the date of this report, we do not expect to make material changes in those methods in the near term. We may change those methods in the future to adapt to changes in circumstances or to implement new techniques.



**Table of Contents****FINANCIAL INSTRUMENTS WITH OFF BALANCE SHEET ARRANGEMENTS**

We are party to credit related financial instruments with off-balance-sheet risk. These financial instruments are entered into in the normal course of business to meet the financing needs of our customers. These financial instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated balance sheets. The contract or notional amounts of these instruments reflect the extent of involvement we have in a particular class of financial instrument.

The following table summarizes our credit related financial instruments with off-balance-sheet risk as of:

|  | September 30<br>2012 | December 31<br>2011 |
|--|----------------------|---------------------|
| Unfunded commitments under lines of credit | \$ 109,593           | \$ 102,822          |
| Commercial and standby letters of credit   | 4,033                | 4,461               |
| Commitments to grant loans                 | 23,377               | 21,806              |

Unfunded commitments under lines of credit are commitments for possible future extensions of credit to existing customers. These commitments may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements.

Commercial and standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support private borrowing arrangements, including commercial paper, bond financing, and similar transactions. These commitments to extend credit and letters of credit generally mature within one year. The credit risk involved in these transactions is essentially the same as that involved in extending loans to customers. We evaluate each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon the extension of credit, is based on a credit evaluation of the borrower. While we consider standby letters of credit to be guarantees, the amount of the liability related to such guarantees on the commitment date is not significant and a liability related to such guarantees is not recorded on the consolidated balance sheets.

Commitments to grant loans 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. The amount of collateral obtained, if it is deemed necessary, is based on management's credit evaluation of the customer. Commitments to grant loans include loans committed to be sold to the secondary market.

Our exposure to credit-related loss in the event of nonperformance by the counter parties to the financial instruments for commitments to extend credit and standby letters of credit could be up to the contractual notional amount of those instruments. We use the same credit policies as we do for extending loans to customers. No significant losses are anticipated as a result of these commitments.

**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. We intend 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 included in this statement for purposes of these safe harbor provisions. Forward looking statements, which are based on certain assumptions and describe future plans, strategies and expectations, are generally identifiable by use of the words believe, expect, intend, anticipate, estimate, project, or similar expressions. Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse effect on the operations and future prospects include, but are not limited to, changes in: interest rates, general economic conditions, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the FRB, the quality or composition of the loan or investment portfolios, demand for loan products, fluctuation in the value of collateral securing our loan portfolio, deposit flows, competition, demand for financial services in our market area, and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating forward looking statements and undue reliance should not be placed on such statements. Further information concerning Isabella Bank Corporation and its business, including additional factors that could materially affect our financial results, is included in our filings with the SEC.

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**Item 3 Quantitative and Qualitative Disclosures about Market Risk**

The information presented in the Market Risk section of the Management's Discussion and Analysis of Financial Condition and Results of Operations is incorporated herein by reference.

**Item 4 Controls and Procedures**

**DISCLOSURE CONTROLS AND PROCEDURES**

We carried out an evaluation, under the supervision and with the participation of the Principal Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15(d)-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)) as of September 30, 2012, pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures as of September 30, 2012, were effective to ensure that information required to be disclosed in reports that we file or submit under the Exchange Act are recorded, processed, summarized and reported within the time periods specified in SEC rules and forms.

**CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

During the most recent fiscal quarter, no change occurred in our internal control over financial reporting that materially affected, or is likely to materially effect, our internal control over financial reporting.

**Table of Contents****PART II OTHER INFORMATION****Item 1 Legal Proceedings**

We are not involved in any material legal proceedings. We are involved in ordinary, routine litigation incidental to our business; however, no such routine proceedings are expected to result in any material adverse effect on operations, earnings, or financial condition.

**Item 1A Risk Factors**

There have been no material changes to the risk factors disclosed in Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2011.

**Item 2 Unregistered Sales of Equity Securities and Use of Proceeds**

(A) None

(B) None

**(C) Repurchases of Common Stock**

We have adopted and announced a common stock repurchase plan. The plan was last amended on April 26, 2012, to allow for the repurchase of an additional 150,000 shares of common stock. These authorizations do not have expiration dates. As shares are repurchased under this plan, they are retired and revert back to the status of authorized, but unissued shares.

The following table provides information for the three month period ended September 30, 2012, with respect to this plan:

|                                    | Shares Repurchased |                            | Total Number of<br>Shares<br>Purchased<br>as Part of Publicly<br>Announced<br>Plan<br>or Program | Maximum Number<br>of<br>Shares That May Yet Be<br>Purchased Under<br>the<br>Plans or Programs |
|------------------------------------|--------------------|----------------------------|--|---|
|                                    | Number             | Average Price<br>Per Share |  |   |
| Balance, June 30, 2012             |                    |                            |  | 127,415   |
| July 1 - 31, 2012                  | 5,691              | \$ 24.60                   | 5,691  | 121,724   |
| August 1 - 31, 2012                | 9,821              | 24.34                      | 9,821  | 111,903   |
| September 1 - 30, 2012             | 6,010              | 23.46                      | 6,010  | 105,893   |
| <b>Balance, September 30, 2012</b> | <b>21,522</b>      | <b>\$ 24.16</b>            | <b>21,522</b>  | <b>105,893</b>  |

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**Item 6 Exhibits**

(a) Exhibits

- 31(a) Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by the Principal Executive Officer
- 31(b) Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by the Principal Financial Officer
- 32 Section 1350 Certification of Principal Executive Officer and Principal Financial Officer
- 101.1\*
  - 101.INS (XBRL Instance Document)
  - 101.SCH (XBRL Taxonomy Extension Schema Document)
  - 101.CAL (XBRL Calculation Linkbase Document)
  - 101.LAB (XBRL Taxonomy Label Linkbase Document)
  - 101.DEF (XBRL Taxonomy Linkbase Document)
  - 101.PRE (XBRL Taxonomy Presentation Linkbase Document)

In accordance with Rule 406T of Regulations S-T, the XBRL related information shall not be deemed to be filed for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and shall not be part of any registration statement or other document filed under the Securities Act or the Exchange Act, except as shall be expressly set forth by specific reference in such filing.



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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.

Isabella Bank Corporation

Date: October 29, 2012

/s/ Richard J. Barz  
Richard J. Barz  
Chief Executive Officer  
(Principal Executive Officer)

Date: October 29, 2012

/s/ Dennis P. Angner  
Dennis P. Angner  
President, Chief Financial Officer  
(Principal Financial Officer, Principal Accounting Officer)