

ISABELLA BANK CORP  
Form 10-Q  
May 09, 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 March 31, 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, 7,600,622 as of April 24, 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)

|   | March 31,<br>2012   | December<br>31<br>2011 |
|---|---------------------|------------------------|
| <b>ASSETS</b>   |                     |                        |
| Cash and cash equivalents   |                     |                        |
| Cash and demand deposits due from banks   | \$ 17,793           | \$ 24,514              |
| Interest bearing balances due from banks  | 3,951               | 4,076                  |
| <b>Total cash and cash equivalents</b>  | <b>21,744</b>       | <b>28,590</b>          |
| Certificates of deposit held in other financial institutions                              | 6,640               | 8,924                  |
| Trading securities  | 4,403               | 4,710                  |
| Available-for-sale securities (amortized cost of \$461,071 in 2012 and \$414,614 in 2011) | 471,655             | 425,120                |
| Mortgage loans available-for-sale   | 3,396               | 3,205                  |
| Loans   |                     |                        |
| Agricultural  | 76,681              | 74,645                 |
| Commercial  | 361,325             | 365,714                |
| Consumer  | 30,459              | 31,572                 |
| Residential real estate   | 274,667             | 278,360                |
| <b>Total loans</b>  | <b>743,132</b>      | <b>750,291</b>         |
| Less allowance for loan losses  | 12,375              | 12,375                 |
| <b>Net loans</b>  | <b>730,757</b>      | <b>737,916</b>         |
| Premises and equipment  | 25,054              | 24,626                 |
| Corporate owned life insurance  | 22,246              | 22,075                 |
| Accrued interest receivable   | 6,044               | 5,848                  |
| Equity securities without readily determinable fair values                                | 17,220              | 17,189                 |
| Goodwill and other intangible assets  | 46,726              | 46,792                 |
| Other assets  | 13,335              | 12,930                 |
| <b>TOTAL ASSETS</b>   | <b>\$ 1,369,220</b> | <b>\$ 1,337,925</b>    |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |                     |                        |
| Deposits  |                     |                        |
| Noninterest bearing   | \$ 122,862          | \$ 119,072             |
| NOW accounts  | 170,701             | 163,653                |
| Certificates of deposit under \$100 and other savings                                     | 460,815             | 440,123                |
| Certificates of deposit over \$100  | 234,748             | 235,316                |
| <b>Total deposits</b>   | <b>989,126</b>      | <b>958,164</b>         |
| Borrowed funds (\$0 in 2012 and \$5,242 in 2011 at fair value)                            | 214,493             | 216,136                |
| Accrued interest payable and other liabilities  | 8,294               | 8,842                  |
| <b>Total liabilities</b>  | <b>1,211,913</b>    | <b>1,183,142</b>       |

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|  |                     |                     |
|--|---------------------|---------------------|
| <b>Shareholders' equity</b>  |                     |                     |
| Common stock - no par value  |                     |                     |
| 15,000,000 shares authorized; issued and outstanding 7,596,772 shares (including 16,686 shares held in a Rabbi Trust) in 2012 and 7,589,226 shares (including 16,585 shares held in the Rabbi Trust) in 2011 | 134,868             | 134,734             |
| Shares to be issued for deferred compensation obligations  | 4,598               | 4,524               |
| Retained earnings  | 14,755              | 13,036              |
| Accumulated other comprehensive income   | 3,086               | 2,489               |
| <b>Total shareholders' equity</b>  | <b>157,307</b>      | <b>154,783</b>      |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>  | <b>\$ 1,369,220</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) 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   |                                       |                   |   | 2,316                | 1,358  | 3,674             |
| Issuance of common stock   | 30,531                                | 728               |   |                      |  | 728               |
| Common stock issued for deferred compensation obligations                                  | 12,037                                | 215               | (182)   |                      |  | 33                |
| Share based payment awards under equity compensation plan                                  |                                       |                   | 180   |                      |  | 180               |
| Common stock purchased for deferred compensation obligations                               |                                       | (164)             |   |                      |  | (164)             |
| Common stock repurchased pursuant to publicly announced repurchase plan                    | (31,739)                              | (577)             |   |                      |  | (577)             |
| Cash dividends (\$0.19 per share)  |                                       |                   |   | (1,434)              |  | (1,434)           |
| <b>Balance, March 31, 2011</b>   | <b>7,560,903</b>                      | <b>\$ 133,794</b> | <b>\$ 4,680</b>   | <b>\$ 9,478</b>      | <b>\$ (351)</b>  | <b>\$ 147,601</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   |                                       |                   |   | 3,234                | 597  | 3,831             |
| Issuance of common stock   | 25,998                                | 609               |   |                      |  | 609               |
| Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations |                                       | 95                | (95)  |                      |  |                   |
| Share based payment awards under equity compensation plan                                  |                                       |                   | 169   |                      |  | 169               |
| Common stock purchased for deferred compensation obligations                               |                                       | (144)             |   |                      |  | (144)             |
| Common stock repurchased pursuant to publicly announced repurchase plan                    | (18,452)                              | (426)             |   |                      |  | (426)             |
| Cash dividends (\$0.20 per share)  |                                       |                   |   | (1,515)              |  | (1,515)           |
| <b>Balance, March 31, 2012</b>   | <b>7,596,772</b>                      | <b>\$ 134,868</b> | <b>\$ 4,598</b>   | <b>\$ 14,755</b>     | <b>\$ 3,086</b>  | <b>\$ 157,307</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>March 31 |               |
|--|--------------------------------|---------------|
|  | 2012                           | 2011          |
| <b>Interest income</b>                                     |                                |               |
| Loans, including fees                                      | \$ 10,940                      | \$ 11,361     |
| Investment securities                                      |                                |               |
| Taxable  | 1,889                          | 1,513         |
| Nontaxable   | 1,204                          | 1,179         |
| Trading account securities                                 | 42                             | 51            |
| Federal funds sold and other                               | 129                            | 134           |
| <b>Total interest income</b>                               | <b>14,204</b>                  | <b>14,238</b> |
| <b>Interest expense</b>                                    |                                |               |
| Deposits   | 2,512                          | 2,785         |
| Borrowings   | 1,192                          | 1,268         |
| <b>Total interest expense</b>                              | <b>3,704</b>                   | <b>4,053</b>  |
| <b>Net interest income</b>                                 | <b>10,500</b>                  | <b>10,185</b> |
| Provision for loan losses                                  | 461                            | 817           |
| <b>Net interest income after provision for loan losses</b> | <b>10,039</b>                  | <b>9,368</b>  |
| <b>Noninterest income</b>                                  |                                |               |
| Service charges and fees                                   | 1,629                          | 1,476         |
| Gain on sale of mortgage loans                             | 379                            | 129           |
| Net loss on trading securities                             | (16)                           | (19)          |
| Net gain on borrowings measured at fair value              | 33                             | 80            |
| Gain on sale of available-for-sale investment securities   | 1,003                          |               |
| Other  | 513                            | 282           |
| <b>Total noninterest income</b>                            | <b>3,541</b>                   | <b>1,948</b>  |
| <b>Noninterest expenses</b>                                |                                |               |
| Compensation and benefits                                  | 5,301                          | 5,005         |
| Occupancy  | 641                            | 646           |
| Furniture and equipment                                    | 1,090                          | 1,106         |
| 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                            |               |
| Other  | 2,259                          | 1,830         |
| <b>Total noninterest expenses</b>                          | <b>9,573</b>                   | <b>8,587</b>  |
| <b>Income before federal income tax expense</b>            | <b>4,007</b>                   | <b>2,729</b>  |
| Federal income tax expense                                 | 773                            | 413           |

|                                       |                 |                 |
|---------------------------------------|-----------------|-----------------|
| <b>NET INCOME</b>                     | <b>\$ 3,234</b> | <b>\$ 2,316</b> |
| <b>Earnings per share</b>             |                 |                 |
| <b>Basic</b>                          | <b>\$ 0.43</b>  | <b>\$ 0.31</b>  |
| <b>Diluted</b>                        | <b>\$ 0.41</b>  | <b>\$ 0.30</b>  |
| <b>Cash dividends per basic share</b> | <b>\$ 0.20</b>  | <b>\$ 0.19</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>March 31 |                 |
|---|--------------------------------|-----------------|
|   | 2012                           | 2011            |
| <b>Net income</b>   | <b>\$ 3,234</b>                | <b>\$ 2,316</b> |
| Unrealized holding gains on available-for-sale securities:                |                                |                 |
| Unrealized holding gains arising during the period                        | 799                            | 1,753           |
| Reclassification adjustment for net realized gains included in net income | (1,003)                        |                 |
| Reclassification adjustment for impairment loss included in net income    | 282                            |                 |
| Net unrealized gains  | 78                             | 1,753           |
| Tax effect  | 519                            | (395)           |
| Other comprehensive income, net of tax                                    | 597                            | 1,358           |
| <b>COMPREHENSIVE INCOME</b>   | <b>\$ 3,831</b>                | <b>\$ 3,674</b> |

See notes to interim condensed consolidated financial statements.

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

(Dollars in thousands)

|   | Three Months Ended<br>March 31 |                 |
|---|--------------------------------|-----------------|
|   | 2012                           | 2011            |
| <b>OPERATING ACTIVITIES</b>   |                                |                 |
| Net income  | \$ 3,234                       | \$ 2,316        |
| Reconciliation of net income to net cash provided by operations:            |                                |                 |
| Provision for loan losses   | 461                            | 817             |
| Impairment of foreclosed assets   | 17                             | 10              |
| Depreciation  | 597                            | 647             |
| Amortization and impairment of originated mortgage servicing rights         | 121                            | 89              |
| Amortization of acquisition intangibles                                     | 66                             | 76              |
| Net amortization of available-for-sale securities                           | 528                            | 362             |
| Available-for-sale security impairment loss                                 | 282                            |                 |
| Gain on sale of available-for-sale securities                               | (1,003)                        |                 |
| Net unrealized losses on trading securities                                 | 16                             | 19              |
| Net gain on sale of mortgage loans  | (379)                          | (129)           |
| Net unrealized gains on borrowings measured at fair value                   | (33)                           | (80)            |
| Increase in cash value of corporate owned life insurance                    | (171)                          | (142)           |
| Share-based payment awards under equity compensation plan                   | 169                            | 180             |
| Origination of loans held for sale  | (25,966)                       | (8,830)         |
| Proceeds from loan sales  | 26,154                         | 9,889           |
| Net changes in operating assets and liabilities which provided (used) cash: |                                |                 |
| Trading securities  | 291                            | 385             |
| Accrued interest receivable   | (196)                          | (802)           |
| Other assets  | (195)                          | (24)            |
| Accrued interest payable and other liabilities                              | (548)                          | (323)           |
| <b>Net cash provided by operating activities</b>                            | <b>3,445</b>                   | <b>4,460</b>    |
| <b>INVESTING ACTIVITIES</b>   |                                |                 |
| Net change in certificates of deposit held in other financial institutions  | 2,284                          | 1,940           |
| Activity in available-for-sale securities                                   |                                |                 |
| Sales   | 24,241                         |                 |
| Maturities and calls  | 19,789                         | 15,597          |
| Purchases   | (90,294)                       | (45,442)        |
| Loan principal collections and (originations), net                          | 6,510                          | (4,315)         |
| Proceeds from sales of foreclosed assets                                    | 328                            | 302             |
| Purchases of premises and equipment   | (1,025)                        | (239)           |
| <b>Net cash used in investing activities</b>                                | <b>(38,167)</b>                | <b>(32,157)</b> |

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

(Dollars in thousands)

**INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

|   | Three Months Ended<br>March 31 |                  |
|---|--------------------------------|------------------|
|   | 2012                           | 2011             |
| <b>FINANCING ACTIVITIES</b>                                       |                                |                  |
| Acceptances and withdrawals of deposits, net                      | \$ 30,962                      | \$ 45,908        |
| Decrease in other borrowed funds                                  | (1,610)                        | (11,574)         |
| Cash dividends paid on common stock                               | (1,515)                        | (1,434)          |
| Proceeds from issuance of common stock                            | 609                            | 546              |
| Common stock repurchased  | (426)                          | (362)            |
| Common stock purchased for deferred compensation obligations      | (144)                          | (164)            |
| <b>Net cash provided by financing activities</b>                  | <b>27,876</b>                  | <b>32,920</b>    |
| <b>(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>           |                                |                  |
| Cash and cash equivalents at beginning of period                  | 28,590                         | 18,109           |
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>                 | <b>\$ 21,744</b>               | <b>\$ 23,332</b> |
| <b>SUPPLEMENTAL CASH FLOWS INFORMATION:</b>                       |                                |                  |
| Interest paid   | \$ 3,784                       | \$ 4,025         |
| <b>SUPPLEMENTAL NONCASH INFORMATION:</b>                          |                                |                  |
| Transfers of loans to foreclosed assets                           | \$ 188                         | \$ 833           |
| Common stock issued for deferred compensation obligations         |                                | 182              |
| Common stock repurchased from an associated Rabbi Trust           |                                | (215)            |
| See notes to interim condensed consolidated financial statements. |                                |                  |

**Table of Contents****NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Dollars in thousands except per share amounts)****NOTE 1 BASIS OF PRESENTATION**

The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles 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 generally accepted accounting principles for complete financial statements. In management's opinion, all adjustments considered necessary for a fair presentation have been included. Operating results for the three month period ended March 31, 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 the Corporation's annual report for the year ended December 31, 2011.

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

**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 by the Corporation relate solely to outstanding shares in the Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors (the Directors Plan).

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

|   | Three Months Ended |                |
|---|--------------------|----------------|
|   | 2012               | 2011           |
| Average number of common shares outstanding for basic calculation                               | 7,594,257          | 7,557,293      |
| Average potential effect of shares in the Directors Plan (1)                                    | 199,882            | 193,128        |
| Average number of common shares outstanding used to calculate diluted earnings per common share | 7,794,139          | 7,750,421      |
| Net income  | \$ 3,234           | \$ 2,316       |
| <b>Earnings per share</b>   |                    |                |
| <b>Basic</b>  | <b>\$ 0.43</b>     | <b>\$ 0.31</b> |
| <b>Diluted</b>  | <b>\$ 0.41</b>     | <b>\$ 0.30</b> |

(1) Exclusive of shares held in the Rabbi Trust

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**NOTE 3 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 the Corporation's 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 U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (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.

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.

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 the Corporation's 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 Corporation's consolidated financial statements as the Corporation has historically elected to present a separate statement of comprehensive income.

**Table of Contents****NOTE 4 TRADING SECURITIES**

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

|                                   | March 31<br>2012 | December 31<br>2011 |
|-----------------------------------|------------------|---------------------|
| States and political subdivisions | \$ 4,403         | \$ 4,710            |

Included in the net trading losses of \$16 during the first three months of 2012 were \$13 of net unrealized trading losses on securities that were held in the Corporation's trading portfolio as of March 31, 2012. Included in the net trading losses of \$19 during the first three months of 2011 were \$17 of net unrealized trading losses on securities that were held in the Corporation's trading portfolio as of March 31, 2011.

**NOTE 5 AVAILABLE-FOR-SALE SECURITIES**

The amortized cost and fair value of available-for-sale securities, with gross unrealized gains and losses, are as follows at:

|                                     | Amortized<br>Cost | March 31, 2012<br>Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value        |
|-------------------------------------|-------------------|--|-------------------------------|-------------------|
| Government sponsored enterprises    | \$ 2,450          | \$ 24  | \$                            | \$ 2,474          |
| States and political subdivisions   | 169,341           | 7,893  | 348                           | 176,886           |
| Auction rate money market preferred | 3,200             |  | 579                           | 2,621             |
| Preferred stocks                    | 6,800             |  | 735                           | 6,065             |
| Mortgage-backed securities          | 154,643           | 1,976  | 180                           | 156,439           |
| Collateralized mortgage obligations | 124,637           | 2,533  |                               | 127,170           |
| <b>Total</b>                        | <b>\$ 461,071</b> | <b>\$ 12,426</b>                               | <b>\$ 1,842</b>               | <b>\$ 471,655</b> |

|                                     | Amortized<br>Cost | December 31, 2011<br>Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value        |
|-------------------------------------|-------------------|---|-------------------------------|-------------------|
| 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> |

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The amortized cost and fair value of available-for-sale securities by contractual maturity at March 31, 2012 are as follows:

|                                     | Maturing                      |   |  |                    | Securities<br>With<br>Variable<br>Monthly<br>Payments<br>or<br>Continual<br>Call<br>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 Years |   |                   |
| Government sponsored enterprises    | \$                            | \$  | \$ 72  | \$ 2,378           | \$  | \$ 2,450          |
| States and political subdivisions   | 8,898                         | 35,262  | 85,647   | 39,534             |   | 169,341           |
| Auction rate money market preferred |                               |   |  |                    | 3,200   | 3,200             |
| Preferred stocks                    |                               |   |  |                    | 6,800   | 6,800             |
| Mortgage-backed securities          |                               |   |  |                    | 154,643   | 154,643           |
| Collateralized mortgage obligations |                               |   |  |                    | 124,637   | 124,637           |
| <b>Total amortized cost</b>         | <b>\$ 8,898</b>               | <b>\$ 35,262</b>                              | <b>\$ 85,719</b>                               | <b>\$ 41,912</b>   | <b>\$ 289,280</b>   | <b>\$ 461,071</b> |
| <b>Fair value</b>                   | <b>\$ 8,928</b>               | <b>\$ 36,518</b>                              | <b>\$ 91,022</b>                               | <b>\$ 42,892</b>   | <b>\$ 292,295</b>   | <b>\$ 471,655</b> |

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.

As auction rate money market preferreds 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 available-for-sale securities was as follows for the three month period ended March 31, 2012:

|                                   |           |
|-----------------------------------|-----------|
| Proceeds from sales of securities | \$ 24,241 |
| Gross realized gains              | \$ 1,003  |
| Applicable income tax expense     | \$ 341    |

There were no sales of available-for-sale securities in the first three 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.

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

|                                     | Less Than Twelve Months       |                  | March 31, 2012<br>Over Twelve Months |                 | Total<br>Unrealized<br>Losses |
|-------------------------------------|-------------------------------|------------------|--------------------------------------|-----------------|-------------------------------|
|                                     | Gross<br>Unrealized<br>Losses | Fair<br>Value    | Gross<br>Unrealized<br>Losses        | Fair<br>Value   |                               |
| States and political subdivisions   | \$ 348                        | \$ 5,783         | \$                                   | \$              | \$ 348                        |
| Auction rate money market preferred |                               |                  | 579                                  | 2,621           | 579                           |
| Preferred stocks                    |                               |                  | 735                                  | 6,066           | 735                           |
| Mortgage-backed securities          | 180                           | 34,854           |                                      |                 | 180                           |
| <b>Total</b>                        | <b>\$ 528</b>                 | <b>\$ 40,637</b> | <b>\$ 1,314</b>                      | <b>\$ 8,687</b> | <b>\$ 1,842</b>               |

**Number of securities in an unrealized loss position:** 21 6 27

|                                     | Less Than Twelve Months       |                  | December 31, 2011<br>Over Twelve Months |                 | Total<br>Unrealized<br>Losses |
|-------------------------------------|-------------------------------|------------------|---|-----------------|-------------------------------|
|                                     | 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>               |

**Number of securities in an unrealized loss position:** 6 6 12

As of March 31, 2012 and December 31, 2011, management conducted an analysis to determine whether all securities currently in an unrealized loss position should be considered other-than-temporarily-impaired ( OTTI ). 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?

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

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



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Has the duration of the investment been extended?

As of March 31, 2012, the Corporation 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. Management has 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, management does not intend to sell the securities in an unrealized loss position, and it is more likely than not that the Corporation will not have to sell the securities before recovery of their cost basis.

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During the three month period ended March 31, 2012, the Corporation had one state issued student loan auction rate available-for-sale 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, the Corporation 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 bifurcation methods were then weighted, with a higher weighting applied to the Estimated Cash Flow Method, to arrive at the estimated credit related impairment of \$282 due to a decline in projected cash flows and credit rating downgrade.

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

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

The total other-than-temporary impairment loss recognized in accumulated other comprehensive income as of March 31, 2012 was \$204 related to the student loan auction rate security. A roll forward of credit related impairment recognized in earnings on available-for-sale securities in the three months ended March 31, 2012 was as follows:

|  |               |
|--|---------------|
| January 1, 2012  | \$            |
| Additions to credit losses for which no previous OTTI was recognized | 282           |
| <b>March 31, 2012</b>  | <b>\$ 282</b> |

There were no credit losses recognized in earnings or OTTI impairment losses recognized in accumulated other comprehensive income on available-for-sale securities in the three months ended March 31, 2011.

Based on the Corporation's analysis using the above criteria, the fact that management has asserted that it does not have the intent to sell these securities in an unrealized loss position, and that it is more likely than not the Corporation will not have to sell the securities before recovery of their cost basis, management does not believe that the values of any other securities are other-than-temporarily impaired as of as of March 31, 2012 or December 31, 2011.

**NOTE 6 LOANS AND ALLOWANCE FOR LOAN LOSSES (ALL)**

The Corporation grants 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 management has the intent and ability to hold in its portfolio are reported at their outstanding principal balance adjusted for any charge-offs, the allowance for loans losses, 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.

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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 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. The Corporation minimizes its 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, the Corporation 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, the Corporation requires annual financial statements, prepares cash flow analyses, and reviews credit reports as deemed necessary.

The Corporation offers 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 the Federal Home Loan Mortgage Corporation. Fixed rate residential real estate loans with an amortization of 15 years or less may be held in the Corporation's portfolio, held for future sale, or sold upon origination. Factors used in determining when to sell these mortgages include management's judgment about the direction of interest rates, the Corporation's need for fixed rate assets in the management of its interest rate sensitivity, and overall loan demand.

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 a mortgage loan committee or through a secondary market automated underwriting system; loans in excess of \$400 require the approval of the Corporation's Internal Loan Committee, Board of Directors, or the Board of Director's Loan Committee.

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 management believes 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 by management and is based upon management's 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 its recorded investment. Historical loss allocations are calculated at the loan class and segment levels based on a migration analysis of the loan portfolio over the preceding three years. An unallocated component is maintained to cover uncertainties that management believes affect its 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.

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

|                                  | <b>Allowance for Loan Losses</b>         |               |                            |               |                 |                  |
|----------------------------------|--|---------------|----------------------------|---------------|-----------------|------------------|
|                                  | <b>Three Months Ended March 31, 2012</b> |               |                            |               |                 |                  |
|                                  | 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                | (449)                                    |               | (115)                      | (91)          |                 | (655)            |
| Recoveries                       | 86                                       |               | 41                         | 67            |                 | 194              |
| Provision for loan losses        | (193)                                    | (144)         | 796                        | 16            | (14)            | 461              |
| <b>March 31, 2012</b>            | <b>\$ 5,728</b>                          | <b>\$ 859</b> | <b>\$ 3,702</b>            | <b>\$ 625</b> | <b>\$ 1,461</b> | <b>\$ 12,375</b> |

|                                       | <b>Allowance for Loan Losses and Recorded Investment in Loans</b> |                  |                            |                  |                 |                   |
|---------------------------------------|---|------------------|----------------------------|------------------|-----------------|-------------------|
|                                       | <b>As of March 31, 2012</b>                                       |                  |                            |                  |                 |                   |
|                                       | Commercial  | Agricultural     | Residential<br>Real Estate | Consumer         | Unallocated     | Total             |
| <b>Allowance for loan losses</b>      |   |                  |                            |                  |                 |                   |
| Individually evaluated for impairment | \$ 2,232  | \$ 531           | \$ 1,287                   | \$               | \$              | \$ 4,050          |
| Collectively evaluated for impairment | 3,496   | 328              | 2,415                      | 625              | 1,461           | 8,325             |
| <b>Total</b>                          | <b>\$ 5,728</b>   | <b>\$ 859</b>    | <b>\$ 3,702</b>            | <b>\$ 625</b>    | <b>\$ 1,461</b> | <b>\$ 12,375</b>  |
| <b>Loans</b>                          |   |                  |                            |                  |                 |                   |
| Individually evaluated for impairment | \$ 17,350   | \$ 3,095         | \$ 8,214                   | \$ 95            |                 | \$ 28,754         |
| Collectively evaluated for impairment | 343,975   | 73,586           | 266,453                    | 30,364           |                 | 714,378           |
| <b>Total</b>                          | <b>\$ 361,325</b>   | <b>\$ 76,681</b> | <b>\$ 274,667</b>          | <b>\$ 30,459</b> |                 | <b>\$ 743,132</b> |

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|                                  | Allowance for Loan Losses         |               |                            |               |                 | Total            |
|----------------------------------|-----------------------------------|---------------|----------------------------|---------------|-----------------|------------------|
|                                  | Three Months Ended March 31, 2011 |               |                            |               |                 |                  |
|                                  | Commercial                        | Agricultural  | Residential<br>Real Estate | Consumer      | Unallocated     |                  |
| <b>Allowance for loan losses</b> |                                   |               |                            |               |                 |                  |
| January 1, 2011                  | \$ 6,048                          | \$ 1,033      | \$ 3,198                   | \$ 605        | \$ 1,489        | \$ 12,373        |
| Loans charged off                | (655)                             |               | (323)                      | (145)         |                 | (1,123)          |
| Recoveries                       | 137                               |               | 74                         | 103           |                 | 314              |
| Provision for loan losses        | 716                               | (257)         | 473                        | 59            | (174)           | 817              |
| <b>March 31, 2011</b>            | <b>\$ 6,246</b>                   | <b>\$ 776</b> | <b>\$ 3,422</b>            | <b>\$ 622</b> | <b>\$ 1,315</b> | <b>\$ 12,381</b> |

|                                       | Allowance for Loan Losses and Recorded Investment in Loans |                  |                            |                  |                 | Total             |
|---------------------------------------|--|------------------|----------------------------|------------------|-----------------|-------------------|
|                                       | As of December 31, 2011                                    |                  |                            |                  |                 |                   |
|                                       | Commercial   | Agricultural     | Residential<br>Real Estate | Consumer         | Unallocated     |                   |
| <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> |

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

| Rating                | March 31, 2012    |                     |                   |                  |                       |                  |
|-----------------------|-------------------|---------------------|-------------------|------------------|-----------------------|------------------|
|                       | Real Estate       | Commercial<br>Other | Total             | Real Estate      | Agricultural<br>Other | Total            |
| 2 - High quality      | \$ 9,938          | \$ 16,472           | \$ 26,410         | \$ 2,465         | \$ 1,739              | \$ 4,204         |
| 3 - High satisfactory | 95,563            | 26,385              | 121,948           | 14,972           | 5,569                 | 20,541           |
| 4 - Low satisfactory  | 114,175           | 53,308              | 167,483           | 24,918           | 17,678                | 42,596           |
| 5 - Special mention   | 15,318            | 2,136               | 17,454            | 1,763            | 1,200                 | 2,963            |
| 6 - Substandard       | 19,692            | 3,717               | 23,409            | 1,874            | 4,027                 | 5,901            |
| 7 - Vulnerable        | 1,802             | 101                 | 1,903             |                  |                       |                  |
| 8 - Doubtful          | 2,681             | 37                  | 2,718             | 190              | 286                   | 476              |
| <b>Total</b>          | <b>\$ 259,169</b> | <b>\$ 102,156</b>   | <b>\$ 361,325</b> | <b>\$ 46,182</b> | <b>\$ 30,499</b>      | <b>\$ 76,681</b> |

| Rating                | December 31, 2011 |                     |                   |                  |                       |                  |
|-----------------------|-------------------|---------------------|-------------------|------------------|-----------------------|------------------|
|                       | Real<br>Estate    | Commercial<br>Other | Total             | Real<br>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> |



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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.

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.

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.

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

|                                      | <b>March 31, 2012</b>              |                    |                 |  |                   |                   |       |
|--------------------------------------|------------------------------------|--------------------|-----------------|--|-------------------|-------------------|-------|
|                                      | Accruing Interest<br>and Past Due: |                    |                 | Total<br>Past Due<br>and<br>Nonaccrual |                   | Current           | Total |
|                                      | 30-89<br>Days                      | 90 Days<br>or More | Nonaccrual      | Nonaccrual                             |                   |                   |       |
| <b>Commercial</b>                    |                                    |                    |                 |  |                   |                   |       |
| Commercial real estate               | \$ 1,350                           | \$ 189             | \$ 4,661        | \$ 6,200                               | \$ 252,969        | \$ 259,169        |       |
| Commercial other                     | 448                                |                    | 101             | 549                                    | 101,607           | 102,156           |       |
| <b>Total commercial</b>              | <b>1,798</b>                       | <b>189</b>         | <b>4,762</b>    | <b>6,749</b>                           | <b>354,576</b>    | <b>361,325</b>    |       |
| <b>Agricultural</b>                  |                                    |                    |                 |  |                   |                   |       |
| Agricultural real estate             | 302                                | 99                 | 189             | 590                                    | 45,592            | 46,182            |       |
| Agricultural other                   | 186                                |                    | 286             | 472                                    | 30,027            | 30,499            |       |
| <b>Total agricultural</b>            | <b>488</b>                         | <b>99</b>          | <b>475</b>      | <b>1,062</b>                           | <b>75,619</b>     | <b>76,681</b>     |       |
| <b>Residential real estate</b>       |                                    |                    |                 |  |                   |                   |       |
| Senior liens                         | 2,538                              | 35                 | 1,130           | 3,703                                  | 212,442           | 216,145           |       |
| Junior liens                         | 103                                | 38                 | 85              | 226                                    | 19,557            | 19,783            |       |
| Home equity lines of credit          | 133                                |                    | 199             | 332                                    | 38,407            | 38,739            |       |
| <b>Total residential real estate</b> | <b>2,774</b>                       | <b>73</b>          | <b>1,414</b>    | <b>4,261</b>                           | <b>270,406</b>    | <b>274,667</b>    |       |
| <b>Consumer</b>                      |                                    |                    |                 |  |                   |                   |       |
| Secured                              | 76                                 |                    |                 | 76                                     | 25,345            | 25,421            |       |
| Unsecured                            | 22                                 |                    |                 | 22                                     | 5,016             | 5,038             |       |
| <b>Total consumer</b>                | <b>98</b>                          |                    |                 | <b>98</b>                              | <b>30,361</b>     | <b>30,459</b>     |       |
| <b>Total</b>                         | <b>\$ 5,158</b>                    | <b>\$ 361</b>      | <b>\$ 6,651</b> | <b>\$ 12,170</b>                       | <b>\$ 730,962</b> | <b>\$ 743,132</b> |       |

|                           | <b>December 31, 2011</b>           |                    |              |  |                |                |       |
|---------------------------|------------------------------------|--------------------|--------------|--|----------------|----------------|-------|
|                           | Accruing Interest<br>and Past Due: |                    |              | Total<br>Past Due<br>and<br>Nonaccrual |                | Current        | Total |
|                           | 30-89<br>Days                      | 90 Days<br>or More | Nonaccrual   | Nonaccrual                             |                |                |       |
| <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         |       |
| <b>Total agricultural</b> | <b>2</b>                           | <b>99</b>          | <b>604</b>   | <b>705</b>                             | <b>73,940</b>  | <b>74,645</b>  |       |

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|                                      |                 |               |                 |                  |                   |                   |
|--------------------------------------|-----------------|---------------|-----------------|------------------|-------------------|-------------------|
| Residential real estate              |                 |               |                 |                  |                   |                   |
| 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>    |
| Consumer                             |                 |               |                 |                  |                   |                   |
| 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:

|   | March 31, 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                                    | \$ 6,759               | \$ 6,969                       | \$ 1,941               | \$ 5,014               | \$ 5,142                       | \$ 1,881               |
| Commercial other  | 714                    | 714                            | 291                    | 734                    | 734                            | 271                    |
| Agricultural other  | 2,243                  | 2,243                          | 531                    | 2,689                  | 2,689                          | 822                    |
| Residential real estate senior liens                      | 7,830                  | 9,165                          | 1,253                  | 7,271                  | 8,827                          | 1,111                  |
| Residential real estate junior liens                      | 185                    | 251                            | 34                     | 195                    | 260                            | 35                     |
| <b>Total impaired loans with a valuation allowance</b>    | <b>\$ 17,731</b>       | <b>\$ 19,342</b>               | <b>\$ 4,050</b>        | <b>\$ 15,903</b>       | <b>\$ 17,652</b>               | <b>\$ 4,120</b>        |
| <b>Impaired loans without a valuation allowance</b>       |                        |                                |                        |                        |                                |                        |
| Commercial real estate                                    | \$ 7,632               | \$ 10,521                      |                        | \$ 7,984               | \$ 10,570                      |                        |
| Commercial other  | 2,245                  | 2,339                          |                        | 365                    | 460                            |                        |
| Agricultural real estate                                  | 190                    | 190                            |                        | 190                    | 190                            |                        |
| Agricultural other  | 662                    | 782                            |                        | 505                    | 625                            |                        |
| Home equity lines of credit                               | 199                    | 499                            |                        | 198                    | 498                            |                        |
| Consumer secured  | 95                     | 104                            |                        | 105                    | 114                            |                        |
| <b>Total impaired loans without a valuation allowance</b> | <b>\$ 11,023</b>       | <b>\$ 14,435</b>               |                        | <b>\$ 9,347</b>        | <b>\$ 12,457</b>               |                        |
| <b>Impaired loans</b>                                     |                        |                                |                        |                        |                                |                        |
| Commercial  | \$ 17,350              | \$ 20,543                      | \$ 2,232               | \$ 14,097              | \$ 16,906                      | \$ 2,152               |
| Agricultural  | 3,095                  | 3,215                          | 531                    | 3,384                  | 3,504                          | 822                    |
| Residential real estate                                   | 8,214                  | 9,915                          | 1,287                  | 7,664                  | 9,585                          | 1,146                  |
| Consumer  | 95                     | 104                            |                        | 105                    | 114                            |                        |
| <b>Total impaired loans</b>                               | <b>\$ 28,754</b>       | <b>\$ 33,777</b>               | <b>\$ 4,050</b>        | <b>\$ 25,250</b>       | <b>\$ 30,109</b>               | <b>\$ 4,120</b>        |



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|   | Three Months Ended                |                                  |                                   |                                  |
|---|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|   | March 31, 2012                    |                                  | March 31, 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                                    | \$ 5,887                          | \$ 98                            | \$ 2,091                          | \$ 24                            |
| Commercial other  | 724                               | 12                               | 9                                 |                                  |
| Agricultural other  | 2,466                             | 37                               | 2,196                             | 33                               |
| Residential real estate senior liens                      | 7,550                             | 83                               | 4,427                             | 36                               |
| Residential real estate junior liens                      | 190                               | 2                                | 170                               | 1                                |
| <b>Total impaired loans with a valuation allowance</b>    | <b>\$ 16,817</b>                  | <b>\$ 232</b>                    | <b>\$ 8,893</b>                   | <b>\$ 94</b>                     |
| <b>Impaired loans without a valuation allowance</b>       |                                   |                                  |                                   |                                  |
| Commercial real estate                                    | \$ 7,808                          | \$ 67                            | \$ 2,676                          | \$ 33                            |
| Commercial other  | 1,305                             | 31                               | 981                               | 60                               |
| Agricultural real estate                                  | 190                               |                                  | 95                                |                                  |
| Agricultural other  | 584                               | 4                                |                                   |                                  |
| Residential real estate senior liens                      | 1                                 |                                  | 537                               | 6                                |
| Home equity lines of credit                               | 199                               | 4                                | 1                                 |                                  |
| Consumer secured  | 100                               | 2                                | 47                                | 2                                |
| <b>Total impaired loans without a valuation allowance</b> | <b>\$ 10,187</b>                  | <b>\$ 108</b>                    | <b>\$ 4,337</b>                   | <b>\$ 101</b>                    |
| <b>Impaired loans</b>                                     |                                   |                                  |                                   |                                  |
| Commercial  | \$ 15,724                         | \$ 208                           | \$ 5,757                          | \$ 117                           |
| Agricultural  | 3,240                             | 41                               | 2,291                             | 33                               |
| Residential real estate                                   | 7,940                             | 89                               | 5,135                             | 43                               |
| Consumer  | 100                               | 2                                | 47                                | 2                                |
| <b>Total impaired loans</b>                               | <b>\$ 27,004</b>                  | <b>\$ 340</b>                    | <b>\$ 13,230</b>                  | <b>\$ 195</b>                    |

The Corporation had pledged to advance \$359 in connection with impaired loans, which include TDR s, as of March 31, 2012.

**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, the Corporation considers if:

1. The borrower is currently in default on any of their debt.
2. It is likely that the borrower would default on any of their debt if the concession was not granted.
3. The borrower s cash flow was sufficient to service all of their debt if the concession was 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 month period ended March 31, 2012:

|                                      | Number<br>of<br>Loans | Pre-<br>Modification<br>Recorded<br>Investment | Post-<br>Modification<br>Recorded<br>Investment |
|--------------------------------------|-----------------------|--|---|
| Commercial other                     | 21                    | \$ 4,586                                       | \$ 4,586  |
| Agricultural other                   | 6                     | 561  | 561   |
| Residential real estate senior liens | 5                     | 721  | 721   |
| <b>Total</b>                         | <b>32</b>             | <b>\$ 5,868</b>                                | <b>\$ 5,868</b>                                 |

The following tables summarize concessions granted by the Corporation to borrowers in financial difficulties in the three month period ended March 31, 2012:

|                                      | Below Market Interest Rate |                                      | Below Market Interest Rate and Extension of Amortization Period |                                      |
|--------------------------------------|----------------------------|--------------------------------------|---|--------------------------------------|
|                                      | Number of Loans            | Pre-Modification Recorded Investment | Number of Loans   | Pre-Modification Recorded Investment |
| Commercial other                     | 21                         | \$ 4,586                             |   | \$                                   |
| Agricultural other                   | 6                          | 561                                  |   |                                      |
| Residential real estate senior liens |                            |                                      | 5   | 721                                  |
| <b>Total</b>                         | <b>27</b>                  | <b>\$ 5,147</b>                      | <b>5</b>  | <b>\$ 721</b>                        |

The Corporation did not restructure any loans through the forbearance of principal or accrued interest in the three month period ended March 31, 2012.

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Based on the Corporation's historical loss experience, losses associated with TDRs are not significantly different than other impaired loans within the same loan segment. As such, TDRs, including TDRs 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.

The following is a summary of loans that defaulted in the first three months of 2012, which were modified within 12 months prior to the default date.

|                                      | Number<br>of<br>Loans | Pre-<br>Default<br>Recorded<br>Investment | Charge Off<br>Recorded<br>Upon<br>Default | Post-<br>Default<br>Recorded<br>Investment |
|--------------------------------------|-----------------------|---|---|--|
| Commercial other                     | 1                     | \$ 82                                     | \$ 42                                     | \$ 40                                      |
| Residential real estate senior liens | 1                     | 47  | 43  | 4  |
| <b>Total</b>                         | <b>2</b>              | <b>\$ 129</b>                             | <b>\$ 85</b>                              | <b>\$ 44</b>                               |

The Corporation had no loans that defaulted during the first three 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:

|                              | March 31<br>2012 | December 31<br>2011 |
|------------------------------|------------------|---------------------|
| Troubled debt restructurings | \$ 23,102        | \$ 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:

|  | March 31<br>2012 | December 31<br>2011 |
|--|------------------|---------------------|
| Federal Home Loan Bank Stock                 | \$ 7,380         | \$ 7,380            |
| Investment in Corporate Settlement Solutions | 6,642            | 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>\$ 17,220</b> | <b>\$ 17,189</b>    |

**NOTE 8 BORROWED FUNDS**

Borrowed funds consist of the following obligations as of:

| March 31, 2012 |      | December 31, 2011 |      |
|----------------|------|-------------------|------|
| Amount         | Rate | Amount            | Rate |

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|  |                   |              |                   |              |
|--|-------------------|--------------|-------------------|--------------|
| Federal Home Loan Bank advances  | \$ 142,000        | 2.61%        | \$ 142,242        | 3.16%        |
| Securities sold under agreements to repurchase without stated maturity dates | 55,791            | 0.20%        | 57,198            | 0.25%        |
| Securities sold under agreements to repurchase with stated maturity dates    | 16,702            | 3.51%        | 16,696            | 3.51%        |
| <b>Total</b>   | <b>\$ 214,493</b> | <b>2.05%</b> | <b>\$ 216,136</b> | <b>2.42%</b> |

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The Federal Home Loan Bank (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 owned by the Corporation. The Corporation had the ability to borrow up to an additional \$121,701 based on assets currently pledged as collateral as of March 31, 2012. During the first quarter of 2012, management reduced funding costs by modifying the terms of \$60,000 of FHLB advances.

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

|                                    | March 31<br>2012  |              | December 31<br>2011 |              |
|------------------------------------|-------------------|--------------|---------------------|--------------|
|                                    | Amount            | Rate         | Amount              | Rate         |
| Fixed rate advances due 2012       | \$ 7,000          | 4.31%        | \$ 17,000           | 2.97%        |
| One year putable advances due 2012 | 15,000            | 4.10%        | 15,000              | 4.10%        |
| Fixed rate advances due 2013       |                   |              | 5,242               | 4.14%        |
| One year putable advances due 2013 |                   |              | 5,000               | 3.15%        |
| Fixed rate advances due 2014       |                   |              | 25,000              | 3.16%        |
| Fixed rate advances due 2015       | 30,000            | 1.32%        | 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%        |                     |              |
| <b>Total</b>                       | <b>\$ 142,000</b> | <b>2.61%</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 \$108,202 and \$99,869 at March 31, 2012 and December 31, 2011, respectively. Such securities remain under the control of the Corporation. The Corporation 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 month periods ended March 31:

|  | 2012                            |  |   | 2011                            |  |   |
|--|---------------------------------|--|---|---------------------------------|--|---|
|  | Maximum<br>Month-End<br>Balance | Quarter<br>to Date<br>Average<br>Balance | Weighted Average<br>Interest Rate<br>During the<br>Period | Maximum<br>Month-End<br>Balance | Quarter<br>to Date<br>Average<br>Balance | Weighted Average<br>Interest Rate<br>During the<br>Period |
| Securities sold under agreements to repurchase without stated maturity dates | \$ 56,923                       | \$ 56,172                                | 0.23%   | \$ 41,406                       | \$ 41,036                                | 0.25%   |
| Federal funds purchased  |                                 | 71                                       | 0.48%   | 3,600                           | 1,206                                    | 0.50%   |



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The Corporation 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:

|   | March 31<br>2012  | December 31<br>2011 |
|---|-------------------|---------------------|
| Pledged to secure borrowed funds  | \$ 322,370        | \$ 292,092          |
| Pledged to secure repurchase agreements   | 108,202           | 99,869              |
| Pledged for public deposits and for other purposes necessary or required by law | 25,302            | 26,761              |
| <b>Total</b>  | <b>\$ 455,874</b> | <b>\$ 418,722</b>   |

The Corporation 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 month periods ended March 31:

|                                   | 2012            | 2011            |
|-----------------------------------|-----------------|-----------------|
| Marketing and community relations | 494             | 223             |
| FDIC insurance premiums           | 215             | 334             |
| Directors fees                    | 210             | 211             |
| Audit and SOX compliance fees     | 176             | 156             |
| Education and travel              | 127             | 105             |
| Consulting fees                   | 187             | 33              |
| Printing and supplies             | 109             | 100             |
| Postage and freight               | 101             | 100             |
| Foreclosed asset and collection   | 97              | 100             |
| Amortization of deposit premium   | 66              | 76              |
| Legal fees                        | 62              | 62              |
| All other                         | 415             | 330             |
| <b>Total</b>                      | <b>\$ 2,259</b> | <b>\$ 1,830</b> |

**NOTE 10 FEDERAL INCOME TAXES**

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 month periods ended March 31:

|   | 2012     | 2011   |
|---|----------|--------|
| Income taxes at 34% statutory rate            | \$ 1,362 | \$ 928 |
| Effect of nontaxable income                   |          |        |
| Interest income on tax exempt municipal bonds | (391)    | (383)  |
| Earnings on corporate owned life insurance    | (58)     | (48)   |
| Other   | (151)    | (94)   |
| Total effect of nontaxable income             | (600)    | (525)  |
| Effect of nondeductible expenses              | 11       | 10     |

|                                   |               |               |
|-----------------------------------|---------------|---------------|
| <b>Federal income tax expense</b> | <b>\$ 773</b> | <b>\$ 413</b> |
|-----------------------------------|---------------|---------------|

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Included in other comprehensive income for the three month periods ended March 31, 2012 and 2011 are changes in unrealized holding gains, related to auction rate money market preferreds 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 other comprehensive income (loss) follows for the three month periods ended March 31:

|   | 2012   |   |                 |
|---|--|---|-----------------|
|   | Auction<br>Rate<br>Money Market<br>Preferreds<br>and<br>Preferred Stocks | All Other<br>Available-for-Sale<br>Securities | Total           |
| Unrealized gains (losses) arising during the period                       | \$ 1,604   | \$ (805)                                      | \$ 799          |
| Reclassification adjustment for net realized gains included in net income |  | (1,003)                                       | (1,003)         |
| Reclassification adjustment for impairment loss included in net income    |  | 282   | 282             |
| Net unrealized gains (losses)   | 1,604  | (1,526)                                       | 78              |
| Tax effect  |  | 519   | 519             |
| <b>Other comprehensive income (loss), net of tax</b>                      | <b>\$ 1,604</b>  | <b>\$ (1,007)</b>                             | <b>\$ 597</b>   |
|   | 2011   |   |                 |
|   | Auction<br>Rate<br>Money Market<br>Preferreds<br>and<br>Preferred Stocks | All Other<br>Available-for-Sale<br>Securities | Total           |
| Unrealized gains arising during the period                                | \$ 595   | \$ 1,158                                      | \$ 1,753        |
| Reclassification adjustment for net realized gains included in net income |  |   |                 |
| Reclassification adjustment for impairment loss included in net income    |  |   |                 |
| Net unrealized gains  | 595  | 1,158   | 1,753           |
| Tax effect  |  | (395)   | (395)           |
| <b>Other comprehensive income, net of tax</b>                             | <b>\$ 595</b>  | <b>\$ 763</b>                                 | <b>\$ 1,358</b> |

**Table of Contents****NOTE 11 DEFINED BENEFIT PENSION PLAN**

The Corporation has 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. The Corporation made a \$135 contribution to the pension plan during the three month period ended March 31, 2012 and made no contributions to the plan in the three month period ended March 31, 2011. The Corporation does not anticipate any further contributions during 2012.

Following are the components of net periodic benefit cost for the three month period ended March 31:

|   | 2012         | 2011         |
|---|--------------|--------------|
| Interest cost on projected benefit obligation   | \$ 118       | \$ 127       |
| Expected return on plan assets                  | (127)        | (131)        |
| Amortization of unrecognized actuarial net loss | 73           | 38           |
| <b>Net periodic benefit cost</b>                | <b>\$ 64</b> | <b>\$ 34</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, the Corporation classifies 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, the Corporation classifies 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 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. Level 2 securities include bonds issued by government sponsored enterprises, states and political subdivisions, mortgage-backed securities, collateralized mortgage obligations issued by government sponsored enterprises, and auction rate money market preferred securities. The values for Level 1 and Level 2 investment securities are generally obtained from an independent third party. On a quarterly basis, management compares the values provided to alternative pricing sources.

Due to the limited trading activity of certain auction rate money market preferred securities and preferred stocks the Corporation measured these securities using Level 3 inputs as of March 31, 2011. As the markets for these securities normalized and established regular trading patterns, the Corporation measured preferred stocks with fair values of \$5,033 utilizing Level 1 inputs and auction rate money market preferred securities with fair values of \$2,049 utilizing Level 2 inputs as of December 31, 2011 and continued to measure at these levels as of March 31, 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 ended March 31, 2011:

|   |                 |
|---|-----------------|
| Level 3 inputs - January 1  | \$ 2,865        |
| Net unrealized losses on available-for-sale investment securities | (62)            |
| <b>Level 3 inputs - March 31</b>                                  | <b>\$ 2,803</b> |



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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 ended March 31, 2011:

|  |                 |
|--|-----------------|
| <b>Level 3 inputs - January 1</b>                                | <b>\$ 6,936</b> |
| Net unrealized gains on available-for-sale investment securities | 657             |
| <b>Level 3 inputs - March 31</b>                                 | <b>\$ 7,593</b> |

*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, the Corporation classifies 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.

The Corporation does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered 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, management measures 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.

The Corporation reviews 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 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. The Corporation uses these valuations to determine if any charge offs or specific reserves are necessary. The Corporation 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, the Corporation records the loan as nonrecurring Level 2. When a current appraised value is not available or management determines the fair value of collateral is further impaired below the appraised value, the Corporation records the impaired loans as nonrecurring Level 3.

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The table below lists the quantitative information about impaired loans measured utilizing Level 3 fair value measurements as of March 31, 2012:

| Valuation Techniques              | Fair Value | Unobservable Input          | Range     |
|-----------------------------------|------------|-----------------------------|-----------|
| <b>Discounted cash flow</b>       | \$ 6,726   | Duration of cash flows      | 10 years  |
|                                   |            | Reduction in interest rate  |           |
|                                   |            | from original loan terms    | 3.00%     |
|                                   |            | Discount applied to         |           |
|                                   |            | collateral appraisal:       |           |
|                                   |            | Real Estate                 | 20% - 30% |
|                                   |            | Equipment                   | 50%       |
| <b>Discounted appraisal value</b> | \$ 17,978  | Livestock                   | 50%       |
|                                   |            | Cash crop inventory         | 50%       |
|                                   |            | Other inventory             | 75%       |
|                                   |            | Accounts receivable         | 75%       |
|                                   |            | Estimated liquidation costs | 10%       |

*Accrued interest:* The carrying amounts of accrued interest approximate fair value. As such, the Corporation classifies 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, management performs 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 management 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, the Corporation 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:* The Corporation has 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. The Corporation classifies nonmarketable equity securities and its 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, the Corporation classifies foreclosed assets as a nonrecurring Level 2. When management determines that the net realizable value of the collateral is further impaired below the appraised value but there is no observable market price, the Corporation records the foreclosed asset as nonrecurring Level 3.

*Originated mortgage servicing rights:* Originated mortgage servicing rights are 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, the Corporation classifies loan servicing rights subject to nonrecurring fair value adjustments as Level 2.

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*Deposits:* 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 the Corporation's other borrowed funds are estimated using discounted cash flow analyses based on the Corporation's current incremental borrowing arrangements.

The Corporation 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 the Corporation's 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, the Corporation classifies other borrowed funds as Level 2.

The activity in borrowings which the Corporation has elected to carry at fair value was as follows for the three months ended March 31:

|  | 2012      | 2011             |
|--|-----------|------------------|
| Borrowings carried at fair value - beginning of year | \$ 5,242  | \$ 10,423        |
| Paydowns and maturities                              | (5,209)   |                  |
| Net unrealized change in fair value                  | (33)      | (80)             |
| <b>Borrowings carried at fair value - March 31</b>   | <b>\$</b> | <b>\$ 10,343</b> |
| <b>Unpaid principal balance - March 31</b>           | <b>\$</b> | <b>\$ 10,000</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. The Corporation does not charge fees for lending commitments; thus 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 the Corporation believes its 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.



**Table of Contents****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, the Corporation uses present value techniques and other valuation methods to estimate the fair values of its 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.

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

|  | Carrying<br>Value | Estimated<br>Fair Value | March 31, 2012 |           |           |
|--|-------------------|-------------------------|----------------|-----------|-----------|
|  |                   |                         | (Level 1)      | (Level 2) | (Level 3) |
| <b>ASSETS</b>  |                   |                         |                |           |           |
| Cash and demand deposits due from banks                        | \$ 21,744         | \$ 21,744               | \$ 21,744      | \$        | \$        |
| Certificates of deposit held in other financial institutions   | 6,640             | 6,674                   |                | 6,674     |           |
| Mortgage loans available-for-sale                              | 3,396             | 3,396                   |                | 3,396     |           |
| Total loans  | 743,132           | 757,635                 |                | 728,881   | 28,754    |
| Less allowance for loan losses                                 | (12,375)          | (12,375)                |                | (8,325)   | (4,050)   |
| Net loans  | 730,757           | 745,260                 |                | 720,556   | 24,704    |
| Accrued interest receivable                                    | 6,044             | 6,044                   | 6,044          |           |           |
| Equity securities without readily determinable fair values (1) | 17,220            | 17,220                  |                |           |           |
| Originated mortgage servicing rights                           | 2,438             | 2,438                   |                | 2,438     |           |
| <b>LIABILITIES</b>   |                   |                         |                |           |           |
| Deposits without stated maturities                             | 510,561           | 510,561                 | 510,561        |           |           |
| Deposits with stated maturities                                | 478,565           | 491,910                 |                | 491,910   |           |
| Borrowed funds   | 214,493           | 220,395                 |                | 220,395   |           |
| Accrued interest payable                                       | 887               | 887                     | 887            |           |           |

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

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

**Financial Instruments Recorded at Fair Value**

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

| Description  | March 31, 2012 |           |            |           | December 31, 2011 |           |            |           |
|--|----------------|-----------|------------|-----------|-------------------|-----------|------------|-----------|
|  | Total          | (Level 1) | (Level 2)  | (Level 3) | Total             | (Level 1) | (Level 2)  | (Level 3) |
| <b>Recurring items</b>                                   |                |           |            |           |                   |           |            |           |
| Trading securities                                       |                |           |            |           |                   |           |            |           |
| States and political subdivisions                        | \$ 4,403       | \$        | \$ 4,403   | \$        | \$ 4,710          | \$        | \$ 4,710   | \$        |
| Available-for-sale investment securities                 |                |           |            |           |                   |           |            |           |
| Government sponsored enterprises                         | 2,474          |           | 2,474      |           | 397               |           | 397        |           |
| States and political subdivisions                        | 176,886        |           | 176,886    |           | 174,938           |           | 174,938    |           |
| Auction rate money market preferred                      | 2,621          |           | 2,621      |           | 2,049             |           | 2,049      |           |
| Preferred stocks   | 6,065          | 6,065     |            |           | 5,033             | 5,033     |            |           |
| Mortgage-backed securities                               | 156,439        |           | 156,439    |           | 143,602           |           | 143,602    |           |
| Collateralized mortgage obligations                      | 127,170        |           | 127,170    |           | 99,101            |           | 99,101     |           |
| Total available-for-sale investment securities           | 471,655        | 6,065     | 465,590    |           | 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)    | 24,704         |           |            | 24,704    | 21,130            |           |            | 21,130    |
| Originated mortgage servicing rights                     | 2,438          |           | 2,438      |           | 2,374             |           | 2,374      |           |
| Foreclosed assets  | 1,719          |           | 1,719      |           | 1,876             |           | 1,876      |           |
|  | \$ 504,919     | \$ 6,065  | \$ 474,150 | \$ 24,704 | \$ 460,452        | \$ 5,033  | \$ 434,289 | \$ 21,130 |
| Percent of assets and liabilities measured at fair value |                | 1.20%     | 93.91%     | 4.89%     |                   | 1.09%     | 94.32%     | 4.59%     |

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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 month periods ended March 31, 2012 and 2011, are summarized as follows:

| Description                          | Trading<br>Losses | 2012<br>Other<br>Gains<br>and (Losses) | Total        | Trading<br>Losses | 2011<br>Other<br>Gains<br>and (Losses) | Total        |
|--------------------------------------|-------------------|--|--------------|-------------------|--|--------------|
| <b>Recurring items</b>               |                   |  |              |                   |  |              |
| Trading securities                   | \$ (16)           | \$                                     | \$ (16)      | \$ (19)           | \$                                     | \$ (19)      |
| Borrowed funds                       |                   | 33                                     | 33           |                   | 80                                     | 80           |
| <b>Nonrecurring items</b>            |                   |  |              |                   |  |              |
| Foreclosed assets                    |                   | (17)                                   | (17)         |                   | (10)                                   | (10)         |
| Originated mortgage servicing rights |                   | 74                                     | 74           |                   | 7                                      | 7            |
| <b>Total</b>                         | <b>\$ (16)</b>    | <b>\$ 90</b>                           | <b>\$ 74</b> | <b>\$ (19)</b>    | <b>\$ 77</b>                           | <b>\$ 58</b> |

**NOTE 13 OPERATING SEGMENTS**

The Corporation's reportable segments are based on legal entities that account for at least 10% of net operating results. Retail banking operations as of March 31, 2012 and 2011 and each of the three month periods then ended, represented 90% or more of the Corporation's 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)

The following is management's discussion and analysis of the financial condition and results of operations for Isabella Bank Corporation. This discussion and analysis is intended to provide a better understanding of the unaudited interim condensed consolidated financial statements and statistical data included elsewhere in this Form 10-Q. This analysis should be read in conjunction with the Corporation's 2011 annual report and with the unaudited interim condensed consolidated financial statements and notes, beginning on page 3 of this report.

**Executive Summary**

Isabella Bank Corporation, as well as other financial institutions in Michigan and across the entire country, continues to be challenged with a persistently weak economy. This economic environment has been defined by historically low interest rates compounded by high levels of loans charged off and foreclosed asset and collection expenses. While specific sectors have shown signs of improvement, sustained overall economic recovery continues to be elusive. Despite the current economic environment, the Corporation continues to grow and remains profitable. The Corporation's success is a result of a continued emphasis on prudent lending standards and consistent long term growth rather than short term gains. These values have enabled the Corporation to continue to meet the needs of the communities it serves which translates in increased shareholder value.

**Recent Legislation**

The Health Care and Education Act of 2010 and the Patient Protection and Affordable Care Act could have a significant impact on the Corporation's operating results in future periods. Aside from the potential increases in the Corporation's health care costs, the implementation of the new rules and requirements is likely to require a substantial commitment from the Corporation's management.

In 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). The Dodd-Frank Act made sweeping changes in the regulation of financial institutions aimed at strengthening the sound operation of the financial services sector. Many of the provisions in the Dodd-Frank Act will not become effective until future years.

Uncertainty remains as to the ultimate impact of the Dodd-Frank Act on the financial services industry as a whole and on the Corporation. In particular, many provisions of the Dodd-Frank Act are subject to rulemaking, which make it difficult to predict the impact of the Dodd-Frank Act on the Corporation, its customers and the financial services industry as a whole. While the overall effects of the Dodd-Frank Act remains unclear, management anticipates that it will be substantial. The Corporation has already begun to experience increased compensation costs as a result of staff additions necessary to comply with the new regulations.

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**CRITICAL ACCOUNTING POLICIES**

A summary of the Corporation's significant accounting policies is set forth in Note 1 of the Consolidated Financial Statements included in the Corporation's Annual Report for the year ended December 31, 2011. Of these significant accounting policies, the Corporation considers its policies regarding the allowance for loan losses, acquisition intangibles, and the determination of the fair value and assessment of other-than-temporary impairment of investment securities to be its most critical accounting policies.

The allowance for loan losses requires management's most subjective and complex judgment. Changes in economic conditions can have a significant impact on the allowance for loan losses and, therefore, the provision for loan losses and results of operations. The Corporation has developed appropriate policies and procedures for assessing the appropriateness of the allowance for loan losses, recognizing that this process requires a number of assumptions and estimates with respect to its loan portfolio. The Corporation's assessments may be impacted in future periods by changes in economic conditions, and the discovery of information with respect to borrowers which is not known to management at the time of the issuance of the consolidated financial statements. For additional discussion concerning the Corporation's allowance for loan losses and related matters, see the detailed discussion to follow under the heading Allowance for Loan Losses .

United States generally accepted accounting principles require that the Corporation determine the fair value of the assets and liabilities of an acquired entity, and record their fair value on the date of acquisition. The Corporation employs a variety of measures in the determination of the fair value, including the use of discounted cash flow analysis, market appraisals, and projected future revenue streams. For certain items that management believes it has the appropriate expertise to determine the fair value, management may choose to use its own calculations of the value. In other cases, where the value is not easily determined, the Corporation consults with outside parties to determine the fair value of the identified asset or liability. Once valuations have been adjusted, the net difference between the price paid for the acquired entity and the value of its balance sheet, including identifiable intangibles, is recorded as goodwill. This goodwill is not amortized, but is evaluated for impairment on at least an annual basis.

The Corporation currently has both available-for-sale and trading investment securities that are carried at fair value. Changes in the fair value of available-for-sale investment securities are included as a component of other comprehensive income, while declines in the fair value of these securities below their cost that are other-than-temporary are reflected as realized losses in the consolidated statements of income. The change in value of trading investment securities is included in current earnings. Management evaluates available-for-sale securities for indications of losses that are considered other-than-temporary, if any, on a regular basis. The market values for available-for-sale and trading investment securities are typically obtained from outside sources and applied to individual securities within the portfolio.

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

The following table outlines the results of operations and provides certain performance measures for the three month periods ended March 31, 2012 and 2011.

|  | 2012      | 2011      |
|--|-----------|-----------|
| <b>INCOME STATEMENT DATA</b>                       |           |           |
| Net interest income                                | \$ 10,500 | \$ 10,185 |
| Provision for loan losses                          | 461       | 817       |
| Net income   | 3,234     | 2,316     |
| <b>PER SHARE DATA</b>                              |           |           |
| Earnings per share                                 |           |           |
| Basic  | \$ 0.43   | \$ 0.31   |
| Diluted  | 0.41      | 0.30      |
| Cash dividends per common share                    | 0.20      | 0.19      |
| Book value (at end of period)                      | 20.70     | 19.52     |
| <b>RATIOS</b>                                      |           |           |
| Average primary capital to average assets          | 12.33%    | 12.63%    |
| Net income to average assets (annualized)          | 0.95      | 0.74      |
| Net income to average equity (annualized)          | 8.29      | 6.34      |
| Net income to average tangible equity (annualized) | 12.19     | 9.56      |

**Net Interest Income**

Net interest income is the primary source of income for the Corporation. Interest income includes loan fees of \$647 and \$566 for the three month periods ended March 31, 2012 and 2011, respectively. For analytical purposes, net interest income is adjusted to a fully taxable equivalent (FTE) basis by adding the income tax savings from interest on tax exempt loans and securities, thus making year to year comparisons more meaningful.

**Table of Contents****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. Federal Reserve Bank and Federal Home Loan Bank restricted equity holdings are included in accrued income and other assets.

The following table displays the results for the three month periods ended March 31:

|   | 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   | \$ 743,921          | \$ 10,940                             | 5.88%                      | \$ 734,630          | \$ 11,361                             | 6.19%                      |
| Taxable investment securities                     | 285,140             | 1,889                                 | 2.65%                      | 201,508             | 1,513                                 | 3.00%                      |
| Nontaxable investment securities                  | 138,628             | 1,965                                 | 5.67%                      | 134,514             | 1,927                                 | 5.73%                      |
| Trading account securities                        | 4,417               | 64                                    | 5.80%                      | 5,527               | 77                                    | 5.57%                      |
| Other   | 48,579              | 129                                   | 1.06%                      | 43,279              | 134                                   | 1.24%                      |
| <b>Total earning assets</b>                       | <b>1,220,685</b>    | <b>14,987</b>                         | <b>4.91%</b>               | <b>1,119,458</b>    | <b>15,012</b>                         | <b>5.36%</b>               |
| <b>NONEARNING ASSETS</b>                          |                     |                                       |                            |                     |                                       |                            |
| Allowance for loan losses                         | 12,608              |                                       |                            | (12,585)            |                                       |                            |
| Cash and demand deposits due from banks           | 20,313              |                                       |                            | 20,512              |                                       |                            |
| Premises and equipment                            | 25,000              |                                       |                            | 24,510              |                                       |                            |
| Accrued income and other assets                   | 102,716             |                                       |                            | 92,607              |                                       |                            |
| <b>Total assets</b>                               | <b>\$ 1,381,322</b> |                                       |                            | <b>\$ 1,244,502</b> |                                       |                            |
| <b>INTEREST BEARING LIABILITIES</b>               |                     |                                       |                            |                     |                                       |                            |
| Interest bearing demand deposits                  | \$ 172,906          | 54                                    | 0.12%                      | \$ 151,228          | 46                                    | 0.12%                      |
| Savings deposits                                  | 207,221             | 122                                   | 0.24%                      | 190,147             | 124                                   | 0.26%                      |
| Time deposits                                     | 479,689             | 2,336                                 | 1.95%                      | 457,374             | 2,615                                 | 2.29%                      |
| Borrowed funds                                    | 211,412             | 1,192                                 | 2.26%                      | 182,943             | 1,268                                 | 2.77%                      |
| <b>Total interest bearing liabilities</b>         | <b>1,071,228</b>    | <b>3,704</b>                          | <b>1.38%</b>               | <b>981,692</b>      | <b>4,053</b>                          | <b>1.65%</b>               |
| <b>NONINTEREST BEARING LIABILITIES</b>            |                     |                                       |                            |                     |                                       |                            |
| Demand deposits                                   | 118,898             |                                       |                            | 107,402             |                                       |                            |
| Other   | 9,859               |                                       |                            | 9,260               |                                       |                            |
| Shareholders' equity                              | 156,121             |                                       |                            | 146,148             |                                       |                            |
| <b>Total liabilities and shareholders' equity</b> | <b>\$ 1,356,106</b> |                                       |                            | <b>\$ 1,244,502</b> |                                       |                            |
| <b>Net interest income (FTE)</b>                  |                     | <b>\$ 11,283</b>                      |                            |                     | <b>\$ 10,959</b>                      |                            |
| <b>Net yield on interest earning assets (FTE)</b> |                     |                                       | <b>3.70%</b>               |                     |                                       | <b>3.92%</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>March 31, 2012 Compared to<br>March 31, 2011<br>Increase (Decrease) Due to: |                 |               |
|--|---|-----------------|---------------|
|  | Volume  | Rate            | Net           |
| <b>CHANGES IN INTEREST INCOME</b>          |   |                 |               |
| Loans                                      | \$ 142  | \$ (563)        | \$ (421)      |
| Taxable investment securities              | 570   | (194)           | 376           |
| Nontaxable investment securities           | 58  | (20)            | 38            |
| Trading account securities                 | (16)  | 3               | (13)          |
| Other                                      | 15  | (20)            | (5)           |
| Total changes in interest income           | 769   | (794)           | (25)          |
| <b>CHANGES IN INTEREST EXPENSE</b>         |   |                 |               |
| Interest bearing demand deposits           | 7   | 1               | 8             |
| Savings deposits                           | 11  | (13)            | (2)           |
| Time deposits                              | 123   | (402)           | (279)         |
| Borrowed funds                             | 181   | (257)           | (76)          |
| Total changes in interest expense          | 322   | (671)           | (349)         |
| <b>Net change in interest margin (FTE)</b> | <b>\$ 447</b>   | <b>\$ (123)</b> | <b>\$ 324</b> |

Historically low interest rates continue to compress the Corporation's net interest margin yield. To offset the impact of the current interest rate margin compression, management has continued to grow net interest income through volume. This strategy has led to increases in net interest income at the cost of accelerating the reduction in net interest margin yield. Management has also reduced funding costs by restructuring \$60,000 of Federal Home Loan Bank advances. This modification strategy will reduce interest expense by approximately \$450 for 2012.

Despite these efforts, management anticipates that net interest margin yield will decline during the remainder of 2012 due to the following factors:

Based on the current economic conditions, management does not anticipate significant changes in interest rates during 2012. However, the declines in interest rates on earning assets will likely decline faster than rates paid on interest bearing liabilities.

Deposit growth continues to be strong, while loan demand continues to be soft. As deposit accounts are expected to continue to grow throughout the year, loans are not likely to keep pace, thus forcing the Corporation to invest these funds in investment securities, which earn significantly lower rates than loans.





**Table of Contents****Allowance for Loan Losses (ALLL)**

The viability of any financial institution is ultimately determined by its management of credit risk. Loans outstanding represent the Corporation's single largest concentration of risk. The ALLL is management's estimation of probable losses inherent in the existing loan portfolio. The Corporation allocates the ALLL throughout its loan portfolio based on management's assessment of the underlying risks associated with each loan segment. Management's 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 Corporation's loan portfolio.

The following table summarizes the Corporation's charge off and recovery activity for the three month periods ended March 31:

|   | 2012              | 2011              | Variance        |
|---|-------------------|-------------------|-----------------|
| Allowance for loan losses - January 1                     | \$ 12,375         | \$ 12,373         | \$ 2            |
| Loans charged off   |                   |                   |                 |
| Commercial and agricultural                               | 449               | 655               | (206)           |
| Residential real estate                                   | 115               | 323               | (208)           |
| Consumer  | 91                | 145               | (54)            |
| <b>Total loans charged off</b>                            | <b>655</b>        | <b>1,123</b>      | <b>(468)</b>    |
| Recoveries  |                   |                   |                 |
| Commercial and agricultural                               | 86                | 137               | (51)            |
| Residential real estate                                   | 41                | 74                | (33)            |
| Consumer  | 67                | 103               | (36)            |
| <b>Total recoveries</b>                                   | <b>194</b>        | <b>314</b>        | <b>(120)</b>    |
| Provision for loan losses                                 | 461               | 817               | (356)           |
| <b>Allowance for loan losses - March 31</b>               | <b>\$ 12,375</b>  | <b>\$ 12,381</b>  | <b>\$ (6)</b>   |
| Net loans charged off                                     | \$ 461            | \$ 809            | \$ (348)        |
| Year to date average loans outstanding                    | 743,921           | 734,630           | 9,291           |
| <b>Net loans charged off to average loans outstanding</b> | <b>0.06%</b>      | <b>0.11%</b>      | <b>-0.05%</b>   |
| <b>Total amount of loans outstanding - March 31</b>       | <b>\$ 743,132</b> | <b>\$ 737,977</b> | <b>\$ 5,155</b> |
| <b>Allowance for loan losses as a % of loans</b>          | <b>1.67%</b>      | <b>1.68%</b>      | <b>-0.01%</b>   |

The Corporation originates and sells fixed rate residential real estate loans to the Federal Home Loan Mortgage Corporation (Freddie Mac). The Corporation has not originated loans for either trading or its own portfolio that would be classified as subprime, nor has it originated adjustable rate mortgages or financed loans for more than 80% of market value unless insured by private third party insurance.

As shown in the preceding table, the reduction in the level of net loans charged off has allowed the Corporation to reduce its provision for loan losses for the three month period ended March 31, 2012 as compared to the same period in 2011. While there have been marked improvements in the level of net loans charged off the overall local, regional and national economies have yet to show consistent improvement.

For further discussion on the allocation of the allowance for loan losses, see Note 6 Loans and Allowance for Loan Losses to the Corporation's 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, management analyzes its historical loss trends on loans past due 30-89 days, 90 days or more, and nonaccrual loans.

The following tables summarize the Corporation's past due and nonaccrual loans as of:

|                             | March 31, 2012          |                    |                 |                  | Total<br>Past Due<br>and<br>Nonaccrual |
|-----------------------------|-------------------------|--------------------|-----------------|------------------|--|
|                             | Accruing Loans Past Due |                    |                 | Nonaccrual       |  |
|                             | 30-89<br>Days           | 90 Days<br>or More |                 |                  |  |
| Commercial and agricultural | \$ 2,286                | \$ 288             | \$ 5,237        | \$ 7,811         |  |
| Residential real estate     | 2,774                   | 73                 | 1,414           | 4,261            |  |
| Consumer                    | 98                      |                    |                 | 98               |  |
| <b>Total</b>                | <b>\$ 5,158</b>         | <b>\$ 361</b>      | <b>\$ 6,651</b> | <b>\$ 12,170</b> |  |

|                             | December 31, 2011       |                    |                 |                  | Total<br>Past Due<br>and<br>Nonaccrual |
|-----------------------------|-------------------------|--------------------|-----------------|------------------|--|
|                             | Accruing Loans Past Due |                    |                 | Nonaccrual       |  |
|                             | 30-89<br>Days           | 90 Days<br>or More |                 |                  |  |
| Commercial and agricultural | \$ 2,149                | \$ 466             | \$ 4,805        | \$ 7,420         |  |
| Residential real estate     | 3,424                   | 289                | 1,584           | 5,297            |  |
| Consumer                    | 181                     | 5                  |                 | 186              |  |
| <b>Total</b>                | <b>\$ 5,754</b>         | <b>\$ 760</b>      | <b>\$ 6,389</b> | <b>\$ 12,903</b> |  |

**Troubled Debt Restructurings (TDR)**

The Corporation has taken a proactive approach to avoid foreclosures on borrowers who are willing to work with the Corporation in modifying their loans, thus making them more affordable. These loan modifications have allowed borrowers to develop a payment structure that will allow them to continue making payments in lieu of foreclosure. The modifications have been extremely successful for both the Corporation and its 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.

Loan modifications are considered to be TDRs 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, the Corporation considers if:

1. The borrower is currently in default on any of their debt.
2. It is likely that the borrower would default on any of their debt if the concession was not granted.
3. The borrower's cash flow was sufficient to service all of their debt if the concession was not granted.

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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 table summarizes the Corporation's troubled debt restructurings component of its impaired loans as of:

|   | March 31, 2012    |                 |                  | December 31, 2011 |                 |                  | Total Change    |
|---|-------------------|-----------------|------------------|-------------------|-----------------|------------------|-----------------|
|   | Accruing Interest | Nonaccrual      | Total            | Accruing Interest | Nonaccrual      | Total            |                 |
| Current                                   | \$ 20,088         | \$ 917          | \$ 21,005        | \$ 16,125         | \$ 514          | \$ 16,639        | \$ 4,366        |
| Past due 30-89 days                       | 876               | 47              | 923              | 1,614             | 429             | 2,043            | (1,120)         |
| Past due 90 days or more                  |                   | 1,174           | 1,174            |                   | 74              | 74               | 1,100           |
| <b>Total troubled debt restructurings</b> | <b>\$ 20,964</b>  | <b>\$ 2,138</b> | <b>\$ 23,102</b> | <b>\$ 17,739</b>  | <b>\$ 1,017</b> | <b>\$ 18,756</b> | <b>\$ 4,346</b> |

The following tables summarize troubled debt restructurings in the three month period ended March 31, 2012:

|                                      | Below Market Interest Rate Pre-Modification Recorded Investment |                 | Below Market Interest Rate and Extension of Amortization Period Pre-Modification Recorded Investment |               |
|--------------------------------------|---|-----------------|--|---------------|
|                                      | Number of Loans   | \$              | Number of Loans  | \$            |
| Commercial other                     | 21  | \$ 4,586        |  | \$            |
| Agricultural other                   | 6   | 561             |  |               |
| Residential real estate senior liens |   |                 | 5  | 721           |
| <b>Total</b>                         | <b>27</b>   | <b>\$ 5,147</b> | <b>5</b>   | <b>\$ 721</b> |

The Corporation did not restructure any loans through the forbearance of principal or accrued interest in the three month period ended March 31, 2012.

**Nonperforming Assets**

The following table summarizes the Corporation's nonperforming assets as of:

|   | March 31 2012   | December 31 2011 | Change          |
|---|-----------------|------------------|-----------------|
| Nonaccrual loans                        | \$ 6,651        | \$ 6,389         | \$ 262          |
| Accruing loans past due 90 days or more | 361             | 760              | (399)           |
| <b>Total nonperforming loans</b>        | <b>7,012</b>    | <b>7,149</b>     | <b>(137)</b>    |
| Other real estate owned (OREO)          | 1,712           | 1,867            | (155)           |
| Repossession assets                     | 7               | 9                | (2)             |
| <b>Total nonperforming assets</b>       | <b>\$ 8,731</b> | <b>\$ 9,025</b>  | <b>\$ (294)</b> |

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|  |              |              |               |
|--|--------------|--------------|---------------|
| <b>Nonperforming loans as a % of total loans</b>   | <b>0.94%</b> | <b>0.95%</b> | <b>-0.01%</b> |
| <b>Nonperforming assets as a % of total assets</b> | <b>0.64%</b> | <b>0.67%</b> | <b>-0.03%</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.

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The following table summarizes the Corporation's nonaccrual loan balances by type as of:

|                             | March 31<br>2012 | December 31<br>2011 | Change        |
|-----------------------------|------------------|---------------------|---------------|
| Commercial and agricultural | \$ 5,237         | \$ 4,805            | \$ 432        |
| Residential real estate     | 1,414            | 1,584               | (170)         |
| <b>Total</b>                | <b>\$ 6,651</b>  | <b>\$ 6,389</b>     | <b>\$ 262</b> |

Included in nonaccrual commercial and agricultural loans was one loan with a balance of \$1,500 as of March 31, 2012 and \$1,900 as of December 31, 2011. As of March 31, 2012 and December 31, 2011, there was no specific allocation established for this loan as it has been charged down to reflect the current market value of the real estate. Nonaccrual commercial and agricultural loans also included one loan with a balance of \$1,008 as of March 31, 2012 and \$1,014 as of December 31, 2011, for which there was no specific allocation established as the net realizable value of the loan's underlying collateral exceeded the loan's outstanding balance. There were no other individually significant credits included in nonaccrual loans as of March 31, 2012 or December 31, 2011.

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

|                             | March 31<br>2012 | December 31<br>2011 | Change          |
|-----------------------------|------------------|---------------------|-----------------|
| Commercial and agricultural | \$ 1,640         | \$ 520              | \$ 1,120        |
| Residential real estate     | 498              | 497                 | 1               |
| <b>Total</b>                | <b>\$ 2,138</b>  | <b>\$ 1,017</b>     | <b>\$ 1,121</b> |

The Corporation has devoted 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. To management's knowledge, all loans that are deemed to be impaired have been recognized. A continued decline in real estate values may require further charge offs and write downs of other real estate owned and could potentially have an adverse impact on the Corporation's financial performance.

Based on management's analysis, the allowance for loan losses is considered appropriate as of March 31, 2012. Management will continue to closely monitor its overall credit quality during the remainder of 2012 to ensure that the allowance for loan losses remains appropriate.

**Table of Contents****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 March 31 |                 |                 |               |
|---|-----------------------------|-----------------|-----------------|---------------|
|   | 2012                        | 2011            | Change<br>\$    | %             |
| <b>Service charges and fees</b>                                     |                             |                 |                 |               |
| NSF and overdraft fees  | \$ 558                      | \$ 571          | \$ (13)         | -2.3%         |
| ATM and debit card fees   | 457                         | 403             | 54              | 13.4%         |
| Trust fees  | 250                         | 221             | 29              | 13.1%         |
| Freddie Mac servicing fee   | 191                         | 182             | 9               | 4.9%          |
| Service charges on deposit accounts                                 | 74                          | 75              | (1)             | -1.3%         |
| Net originated mortgage servicing rights gain (loss)                | 63                          | (14)            | 77              | N/M           |
| All other   | 36                          | 38              | (2)             | -5.3%         |
| <b>Total service charges and fees</b>                               | <b>1,629</b>                | <b>1,476</b>    | <b>153</b>      | <b>10.4%</b>  |
| <b>Gain on sale of mortgage loans</b>                               | <b>379</b>                  | <b>129</b>      | <b>250</b>      | <b>193.8%</b> |
| <b>Net loss on trading securities</b>                               | <b>(16)</b>                 | <b>(19)</b>     | <b>3</b>        | <b>N/M</b>    |
| <b>Net gain on borrowings measured at fair value</b>                | <b>33</b>                   | <b>80</b>       | <b>(47)</b>     | <b>-58.8%</b> |
| <b>Gain on sale of available-for-sale investment securities</b>     | <b>1,003</b>                |                 | <b>1,003</b>    | <b>N/M</b>    |
| <b>Other</b>  |                             |                 |                 |               |
| Earnings on corporate owned life insurance policies                 | 171                         | 142             | 29              | 20.4%         |
| Brokerage and advisory fees   | 130                         | 139             | (9)             | -6.5%         |
| Investment in Corporate Settlement Solutions recognized gain (loss) | 32                          | (137)           | 169             | N/M           |
| All other   | 180                         | 138             | 42              | 30.4%         |
| <b>Total other</b>  | <b>513</b>                  | <b>282</b>      | <b>231</b>      | <b>81.9%</b>  |
| <b>Total noninterest income</b>                                     | <b>\$ 3,541</b>             | <b>\$ 1,948</b> | <b>\$ 1,593</b> | <b>81.8%</b>  |

Significant changes in noninterest income are detailed below:

Management continuously analyzes various fees related to deposit accounts including service charges and NSF and overdraft fees. Based on these analyses, the Corporation makes any necessary adjustments to ensure that its fee structure is within the range of its competitors, while at the same time making sure that the fees remain fair to deposit customers. The Corporation anticipates that NSF and overdraft fees will approximate current levels throughout the remainder of 2012.

The increases in ATM and debit card fees are primarily the result of the increased usage of debit cards by customers. As management does not anticipate any significant changes to the ATM and debit card fee structures, income is expected to continue to increase as the usage of debit cards increases.

Trust fees have increased primarily due to changes in fee structure. As management does not anticipate any further changes to the fee structure in 2012, trust fees are expected to approximate current levels for the remainder of 2012.



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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 increases in the gain on sale of mortgage loans. Additionally, this refinancing activity has increased revenues for Corporate Settlement Solutions (a title insurance agency). Management anticipates this trend to continue for much of 2012.

Fluctuations in the gains and losses related to trading securities and borrowings measured at fair value are caused by interest rate variances.

During the first quarter of 2012, management 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, management elected to realize these gains through sales as the investments would have likely been paid off in the near term through refinancing activity. Management does not anticipate any further significant investment sales during the remainder of 2012.

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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.

The fluctuation in all other income is spread throughout various categories, none of which are individually significant.

**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 March 31 |              |             |              |
|--|-----------------------------|--------------|-------------|--------------|
|  | 2012                        | 2011         | \$ Change   | %            |
| <b>Compensation and benefits</b>                   |                             |              |             |              |
| Compensation                                       | \$ 3,828                    | \$ 3,556     | \$ 272      | 7.6%         |
| Benefits   | 1,473                       | 1,449        | 24          | 1.7%         |
| <b>Total compensation and benefits</b>             | <b>5,301</b>                | <b>5,005</b> | <b>296</b>  | <b>5.9%</b>  |
| <b>Occupancy</b>                                   |                             |              |             |              |
| Outside services                                   | 147                         | 162          | (15)        | -9.3%        |
| Depreciation                                       | 154                         | 148          | 6           | 4.1%         |
| Property taxes                                     | 129                         | 128          | 1           | 0.8%         |
| Utilities  | 126                         | 127          | (1)         | -0.8%        |
| Building repairs                                   | 65                          | 60           | 5           | 8.3%         |
| All other  | 20                          | 21           | (1)         | -4.8%        |
| <b>Total occupancy</b>                             | <b>641</b>                  | <b>646</b>   | <b>(5)</b>  | <b>-0.8%</b> |
| <b>Furniture and equipment</b>                     |                             |              |             |              |
| Computer / service contracts                       | 480                         | 460          | 20          | 4.3%         |
| Depreciation                                       | 443                         | 499          | (56)        | -11.2%       |
| ATM and debit card fees                            | 151                         | 139          | 12          | 8.6%         |
| All other  | 16                          | 8            | 8           | 100.0%       |
| <b>Total furniture and equipment</b>               | <b>1,090</b>                | <b>1,106</b> | <b>(16)</b> | <b>-1.4%</b> |
| <b>Available-for-sale security impairment loss</b> | <b>282</b>                  |              | <b>282</b>  | <b>N/M</b>   |
| <b>Other</b>                                       |                             |              |             |              |
| Marketing and community relations                  | 494                         | 223          | 271         | 121.5%       |
| FDIC insurance premiums                            | 215                         | 334          | (119)       | -35.6%       |
| Directors fees                                     | 210                         | 211          | (1)         | -0.5%        |
| Audit fees   | 176                         | 156          | 20          | 12.8%        |
| Education and travel                               | 127                         | 105          | 22          | 21.0%        |
| Consulting fees                                    | 187                         | 33           | 154         | N/M          |
| Printing and supplies                              | 109                         | 100          | 9           | 9.0%         |
| Postage and freight                                | 101                         | 100          | 1           | 1.0%         |
| Foreclosed asset and collection                    | 97                          | 100          | (3)         | -3.0%        |
| Amortization of deposit premium                    | 66                          | 76           | (10)        | -13.2%       |
| Legal fees   | 62                          | 62           |             |              |
| All other  | 415                         | 330          | 85          | 25.8%        |
| <b>Total other</b>                                 | <b>2,259</b>                | <b>1,830</b> | <b>429</b>  | <b>23.4%</b> |

|                                   |                 |                 |               |              |
|-----------------------------------|-----------------|-----------------|---------------|--------------|
| <b>Total noninterest expenses</b> | <b>\$ 9,573</b> | <b>\$ 8,587</b> | <b>\$ 986</b> | <b>11.5%</b> |
|-----------------------------------|-----------------|-----------------|---------------|--------------|

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Significant changes in noninterest expenses are detailed below:

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

During the three month period ended March 31, 2012, the Corporation recorded a credit impairment on an available-for-sale investment security through earnings due to the bond being downgraded to Caa3. The Corporation will continue to monitor its investment portfolio throughout the year for other potential other-than-temporary impairments. For further discussion, see Note 5 Available-For-Sale Securities to the Corporation's interim condensed consolidated financial statements.

Marketing and community relations expenses have increased primarily as a result of a charitable contribution of \$250 during the first quarter of 2012 to the Isabella Bank Foundation. Marketing and community relations expenses are expected to normalize throughout the remainder of 2012.

The increase in consulting fees is primarily related to the Corporation employing the services of a consultant to review the Federal Home Loan Bank advance restructure (see Volume and Rate Variance Analysis, above). Consulting fees are anticipated to decline over the remainder of 2012.

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

**ANALYSIS OF CHANGES IN FINANCIAL CONDITION**

|  | March 31<br>2012    | December<br>31<br>2011 | \$ Change        | % Change<br>(unannualized) |
|--|---------------------|------------------------|------------------|----------------------------|
| <b>ASSETS</b>  |                     |                        |                  |                            |
| Cash and cash equivalents                                    | \$ 21,744           | \$ 28,590              | \$ (6,846)       | -23.95%                    |
| Certificates of deposit held in other financial institutions | 6,640               | 8,924                  | (2,284)          | -25.59%                    |
| Trading securities   | 4,403               | 4,710                  | (307)            | -6.52%                     |
| Available-for-sale securities                                | 471,655             | 425,120                | 46,535           | 10.95%                     |
| Mortgage loans available-for-sale                            | 3,396               | 3,205                  | 191              | 5.96%                      |
| Loans  | 743,132             | 750,291                | (7,159)          | -0.95%                     |
| Allowance for loan losses                                    | (12,375)            | (12,375)               |                  | 0.00%                      |
| Premises and equipment                                       | 25,054              | 24,626                 | 428              | 1.74%                      |
| Corporate owned life insurance                               | 22,246              | 22,075                 | 171              | 0.77%                      |
| Accrued interest receivable                                  | 6,044               | 5,848                  | 196              | 3.35%                      |
| Equity securities without readily determinable fair values   | 17,220              | 17,189                 | 31               | 0.18%                      |
| Goodwill and other intangible assets                         | 46,726              | 46,792                 | (66)             | -0.14%                     |
| Other assets   | 13,335              | 12,930                 | 405              | 3.13%                      |
| <b>TOTAL ASSETS</b>  | <b>\$ 1,369,220</b> | <b>\$ 1,337,925</b>    | <b>\$ 31,295</b> | <b>2.34%</b>               |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                  |                     |                        |                  |                            |
| <b>Liabilities</b>   |                     |                        |                  |                            |
| Deposits   | \$ 989,126          | \$ 958,164             | \$ 30,962        | 3.23%                      |
| Borrowed funds   | 214,493             | 216,136                | (1,643)          | -0.76%                     |
| Accrued interest payable and other liabilities               | 8,294               | 8,842                  | (548)            | -6.20%                     |

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|  |                     |                     |                  |              |
|--|---------------------|---------------------|------------------|--------------|
| <b>Total liabilities</b>                         | <b>1,211,913</b>    | <b>1,183,142</b>    | <b>28,771</b>    | <b>2.43%</b> |
| <b>Shareholders equity</b>                       | <b>157,307</b>      | <b>154,783</b>      | <b>2,524</b>     | <b>1.63%</b> |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b> | <b>\$ 1,369,220</b> | <b>\$ 1,337,925</b> | <b>\$ 31,295</b> | <b>2.34%</b> |

As shown above, the Corporation was able to grow its balance sheet since December 31, 2011 primarily as a result of increases in total deposits. As loans have remained essentially unchanged since year end 2011, these funds were deployed into available-for-sale

investment securities. Management anticipates that loan growth will continue to be a challenge and that deposit growth will level off over the remainder of the year.

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The following table outlines the changes in the loan portfolio:

|                         | March 31<br>2012  | December 31<br>2011 | \$ Change         | % Change<br>(unannualized) |
|-------------------------|-------------------|---------------------|-------------------|----------------------------|
| Agricultural            | \$ 76,681         | \$ 74,645           | \$ 2,036          | 2.73%                      |
| Commercial              | 361,325           | 365,714             | (4,389)           | -1.20%                     |
| Consumer                | 30,459            | 31,572              | (1,113)           | -3.53%                     |
| Residential real estate | 274,667           | 278,360             | (3,693)           | -1.33%                     |
| <b>Total</b>            | <b>\$ 743,132</b> | <b>\$ 750,291</b>   | <b>\$ (7,159)</b> | <b>-0.95%</b>              |

The following table outlines the changes in the deposit portfolio:

|                                     | March 31<br>2012  | December 31<br>2011 | \$ Change        | % Change<br>(unannualized) |
|-------------------------------------|-------------------|---------------------|------------------|----------------------------|
| Noninterest bearing demand deposits | \$ 122,862        | \$ 119,072          | \$ 3,790         | 3.18%                      |
| Interest bearing demand deposits    | 170,701           | 163,653             | 7,048            | 4.31%                      |
| Savings deposits                    | 216,998           | 193,902             | 23,096           | 11.91%                     |
| Certificates of deposit             | 391,107           | 395,777             | (4,670)          | -1.18%                     |
| Brokered certificates of deposit    | 53,704            | 54,326              | (622)            | -1.14%                     |
| Internet certificates of deposit    | 33,754            | 31,434              | 2,320            | 7.38%                      |
| <b>Total</b>                        | <b>\$ 989,126</b> | <b>\$ 958,164</b>   | <b>\$ 30,962</b> | <b>3.23%</b>               |

Borrowed funds consist of the following obligations as of:

|  | March 31, 2012    |              | December 31, 2011 |              |
|--|-------------------|--------------|-------------------|--------------|
|  | Amount            | Rate         | Amount            | Rate         |
| Federal Home Loan Bank advances  | \$ 142,000        | 2.61%        | \$ 142,242        | 3.16%        |
| Securities sold under agreements to repurchase without stated maturity dates | 55,791            | 0.20%        | 57,198            | 0.25%        |
| Securities sold under agreements to repurchase with stated maturity dates    | 16,702            | 3.51%        | 16,696            | 3.51%        |
| <b>Total</b>   | <b>\$ 214,493</b> | <b>2.05%</b> | <b>\$ 216,136</b> | <b>2.42%</b> |

The Federal Home Loan Bank (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 owned by the Corporation. The Corporation had the ability to borrow up to an additional \$121,701 based on assets currently pledged as collateral as of March 31, 2012. During the first quarter of 2012, management reduced funding costs by modifying the terms of \$60,000 of FHLB advances. This modification strategy extended the duration of the Corporation's interest bearing liabilities and will reduce interest expense by approximately \$450 for 2012.

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

|                                    | March 31<br>2012  |              | December 31<br>2011 |              |
|------------------------------------|-------------------|--------------|---------------------|--------------|
|                                    | Amount            | Rate         | Amount              | Rate         |
| Fixed rate advances due 2012       | \$ 7,000          | 4.31%        | \$ 17,000           | 2.97%        |
| One year putable advances due 2012 | 15,000            | 4.10%        | 15,000              | 4.10%        |
| Fixed rate advances due 2013       |                   |              | 5,242               | 4.14%        |
| One year putable advances due 2013 |                   |              | 5,000               | 3.15%        |
| Fixed rate advances due 2014       |                   |              | 25,000              | 3.16%        |
| Fixed rate advances due 2015       | 30,000            | 1.32%        | 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%        |                     |              |
| <b>Total</b>                       | <b>\$ 142,000</b> | <b>2.61%</b> | <b>\$ 142,242</b>   | <b>3.16%</b> |

**Capital**

The capital of the Corporation consists solely of common stock, retained earnings, and accumulated other comprehensive income. The Corporation offers dividend reinvestment, employee and director stock purchase, and shareholder stock purchase plans. Under the provisions of these plans, the Corporation issued 25,998 shares or \$609 of common stock during the first three months of 2012, as compared to 30,531 shares or \$728 of common stock during the same period in 2011. The Corporation also offers a deferred compensation plan for its directors, which allows participants to purchase stock units, in lieu of cash payments. Pursuant to this plan, the Corporation increased shareholders' equity by \$169 and \$180 during the three month periods ended March 31, 2012 and 2011, respectively.

The Board of Directors has approved a publicly announced common stock repurchase plan to enable the Corporation to repurchase its common stock. During the three months of 2012 and 2011, pursuant to this plan, the Corporation repurchased 18,452 shares of common stock at an average price of \$23.09 and 31,739 shares of common stock at an average price of \$18.18, respectively. As of March 31, 2012, the Corporation was authorized to repurchase up to an additional 544 shares of common stock.

Accumulated other comprehensive income increased \$597 for the three month period ended March 31, 2012, net of tax. The increase is a result of unrealized gains on available-for-sale investment securities.

There are no significant regulatory constraints placed on the Corporation's capital. The Federal Reserve's current recommended minimum primary capital to assets requirement is 6.0%. The Corporation's primary capital to adjusted average assets, which consists of shareholders' equity plus the allowance for loan losses less acquisition intangibles, was 8.19% as of March 31, 2012.

The Federal Reserve 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 the Corporation's values as of:

|                      | March 31<br>2012 | December 31<br>2011 | Required     |
|----------------------|------------------|---------------------|--------------|
| Equity Capital       | 13.20%           | 12.92%              | 4.00%        |
| Secondary Capital    | 1.25%            | 1.25%               | 4.00%        |
| <b>Total Capital</b> | <b>14.45%</b>    | <b>14.17%</b>       | <b>8.00%</b> |

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The Corporation's 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.



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The Federal Reserve and FDIC also prescribe minimum capital requirements for the Bank. At March 31, 2012, the Bank exceeded these minimum capital requirements. Recently passed legislation may increase the required level of capital for banks. This increase in capital levels may have an adverse impact on the Corporation's ability to grow and pay dividends.

**Liquidity**

Liquidity is monitored regularly by the Corporation's 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.

The primary sources of the Corporation's 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 \$504,442 or 36.8% of assets as of March 31, 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.

The primary source of funds for the Corporation is deposits. The Corporation also seeks noninterest bearing deposits, or checking accounts, to expand its customer base, while reducing the Corporation's cost of funds.

The Corporation has the ability to borrow from the Federal Home Loan Bank, the Federal Reserve Bank, 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 Federal Home Loan Bank Advances, Federal Reserve Bank Discount Window Advances, and repurchase agreements, require the Corporation to pledge assets, typically in the form of certificates of deposits held in other financial institutions, investment securities, or loans as collateral. The Corporation had the ability to borrow up to an additional \$121,701 based on the assets currently pledged as collateral.

The following table summarizes the Corporation's sources and uses of cash for the three month periods ended March 31:

|  | 2012             | 2011             | \$<br>Variance    |
|--|------------------|------------------|-------------------|
| Net cash provided by operating activities        | \$ 3,445         | \$ 4,460         | \$ (1,015)        |
| Net cash used in investing activities            | (38,167)         | (32,157)         | (6,010)           |
| Net cash provided by financing activities        | 27,876           | 32,920           | (5,044)           |
| (Decrease) increase in cash and cash equivalents | (6,846)          | 5,223            | (12,069)          |
| Cash and cash equivalents January 1              | 28,590           | 18,109           | 10,481            |
| <b>Cash and cash equivalents March 31</b>        | <b>\$ 21,744</b> | <b>\$ 23,332</b> | <b>\$ (1,588)</b> |

**FINANCIAL INSTRUMENTS WITH OFF BALANCE SHEET ARRANGEMENTS**

The Corporation is 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 its 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 the Corporation has in a particular class of financial instrument.

The following table summarizes the Corporation's credit related financial instruments with off-balance-sheet risk as of:

|  | March 31<br>2012 | December 31<br>2011 |
|--|------------------|---------------------|
| Unfunded commitments under lines of credit | \$ 112,549       | \$ 102,822          |
| Commercial and standby letters of credit   | 4,493            | 4,461               |
| Commitments to grant loans                 | 26,871           | 21,806              |

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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.

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Commercial and standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support 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. The Corporation evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Corporation upon the extension of credit, is based on management's credit evaluation of the borrower. While the Corporation considers 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 by the Corporation, is based on management's credit evaluation of the customer. Commitments to grant loans include loans committed to be sold to the secondary market.

The Corporation's 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. The Corporation uses the same credit policies in deciding to make these commitments as it does 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. The Corporation intends such forward looking statements to be covered by the safe harbor provisions for forward looking statements contained in the Private Securities Litigation Reform Act of 1995, and is including this statement for purposes of these safe harbor provisions. Forward looking statements, which are based on certain assumptions and describe future plans, strategies and expectations of the Corporation, are generally identifiable by use of the words believe, expect, intend, anticipate, estimate, project, or similar expressions. The Corporation's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse effect on the operations and future prospects of the Corporation and its subsidiaries 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 Federal Reserve, 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 the Corporation's 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 the Corporation and its business, including additional factors that could materially affect the Corporation's financial results, is included in the Corporation's filings with the Securities and Exchange Commission.

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

The Corporation's primary market risks are interest rate risk (IRR) and liquidity risk. The Corporation has no significant foreign exchange risk and does not utilize interest rate swaps or derivatives, except for interest rate locks and forward loan commitments, in the management of its interest rate risk. Any changes in foreign exchange rates or commodity prices would have an insignificant impact on the Corporation's interest income and cash flows.

IRR is the exposure of the Corporation's net interest income, its primary source of 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 the Corporation's earnings and capital.

The Federal Reserve, the Corporation's primary Federal regulator, has adopted a policy requiring the Board of Directors and senior management to effectively manage the various risks that can have a material impact on the safety and soundness of the Corporation. The risks include credit, interest rate, liquidity, operational, and reputational. The Corporation has 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 the Board of Directors.

The Corporation uses several techniques to manage IRR. The first method is gap analysis. Gap analysis measures the cash flows and/or the earliest repricing of the Corporation's 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 the Corporation's 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 the Corporation's cash flows from these assets. A significant portion of the Corporation's securities are callable or subject to prepayment. The call option is 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 imbedded options. Savings and checking deposits 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 second technique used in the management of IRR is to combine the projected cash flows and repricing characteristics generated by the gap analysis and the interest rates associated with those cash flows to project future interest income. By changing the amount and timing of the cash flows and the repricing interest rates of those cash flows, the Corporation can project the effect of changing interest rates on its interest income. Based on the projections prepared for the year ending December 31, 2012, the Corporation's net interest income would decrease slightly during a period of increasing interest rates.

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The following tables provide information about the Corporation's assets and liabilities that are sensitive to changes in interest rates as of March 31, 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.

| (dollars in thousands)               | March 31, 2012 |            |           |           |           |            | Total      | Fair Value |
|--------------------------------------|----------------|------------|-----------|-----------|-----------|------------|------------|------------|
|                                      | 2013           | 2014       | 2015      | 2016      | 2017      | Thereafter |            |            |
| <b>Rate sensitive assets</b>         |                |            |           |           |           |            |            |            |
| Other interest bearing assets        | \$ 7,326       | \$ 3,265   | \$        | \$        | \$        | \$         | \$ 10,591  | \$ 10,625  |
| Average interest rates               | 0.84%          | 1.34%      |           |           |           |            | 1.00%      |            |
| Trading securities                   | \$ 2,854       | \$ 1,028   | \$ 521    | \$        | \$        | \$         | \$ 4,403   | \$ 4,403   |
| Average interest rates               | 3.82%          | 2.60%      | 2.59%     |           |           |            | 3.39%      |            |
| Fixed interest rate securities       | \$ 97,372      | \$ 61,876  | \$ 52,725 | \$ 43,164 | \$ 40,125 | \$ 176,393 | \$ 471,655 | \$ 471,655 |
| Average interest rates               | 2.68%          | 2.73%      | 2.82%     | 2.86%     | 3.01%     | 2.86%      | 2.81%      |            |
| Fixed interest rate loans (1)        | \$ 142,578     | \$ 114,627 | \$ 89,824 | \$ 79,095 | \$ 86,786 | \$ 63,396  | \$ 576,306 | \$ 590,809 |
| Average interest rates               | 6.20%          | 6.00%      | 5.94%     | 5.83%     | 5.04%     | 5.10%      | 5.77%      |            |
| Variable interest rate loans (1)     | \$ 67,642      | \$ 23,555  | \$ 24,825 | \$ 17,383 | \$ 18,601 | \$ 14,820  | \$ 166,826 | \$ 166,826 |
| Average interest rates               | 4.63%          | 3.96%      | 4.06%     | 3.68%     | 3.60%     | 3.87%      | 4.17%      |            |
| <b>Rate sensitive liabilities</b>    |                |            |           |           |           |            |            |            |
| Borrowed funds                       | \$ 78,222      | \$ 5,104   | \$ 11,167 | \$ 30,000 | \$ 40,000 | \$ 50,000  | \$ 214,493 | \$ 220,395 |
| Average interest rates               | 1.33%          | 4.47%      | 0.89%     | 2.15%     | 2.10%     | 3.11%      | 2.05%      |            |
| Savings and NOW accounts             | \$ 91,083      | \$ 69,599  | \$ 56,043 | \$ 53,691 | \$ 37,300 | \$ 79,983  | \$ 387,699 | \$ 387,699 |
| Average interest rates               | 0.17%          | 0.17%      | 0.17%     | 0.17%     | 0.17%     | 0.15%      | 0.17%      |            |
| Fixed interest rate time deposits    | \$ 257,073     | \$ 61,135  | \$ 50,120 | \$ 57,426 | \$ 44,142 | \$ 7,114   | \$ 477,010 | \$ 490,355 |
| Average interest rates               | 1.52%          | 2.58%      | 2.26%     | 2.43%     | 2.18%     | 1.83%      | 1.91%      |            |
| Variable interest rate time deposits | \$ 935         | \$ 620     | \$        | \$        | \$        | \$         | \$ 1,555   | \$ 1,555   |
| Average interest rates               | 0.52%          | 0.56%      |           |           |           |            | 0.54%      |            |
| <b>December 31, 2011</b>             |                |            |           |           |           |            |            |            |
|                                      | 2012           | 2013       | 2014      | 2015      | 2016      | Thereafter | Total      | Fair Value |
| <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 | \$ 222,538 |
| 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.

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**Item 4 Controls and Procedures**

**DISCLOSURE CONTROLS AND PROCEDURES**

The Corporation's management 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 the Corporation's 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 March 31, 2012, pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Principal Executive Officer and Principal Financial Officer concluded that the Corporation's disclosure controls and procedures as of March 31, 2012, were effective to ensure that information required to be disclosed by the Corporation in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

**CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

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

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

The Corporation is not involved in any material legal proceedings. The Corporation is involved in ordinary, routine litigation incidental to its 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 the Corporation's 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**

The Board of Directors has adopted and announced a common stock repurchase plan. On April 27, 2011, the Board of Directors amended the plan to allow for the repurchase of an additional 100,000 shares of the Corporation's 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 March 31, 2012, with respect to this plan:

|                                | Shares Repurchased |                         | Total Number of Shares Purchased as Part of Publicly Announced Plan or Program | Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs |
|--------------------------------|--------------------|-------------------------|--|--|
|                                | Number             | Average Price Per Share |  |  |
| Balance, December 31, 2011     |                    |                         |  | 18,996   |
| January 1 - 31, 2012           | 5,915              | \$ 23.67                | 5,915  | 13,081   |
| February 1 - 29, 2012          | 5,486              | 22.97                   | 5,486  | 7,595  |
| March 1 - 31, 2012             | 7,051              | 22.69                   | 7,051  | 544  |
| <b>Balance, March 31, 2012</b> | <b>18,452</b>      | <b>\$ 23.09</b>         | <b>18,452</b>  | <b>544</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: April 30, 2012

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

Date: April 30, 2012

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