ISABELLA BANK CORP
Form 10-K
March 12, 2012
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**
For the fiscal year ended December 31, 2011

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)

Michigan	**38-2830092**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer identification No.)**

401 North Main Street, Mount Pleasant, Michigan 48858

(Address of principal executive offices) (Zip Code)

Registrant s telephone number, including area code (989) 772-9471

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	**Name of each exchange on which registered**

Securities registered pursuant to Section 12(g) of the Act:

Common Stock - No Par Value

(Title of Class)

Indicated by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicated by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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 x 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 x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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 definition 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	x
Non-accelerated filer	¨	Smaller reporting company	¨

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

The aggregate market value of the voting stock held by non-affiliates of the registrant was $132,423,000 as of the last business day of the registrant s most recently completed second fiscal quarter.

The number of shares outstanding of the registrant s Common Stock (no par value) was 7,584,909 as of February 16, 2012.

DOCUMENTS INCORPORATED BY REFERENCE

(Such documents are incorporated herein only to the extent specifically set forth in response to an item herein.)

Documents	**Part of Form 10-K Incorporated into**
Isabella Bank Corporation Proxy Statement for its Annual Meeting of Shareholders to be held May 1, 2012	Part III

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ISABELLA BANK CORPORATION

ANNUAL REPORT ON FORM 10-K

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Part I

Item 1. Business (All dollars in thousands)

General

Isabella Bank Corporation (the Corporation) is a registered financial services holding company incorporated in September 1988 under Michigan law. The Corporation has three subsidiaries: Isabella Bank (the Bank), IB&T Employee Leasing, LLC, and Financial Group Information Services. Isabella Bank has 25 banking offices located throughout Clare, Gratiot, Isabella, Mecosta, Midland, Montcalm, and Saginaw counties. The area includes significant agricultural production, light manufacturing, retail, gaming and tourism, and five colleges and universities. IB&T Employee Leasing, LLC is an employee leasing company. Financial Group Information Services renders computer services to the Corporation and its subsidiaries. All employees of the Corporation are employed by IB&T Employee Leasing, LLC which leases employees to the Corporation and each of its subsidiaries. The principal city in which the Corporation operates is Mount Pleasant, Michigan which has a population of approximately 26,000.

The Corporation s reportable segments are based on legal entities that account for at least 10% of net operating results. Retail banking operations for 2011, 2010, and 2009 represent approximately 90% or greater of the Corporation s total assets and operating results. As such, the Corporation has only one reportable segment.

Competition

The Corporation competes with other commercial banks, many of which are subsidiaries of other bank holding companies, savings and loan associations, mortgage brokers, finance companies, credit unions, and retail brokerage firms. The Bank is a community bank with a focus on providing high quality, personalized service at a fair price. The Bank offers a broad array of banking services to businesses, institutions, and individuals. Deposit services offered include checking accounts, savings accounts, certificates of deposit, direct deposits, cash management services, mobile and internet banking, electronic bill pay services, and automated teller machines. Lending activities include loans made pursuant to commercial and agricultural operating and real estate purposes, residential real estate loans, and consumer loans. The Bank also offers full service trust and brokerage services.

Lending

The Corporation limits lending activities primarily to local markets and has not purchased any loans from the secondary market. The Corporation does not make loans to fund leveraged buyouts, has no foreign corporate or government loans, and has limited holdings of corporate debt securities. The general lending philosophy is to limit concentrations to individuals and business segments. The following table sets forth the composition of the Corporation s loan portfolio as of December 31, 2011:

	Amount	%
Commercial		
Commercial real estate	$ 258,095	34.40%
Commercial other	107,619	14.34%
Total commercial	365,714	48.74%
Agricultural		
Agricultural real estate	44,683	5.96%
Agricultural other	29,962	3.99%
Total agricultural	74,645	9.95%
Residential mortgage		
Senior liens	217,601	29.00%
Junior liens	21,246	2.83%
Home equity lines of credit	39,513	5.27%

Total residential mortgage	278,360	37.10%
Consumer		
Secured	26,174	3.49%
Unsecured	5,398	0.72%
Total consumer	31,572	4.21%
Total	$ 750,291	100.00%

The Corporation grants commercial, agricultural, residential, 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 mortgage 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.

The accrual of interest on mortgage and commercial 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 fixed assets. 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 mortgage 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 mortgages 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 Bank 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 ability to pay rather than collateral value. No consumer loans are sold to the secondary market.

Supervision and Regulation

The Corporation is subject to supervision and regulation by the Securities and Exchange Commission (SEC) under the Securities Act of 1933 and the Securities Exchange Act of 1934 and by the Board of Governors of the Federal Reserve Bank System (the FRB) under the Bank Holding Company Act of 1956 as amended (BHC Act), the Financial Services Holding Company Act of 2000, and the Dodd-Frank Act of 2011 (the Dodd-Frank Act). A bank holding company and its subsidiaries are able to conduct only the business of commercial banking and activities closely related or incidental to commercial banking (see Regulation below).

Isabella Bank is chartered by the State of Michigan and is a member of the FRB. The Bank s deposits are insured by the Federal Deposit Insurance Corporation (FDIC) to the extent provided by law. The Bank is a member of the Federal Home Loan Bank of Indianapolis. The Bank is supervised and regulated by the Michigan Office of Financial and Insurance Regulation (OFIR), the FRB, and the Consumer Financial Protection Bureau (CFPB). For further discussion, see Regulation below.

Personnel

As of December 31, 2011, the Corporation and its subsidiaries had 352 full-time equivalent employees. The Corporation provides group life, health, accident, disability, and other insurance programs for employees as well as a number of other employee benefit programs. The Corporation believes its relationship with its employees to be good. None of the Corporation s workforce is subject to collective bargaining agreements.

Legal Proceedings

There are various claims and lawsuits in which the Corporation and its subsidiaries are periodically involved, such as claims to enforce liens, condemnation proceedings on making and servicing of real property loans, and other issues incidental to the Corporation s business. However, the Corporation and its subsidiaries are not involved in any material pending litigation.

AVAILABLE INFORMATION

The Corporation s SEC filings (including the Corporation s Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Definitive Proxy Statements, Current Reports on Form 8-K and amendments to those reports) are available through the Bank s website (www.isabellabank.com). The Corporation will provide paper copies of its SEC reports free of charge upon request of a shareholder.

The SEC maintains an internet site (http://www.sec.gov) that contains reports, proxy and information statements and other information regarding the Corporation (CIK #0000842517) and other issuers.

REGULATION

The earnings and growth of the banking industry and, therefore, the earnings of the Corporation and of the Bank are affected by the credit policies of monetary authorities, including the FRB. An important function of the FRB is to regulate the national supply of bank credit in order to combat recessions and curb inflationary pressures. Among the instruments of monetary policy used by the FRB to implement these objectives are open market operations in U.S. Treasury and U.S. Government Agency securities, changes in the discount rate on member bank borrowings, and changes in reserve requirements against member bank deposits. These methods are used in varying combinations to influence overall growth of bank loans, investments and deposits and may also affect interest rates charged on loans or paid for deposits. The monetary policies of the FRB have had a significant effect on the operating results of commercial banks and related financial service providers in the past and are expected to continue to do so in the future. The effect of such policies upon the future business and earnings of the Corporation cannot be predicted.

The Corporation

The Corporation, as a financial services holding company, is regulated under the BHC Act, and is subject to the supervision of the FRB. The Corporation is registered as a financial services holding company with the FRB and is required to file with the FRB an annual report and such additional information as the FRB requires. The FRB makes inspections and examinations of the Corporation and its subsidiaries.

Prior to March 13, 2000, a bank holding company generally was prohibited under the BHC Act from acquiring the beneficial ownership or control of more than 5% of the voting shares or substantially all the assets of any company, including a bank, without the FRB s prior approval. Also, prior to March 13, 2000, a bank holding company generally was limited to engaging in banking and such other activities as determined by the FRB to be closely related to banking.

Under the Gramm-Leach-Bliley Act of 1999 (GLB Act), beginning March 13, 2000, an eligible bank holding company was able to elect to become a financial holding company and thereafter affiliate with securities firms and insurance companies and engage in other activities that are financial in nature. The GLB Act defines financial in nature to include securities underwriting, dealing and market making; sponsoring mutual funds and investment companies; insurance underwriting and agency; merchant banking activities; activities that the FRB has determined to be closely related to banking; and other activities that the FRB, after consultation with the Secretary of the Treasury, determines by regulation or order to be financial in nature or incidental to a financial activity. No FRB approval is required for a financial holding company to acquire a company, other than a bank holding company, bank or savings association, engaged in activities that are financial in nature or incidental to activities that are financial in nature, as defined in the GLB Act or as determined by the FRB.

A bank holding company is eligible to become a financial holding company if each of its subsidiary banks and savings associations is well capitalized under the prompt corrective action provisions of the Federal Deposit Insurance Act (FDI Act), is well managed and has a rating under the Community Reinvestment Act (CRA) of satisfactory or better. If any bank or savings association subsidiary of a financial holding company ceases to be well capitalized or well managed, the FRB may require the financial holding company to divest the subsidiary. Alternatively, the financial holding company may elect to conform its activities to those permissible for bank holding companies that do not elect to become financial holding companies. If any bank or savings association subsidiary of a financial holding company receives a CRA rating of less than satisfactory, the financial holding company will be prohibited from engaging in new activities or acquiring companies other than bank holding companies, banks or savings associations.

The Corporation became a financial holding company effective March 13, 2000. It continues to maintain its status as a bank holding company for purposes of other FRB regulations.

Under FRB policy, the Corporation is expected to act as a source of financial strength to its subsidiary Bank and to commit resources to support its subsidiaries. This support may be required at times when, in the absence of such FRB policy, the Corporation would not otherwise be required to provide it.

Under Michigan law, if the capital of a Michigan state chartered bank (such as the Bank) has become impaired by losses or otherwise, the Commissioner of the OFIR may require that the deficiency in capital be met by assessment upon the bank s shareholders pro rata on the amount of capital stock held by each, and if any such assessment is not paid by any shareholder within 30 days of the date of mailing of notice thereof to such shareholder, cause the sale of the stock of such shareholder to pay such assessment and the costs of sale of such stock.

Any capital loans by a bank holding company to any of its subsidiary banks are subordinate in right of payment to deposits and to certain other indebtedness of such subsidiary bank. In the event of a bank holding company s bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and entitled to a priority of payment. This priority would apply to guarantees of capital plans under the Federal Deposit Insurance Corporation Improvement Act of 1991.

The Sarbanes-Oxley Act of 2002 (SOX) contains important requirements for public companies in the area of financial disclosure and corporate governance. In accordance with Section 302(a) of SOX, written certifications by the Corporation s principal executive, financial, and accounting officers are required. These certifications attest that the Corporation s quarterly and annual reports filed with the SEC do not contain any untrue statement of a material fact. See the Certifications filed as Exhibits 31 (a) and (b) to this Form 10-K for such certification of the financial statements and other information for this 2011 Form 10-K. The Corporation has also implemented a program designed to comply with Section 404 of SOX, which included the identification of significant processes and accounts, documentation of the design of control effectiveness over process and entity level controls, and testing of the operating effectiveness of key controls. See Item 9A, Controls and Procedures for the Corporation s evaluation of its disclosure controls and procedures.

Certain additional information concerning regulatory guidelines for capital adequacy and other regulatory matters is presented herein under the caption Capital on page 35 and in the notes to the consolidated financial statements Note 15 Commitments and Other Matters and Note 16 Minimum Regulatory Capital Requirements .

Isabella Bank

The Bank is subject to regulation and examination primarily by OFIR and is also subject to regulation and examination by the FRB.

The agencies and federal and state laws extensively regulate various aspects of the banking business including, among other things, permissible types and amounts of loans, investments and other activities, capital adequacy, branching, interest rates on loans and on deposits and the safety and soundness of banking practices.

The deposits of the Corporation are insured up to applicable limits by the Deposit Insurance Fund (DIF) of the FDIC and are subject to deposit insurance assessments to maintain the DIF. The FDIC utilizes a risk-based assessment system that assesses insurance premiums based upon a risk matrix that takes into account a bank s capital level and supervisory ratings.

Banking laws and regulations also restrict transactions by insured banks owned by a bank holding company, including loans to and certain purchases from the parent holding company, non bank and bank subsidiaries of the parent holding company, principal shareholders, officers, directors and their affiliates, and investments by the subsidiary bank in the shares or securities of the parent holding company (or any of the other non bank or bank affiliates), or acceptance of such shares or securities as collateral security for loans to any borrower.

The Bank is also subject to legal limitations on the frequency and amount of dividends that can be paid to the Corporation. For example, a Michigan state chartered bank may not declare a cash dividend or a dividend in kind except out of net profits then on hand after deducting all losses and bad debts, and then only if it will have a

surplus amounting to not less than 20% of its capital after the payment of the dividend. Moreover, a Michigan state chartered bank may not declare or pay any cash dividend or dividend in kind until the cumulative dividends on its preferred stock, if any, have been paid in full. Further, if the surplus of a Michigan state chartered bank is at any time less than the amount of its capital, before the declaration of a cash dividend or dividend in kind, it must transfer to surplus not less than 10% of its net profits for the preceding half year (in the case of quarterly or semiannual dividends) or the preceding two consecutive half year periods (in the case of annual dividends).

The payment of dividends by the Corporation and the Bank is also affected by various regulatory requirements and policies, such as the requirement to maintain adequate capital above regulatory guidelines. Federal laws impose further restrictions on the payment of dividends by insured banks that fail to meet specified capital levels. The FDIC may prevent an insured bank from paying dividends if the bank is in default of payment of any assessment due to the FDIC. In addition, payment of dividends by a bank may be prevented by the applicable federal regulatory authority if such payment is determined, by reason of the financial condition of such bank, to be an unsafe and unsound banking practice. The FRB and the FDIC have issued policy statements providing that bank holding companies and insured banks should generally pay dividends only out of current operating earnings. Additionally beginning in 2009, the FRB Board of Governors required the Corporation to notify the FRB prior to increasing its cash dividend by more than 10% over the prior year.

In 2010, the President signed into law 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. The Dodd-Frank Act included the following provisions, among other things:

- Directed the Federal Reserve to issue rules which to limit debit-card interchange fees for financial institutions with assets in excess of $10,000,000;

- Created the CFPB, which has rulemaking and enforcement authority for a wide range of consumer protection laws affecting financial institutions;

- Increased leverage and risk-based capital requirements, FDIC premiums and examination fees;

- Provided for new disclosure, say-on-pay, and other rules relating to executive compensation and corporate governance for public companies, including public financial institutions;

- Permanently increased the federal deposit insurance coverage limit to $250;

- Provided for mortgage reform addressing a customer s ability to repay, restricted variable-rate lending, and made more loans subject to disclosure requirements and other restrictions; and

- Created a financial stability oversight council that will recommend to the FRB increasingly strict rules for capital, leverage, liquidity, risk management and other requirements as companies grow in size and complexity.

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. During 2011, the Corporation began to experience increased compensation costs as a result of staff additions necessary to comply with the new regulations.

The aforementioned regulations and restrictions may limit the Corporation s ability to obtain funds from the Bank for its cash needs, including payment of dividends and operating expenses.

The activities and operations of the Bank are also subject to other federal and state laws and regulations, including usury and consumer credit laws, the Federal Truth-in-Lending Act, Truth-in-Saving and Regulation Z of the FRB, the Federal Bank Merger Act, and the Bank Secrecy Act.

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Item 1A. Risk Factors

In the normal course of business the Corporation is exposed to various risks. These risks, if not managed correctly, could have a significant impact on the Corporation s earnings, capital, share price, and ability to pay dividends. In order to effectively monitor and control the following risks, management utilizes an enterprise risk model. Management balances the Corporation s strategic goals, including revenue and profitability objectives, with associated risks through the use of policies, systems, and procedures which have been adopted to identify, assess, control, monitor, and manage each risk area. Senior management continually reviews the adequacy and effectiveness of these policies, systems, and procedures.

In order to effectively monitor and control the following risks, management utilizes an enterprise risk process which covers each of the following areas.

Increases to loan losses and the Corporation s required allowance for loan losses

To manage the credit risk arising from lending activities, the Corporation s most significant source of credit risk, management maintains what it believes are sound underwriting policies and procedures. Management continuously monitors asset quality in order to manage the Corporation s credit risk to determine the appropriateness of valuation allowances. These valuation allowances take into consideration various factors including, but not limited to, local, regional, and national economic conditions.

The Corporation maintains an allowance for loan losses, which is a reserve established through a provision for loan losses charged to expense, that represents management s best estimate of losses that may be incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The level of the allowance reflects management s continuing evaluation of industry concentrations; specific credit risks; loan loss experience; current loan portfolio quality; present economic, political and regulatory conditions; and unidentified losses inherent in the current loan portfolio. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires the Corporation to make significant estimates of current credit risks and economic trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of the Corporation s control, may require an increase in the allowance for loan losses. In addition, bank regulatory agencies periodically review the Corporation s allowance for loan losses and may require an increase in the provision for loan losses or the recognition of further loan charge offs, based on judgments different than those of management.

Changes in economic conditions

An economic downturn within the Corporation s local markets, as well as downturns in the state or national markets, could negatively impact household and corporate incomes. This could lead to decreased demand for both loan and deposit products and lead to an increase of customers who fail to pay interest or principal on their loans. Management continually monitors key economic indicators in an effort to anticipate the possible effects of downturns in the local, regional, and national economies.

The Corporation s success depends primarily on the general economic conditions of the State of Michigan and the specific local markets in which the Corporation operates. Unlike larger national or other regional banks that are more geographically diversified, the Corporation provides banking and financial services to customers located primarily in the Clare, Gratiot, Isabella, Mecosta, Midland, Montcalm, and Saginaw counties in Michigan. The local economic conditions in these areas have a significant impact on the demand for the Corporation s products and services, as well as the ability of the Corporation s customers to repay loans, the value of the collateral securing loans and the stability of the Corporation s deposit funding sources. A significant decline in general economic conditions, caused by inflation, recession, acts of terrorism, outbreak of hostilities or

other international or domestic occurrences, unemployment, changes in securities markets or other factors could impact these local economic conditions and, in turn, have a material adverse effect on the Corporation s financial condition and results of operations.

Changes in interest rates

Interest rate risk is the timing differences in the maturity or repricing frequency of a financial institution s interest earning assets and its interest bearing liabilities. Management monitors the potential effects of changes in interest rates through rate shock and gap analyses. To help mitigate the effects of changes in interest rates, management makes significant efforts to stagger projected cash flows and maturities of interest sensitive assets and liabilities.

Liquidity risk

Liquidity risk is the risk to earnings or capital arising from the Corporation s inability to meet its obligations when they come due without incurring unacceptable costs. Liquidity risk includes the inability to manage unplanned decreases or changes in funding sources, or failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value. The Corporation has significant borrowing capacity through correspondent banks and the ability to sell certain investments to fund potential cash shortages, which management may use to help mitigate this risk.

The value of investment securities may be negatively impacted by fluctuations in the market

A volatile, illiquid market could require the Corporation to recognize an other-than-temporary impairment loss related to the investment securities held in the Corporation s portfolio. Management considers many factors in determining whether other-than-temporary impairment exists including the length of time and extent to which fair value has been less than cost, the investment credit rating, and the probability the issuer will be unable to pay the amount when due. The presence of these factors could lead to impairment charges. These risks are mitigated by the fact that the Corporation asserts that it does not intend to sell the security in an unrealized loss position and it is more likely than not it will not have to sell the securities before recovery of its cost basis.

Inadequate or failed internal processes, people, and systems, or external events

The Corporation is exposed to operational risk. Operational risk is the risk of loss resulting from inadequate or failed internal processes, people, and systems, or external events and includes reputation risk and transaction risk. Reputation risk is developing and retaining marketplace confidence in handling customers financial transactions in an appropriate manner and protecting the safety and soundness of the Corporation. Transaction risk includes losses from fraud, error, the inability to deliver products or services, and loss or theft of information. Transaction risk also encompasses product development and delivery, transaction processing, information technology systems, and the internal control environment.

To help minimize the potential losses due to operational risks, management has established a robust system of internal controls as well as an internal audit department and has retained the services of a certified public accounting firm to assist in performing such internal audit work. The focus of these internal audit procedures is to verify the validity and appropriateness of various transactions, processes, and controls. The results of these procedures are reported to the Corporation s Audit Committee.

The adoption of, violations of, or nonconformance with laws, rules, regulations, or prescribed practices

The financial services industry and public companies are extensively regulated and must meet regulatory standards set by the FDIC, OFIR, the FRB, Financial Accounting Standards Board (FASB), SEC, Public Company Accounting Oversight Board (PCAOB), the CPFB, and other regulatory bodies. Federal and state

laws and regulations are designed primarily to protect the deposit insurance funds and consumers, and not necessarily to benefit the Corporation s shareholders. The nature, extent, and timing of the adoption of significant new laws, changes in existing laws, or repeal of existing laws may have a material impact on the Corporation s business, results of operations, and financial condition, the effect of which is impossible to predict at this time.

The Corporation s compliance department annually assesses the adequacy and effectiveness of the Corporation s processes for controlling and managing its principal compliance risks.

The Corporation may not adjust to changes in the financial services industry

The Corporation s financial performance depends in part on its ability to maintain and grow its core deposit customer base and expand its financial services to its existing and new customers. In addition to other banks, competitors include savings associations, credit unions, securities dealers, brokers, mortgage bankers, investment advisors and finance and insurance companies. The increasingly competitive environment is, in part, a result of changes in technology and product delivery systems and the accelerating pace of consolidation among financial service providers. New competitors may emerge to increase the degree of competition for the Corporation s products and services. Financial services and products are also constantly changing. The Corporation s financial performance is also dependent upon customer demand for the Corporation s products and services and the Corporation s ability to develop and offer competitive financial products and services.

The Corporation may be required to recognize an impairment of goodwill

Goodwill represents the excess of the amounts paid to acquire subsidiaries over the fair value of their net assets at the date of acquisition. The majority of the recorded goodwill is related to acquisitions of other banks, which were subsequently merged into Isabella Bank. If it is determined that the goodwill has been impaired, the Corporation must write-down the goodwill by the amount of the impairment.

The Corporation may face increasing pressure from purchasers of its residential mortgage loans to repurchase loans sold or reimburse purchasers for losses related to such loans

The Corporation generally sells the fixed rate long term residential mortgage loans it originates in the secondary market. In response to the financial crisis, the purchasers of residential mortgage loans, such as government sponsored entities, have increased their efforts to require sellers of residential mortgage loans to either repurchase loans previously sold, or reimburse the purchasers for losses incurred on foreclosed loans due to actual or alleged failure to strictly conform to the purchaser s purchase criteria.

Consumers may decide not to use banks to complete their financial transactions.

Technology and other changes are allowing customers to complete financial transactions without the involvement of banks. For example, consumers can now pay bills and transfer funds directly without banks. The process of eliminating banks as intermediaries in financial transactions could result in the loss of fee income, as well as the loss of customer deposits and income generated from those deposits.

Changes to the financial services industry as a result of regulatory changes or actions, or significant litigation

The financial services industry is extensively regulated. The Corporation is subject to extensive state and federal regulation, supervision and legislation that govern almost all aspects of its operations. Laws and regulations may change from time to time and are primarily intended for the protection of consumers, depositors, and the deposit insurance funds. The impact of any changes to laws and regulations or other actions by regulatory agencies may negatively impact the Corporation or its ability to increase the value of its business. Regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the imposition of

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restrictions on the operation of an institution, the classification of assets by the institution and the adequacy of an institution s allowance for loan losses. Future regulatory changes or accounting pronouncements may increase the Corporation s regulatory capital requirements or adversely affect its regulatory capital levels. Additionally, actions by regulatory agencies or significant litigation against the Corporation could require the dedication of significant time and resources to defending its business and may lead to penalties.

Unauthorized disclosure of sensitive or confidential client or customer information, whether through a breach of computer systems or otherwise

As part of the Corporation s business, the Corporation collects and retains sensitive and confidential client and customer information on behalf of the Corporation and other third parties. Despite the security measures the Corporation has in place for its facilities and systems, and the security measures of its third party service providers, the Corporation may be vulnerable to security breaches, acts of vandalism, computer viruses, misplaced or lost data, human errors or other similar events. Any security breach involving the misappropriation, loss or other unauthorized disclosure of confidential customer information, whether by the Corporation or by its vendors, could severely damage the Corporation s reputation, expose it to the risks of litigation and liability, disrupt the Corporation s operations and have a material adverse effect on the Corporation s business.

Management s estimates and assumptions may be incorrect

The Corporation s consolidated financial statements conform with generally accepted accounting principles, which require management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements. These estimates are based on information available to management at the time the estimates are made. Actual results could differ from those estimates. For further discussion regarding significant accounting estimates, see Note 1- Nature of Operations and Summary of Significant Accounting Policies in the Notes to the Consolidated Financial Statements.

Disruption of infrastructure

The Corporation s operations depend upon its technological and physical infrastructure, including its equipment and facilities. Extended disruption of its vital infrastructure by fire, power loss, natural disaster, telecommunications failure, computer hacking and viruses, or other events outside of the Corporation s control, could affect the financial outcome of the Corporation or the financial services industry as a whole. The Corporation has developed disaster recovery plans, which provide detailed instructions covering all significant aspects of the Corporation s operations.

Increases in FDIC insurance premiums

The Corporation is unable to control the amount of premiums that it is required to pay for FDIC insurance. If there are additional bank or financial institution failures, the Corporation may be required to pay higher FDIC premiums. These announced increases have, and any future increases in FDIC insurance premiums will, materially adversely affect the Corporation s results of operations, financial condition and ability to continue to pay dividends on its common shares at the current rate.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

The Corporation s executive offices are located at 401 North Main Street, Mount Pleasant, Michigan 48858. Isabella Bank owns 25 branches and an operations center. The Corporation s facilities current, planned, and best use is for conducting its current activities, with the exception of approximately 75% of the Corporation s

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previous main office location, approximately 25% of the building that houses the Lake Isabella office, and approximately 25% of the building that houses the Corporation s mortgage processing operations which are leased to non-related parties. Management continually monitors and assesses the need for expansion and/or improvement for all facilities. In management s opinion, each facility has sufficient capacity and is in good condition.

Item 3. Legal Proceedings

The Corporation and its subsidiaries are not involved in any material pending legal proceedings. The Corporation, because of the nature of its business, is at times subject to numerous pending and threatened legal actions that arise out of the normal course of operating its business.

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Part II

Item 5. Market for Registrant s Common Equity, Related Shareholders Matters and Issuer Purchases of Equity Securities

Common Stock and Dividend Information

The Corporation s common stock is traded in the over the counter market. The common stock is quoted on the OTCQB tier of the OTC Markets Group, Inc. s electronic quotation system (www.otcmarkets.com) under the symbol ISBA . Other trades in the common stock occur in privately negotiated transactions from time to time of which the Corporation may have little or no information.

Management has reviewed the information available as to the range of reported high and low bid quotations, including high and low bid information as reported by OTC Markets and as reported by the parties to privately negotiated transactions. The following table sets forth management s compilation of that information for the periods indicated. Price information obtained from OTC Markets reflects inter dealer prices, without retail mark up, mark down or commissions and may not necessarily represent actual transactions. Price information obtained from parties to privately negotiated transactions reflects actual closing prices that were disclosed to the Corporation, which management has not independently verified. The following compiled data is provided for information purposes only and should not be viewed as indicative of the actual or market value of the Corporation s common stock.

	Number of	Sale Price	
	Shares	Low	High
2011			
First Quarter	48,909	$ 17.00	$ 19.75
Second Quarter	65,090	17.00	18.50
Third Quarter	92,953	17.41	18.95
Fourth Quarter	106,210	17.74	24.45
	313,162		
2010			
First Quarter	45,695	$ 16.75	$ 19.00
Second Quarter	64,290	17.00	18.50
Third Quarter	53,897	16.05	17.99
Fourth Quarter	56,534	16.57	18.30
	220,416		

The following table sets forth the cash dividends paid for the following quarters:

	Per Share	
	2011	2010
First Quarter	$ 0.19	$ 0.18
Second Quarter	0.19	0.18
Third Quarter	0.19	0.18
Fourth Quarter	0.19	0.18
Total	**$ 0.76**	**$ 0.72**

Isabella Bank Corporation s authorized common stock consists of 15,000,000 shares, of which 7,589,226 shares are issued and outstanding as of December 31, 2011. As of that date, there were 3,043 shareholders of record.

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The Board of Directors has authorized 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 revert back to the status of authorized, but unissued shares.

The following table provides information for the three month period ended December 31, 2011, 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, September 30, 2011				62,729
October 1 - 31, 2011	7,934	$ 18.78	7,934	54,795
November 1 - 30, 2011	1,481	19.58	1,481	53,314
December 1 - 31, 2011	34,318	18.50	34,318	18,996
Balance, December 31, 2011	**43,733**	**$ 18.59**	**43,733**	**18,996**

Information concerning Securities Authorized for Issuance Under Equity Compensation Plans appears under Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters included elsewhere in this annual report on Form 10-K.

Stock Performance

The following graph compares the cumulative total shareholder return on Corporation common stock for the last five years with the cumulative total return on (1) the NASDAQ Stock Market Index (NASDAQ), which is comprised of all United States common shares traded on the NASDAQ and (2) the NASDAQ Bank Stock Index (NASDAQ Banks), which is comprised of bank and bank holding company common shares traded on the NASDAQ over the same period. The graph assumes the value of an investment in the Corporation and each index was $100 at December 31, 2006 and all dividends are reinvested.

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The dollar values for total shareholder return plotted in the graph above are shown in the table below:

Comparison of Five Year Cumulative

Among Isabella Bank Corporation, NASDAQ Stock Market,

and NASDAQ Bank Stock

Year	Isabella Bank Corporation	NASDAQ	NASDAQ Banks
12/31/2006	100.0	100.0	100.0
12/31/2007	101.6	110.6	80.4
12/31/2008	66.1	66.6	63.3
12/31/2009	51.0	96.6	52.9
12/31/2010	48.5	114.0	60.4
12/31/2011	69.1	113.1	54.0

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Item 6. Selected Financial Data

RESULTS OF OPERATIONS

SUMMARY OF SELECTED FINANCIAL DATA

(Dollars in thousands except per share data)

	2011	2010	2009	2008	2007
INCOME STATEMENT DATA					
Total interest income	$ 57,905	$ 57,217	$ 58,105	$ 61,385	$ 53,972
Net interest income	41,702	40,013	38,266	35,779	28,013
Provision for loan losses	3,826	4,857	6,093	9,500	1,211
Net income	10,210	9,045	7,800	4,101	7,930
BALANCE SHEET DATA					
End of year assets	$ 1,337,925	$ 1,225,810	$ 1,143,944	$ 1,139,263	$ 957,282
Daily average assets	1,287,195	1,182,930	1,127,634	1,113,102	925,631
Daily average deposits	927,186	840,392	786,714	817,041	727,762
Daily average loans/net	730,919	712,272	712,965	708,434	596,739
Daily average equity	145,725	139,855	139,810	143,626	119,246
PER SHARE DATA					
Earnings per share					
Basic	$ 1.35	$ 1.20	$ 1.04	$ 0.55	$ 1.14
Diluted	1.31	1.17	1.01	0.53	1.11
Cash dividends	0.76	0.72	0.70	0.65	0.62
Book value (at year end)	20.40	19.23	18.69	17.89	17.58
FINANCIAL RATIOS					
Shareholders equity to assets (at year end)	11.57%	11.84%	12.31%	11.80%	12.86%
Return on average equity	7.01	6.47	5.58	2.86	6.65
Return on average tangible equity	10.30	9.55	8.53	4.41	8.54
Cash dividend payout to net income	56.51	59.93	67.40	118.82	54.27
Return on average assets	0.79	0.76	0.69	0.37	0.86

	2011				2010			
	4th	3rd	2nd	1st	4th	3rd	2nd	1st
Quarterly Operating Results:								
Total interest income	$ 14,466	$ 14,532	$ 14,669	$ 14,238	$ 14,540	$ 14,306	$ 14,272	$ 14,099
Interest expense	3,979	4,070	4,101	4,053	4,217	4,296	4,291	4,400
Net interest income	10,487	10,462	10,568	10,185	10,323	10,010	9,981	9,699
Provision for loan losses	1,443	963	603	817	1,626	968	1,056	1,207
Noninterest income	2,433	1,859	1,978	1,948	2,629	2,634	1,870	2,167
Noninterest expenses	8,651	8,513	8,779	8,587	8,558	8,620	8,275	8,354
Net income	2,711	2,511	2,672	2,316	2,318	2,553	2,151	2,023
Per Share of Common Stock:								
Earnings per share								
Basic	$ 0.36	$ 0.33	$ 0.35	$ 0.31	$ 0.30	$ 0.34	$ 0.29	$ 0.27
Diluted	0.35	0.32	0.34	0.30	0.30	0.33	0.28	0.26
Cash dividends	0.19	0.19	0.19	0.19	0.18	0.18	0.18	0.18
Book value (at quarter end)	20.40	20.53	20.00	19.52	19.23	19.59	19.39	18.89

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Item 7. 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 consolidated financial statements and statistical data included elsewhere in the Annual Report.

Executive Summary

Isabella Bank Corporation, as well as all other financial institutions in Michigan and across the entire country, continues to experience the negative impacts on its operations from the persistent weak economy. The current economic environment has led to historically high levels of loans charged off and foreclosed asset and collection expenses.

In spite of the economic downturn that has occurred over the past few years, the Corporation continues to be profitable, with net income of $10,210 for the year ended December 31, 2011. Not only has the Corporation remained profitable, its loan quality also compares well to its peers as its ratio of nonperforming loans to total loans was 0.95% as of December 31, 2011 compared to 3.26% for all bank holding companies in the Corporation s peer group as of September 30, 2011 (December 31, 2011 peer group ratios are not yet available). The Corporation s interest margins also continue to be strong, as the net yield on interest earning assets (on a fully taxable equivalent basis) was 3.87% for the year ended December 31, 2011.

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.

The Dodd-Frank Act is very broad and complex legislation that puts in place a sweeping new financial services framework that is likely to have significant regulatory and legal consequences and will likely impact the Corporation s future operating results. Implementation of the Act will require compliance with numerous new regulations, which will increase compliance and documentation costs. For more information, see the summary of the Dodd-Frank Act under the heading Supervision and Regulation in Item 1, on page 5.

Other

The Corporation has not received any notices of regulatory actions as of February 16, 2012.

CRITICAL ACCOUNTING POLICIES:

The Corporation s significant accounting policies are set forth in Note 1 of the Consolidated Financial Statements. 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.

Due to the limited trading of certain auction rate money market preferred securities and preferred stocks during 2010, the Corporation utilized a discounted cash flow analysis to determine fair values on December 31, 2010. This analysis considered the creditworthiness of the counterparty, the timing of expected future cash flows, the current volume of trading activity, and recent trade prices. The discount rates used were determined by using the interest rates of similarly rated financial institution debt based on the weighted average of a range of terms for corporate bond interest rates, which were obtained from published sources and ranged from 3.90% to 6.90% as of December 31, 2010. During 2011, the markets for these securities have normalized and established regular trading patterns. As such, the Corporation determined the fair value for these securities based on quoted prices for identical securities, or based on quoted prices for similar securities as of December 31, 2011.

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DISTRIBUTION OF ASSETS, LIABILITIES, AND SHAREHOLDERS EQUITY

INTEREST RATE AND INTEREST DIFFERENTIAL

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 for the last three years. These schedules also presents an analysis of interest income and interest expense for the periods indicated. All interest income is reported on a fully taxable equivalent (FTE) basis using a 34% federal income tax rate. Nonaccruing loans, for the purpose of the following computations, are included in the average loan amounts outstanding. Federal Reserve and Federal Home Loan Bank stock holdings which are restricted are included in accrued income and other assets.

	Year Ended December 31								
	2011			2010			2009		
	Average Balance	Tax Equivalent Interest	Average Yield / Rate	Average Balance	Tax Equivalent Interest	Average Yield / Rate	Average Balance	Tax Equivalent Interest	Average Yield / Rate
INTEREST EARNING ASSETS									
Loans	$ 743,441	$ 45,463	6.12%	$ 725,534	$ 46,794	6.45%	$ 725,299	$ 47,706	6.58%
Taxable investment securities	235,437	6,941	2.95%	160,514	5,271	3.28%	119,063	4,712	3.96%
Nontaxable investment securities	136,356	7,847	5.75%	120,999	7,095	5.86%	121,676	7,217	5.93%
Trading account securities	5,087	286	5.62%	8,097	436	5.38%	17,279	856	4.95%
Federal funds sold							842	1	0.12%
Other	37,539	506	1.35%	45,509	479	1.05%	27,433	376	1.37%
Total earning assets	1,157,860	61,043	5.27%	1,060,653	60,075	5.66%	1,011,592	60,868	6.02%
NONEARNING ASSETS									
Allowance for loan losses	(12,522)			(13,262)			(12,334)		
Cash and demand deposits due from banks	20,195			18,070			18,190		
Premises and equipment	24,397			24,624			23,810		
Accrued income and other assets	97,265			92,845			86,376		
Total assets	$ 1,287,195			$ 1,182,930			$ 1,127,634		
INTEREST BEARING LIABILITIES									
Interest bearing demand deposits	$ 152,530	189	0.12%	$ 137,109	151	0.11%	$ 116,412	146	0.13%
Savings deposits	192,999	488	0.25%	169,579	391	0.23%	177,538	399	0.22%
Time deposits	467,931	10,258	2.19%	430,892	10,988	2.55%	398,356	13,043	3.27%
Borrowed funds	198,828	5,268	2.65%	188,512	5,674	3.01%	193,922	6,251	3.22%
Total interest bearing liabilities	1,012,288	16,203	1.60%	926,092	17,204	1.86%	886,228	19,839	2.24%
NONINTEREST BEARING LIABILITIES									
Demand deposits	113,726			102,812			94,408		
Other	15,456			14,171			7,188		
Shareholders equity	145,725			139,855			139,810		
Total liabilities and shareholders equity	$ 1,287,195			$ 1,182,930			$ 1,127,634		

Net interest income (FTE)	$ 44,840	$ 42,871	$ 41,029
Net yield on interest earning assets (FTE)	3.87%	4.04%	4.06%

Net Interest Income

The Corporation derives the majority of its gross income from interest earned on loans and investments, while its most significant expense is the interest cost incurred for funds used. Net interest income is the amount by which interest income on earning assets exceeds the interest cost of deposits and borrowings. Net interest income is influenced by changes in the balance and mix of assets and liabilities and market interest rates. Management exerts some control over these factors; however, Federal Reserve monetary policy and competition have a significant impact. Interest income includes loan fees of $2,385 in 2011, $2,196 in 2010, and $1,963 in 2009. For analytical purposes, net interest income is adjusted to a taxable equivalent basis by adding the income tax savings from interest on tax exempt loans and securities, thus making year to year comparisons more meaningful.

VOLUME AND RATE VARIANCE ANALYSIS

The following table details the dollar amount of changes in FTE net interest income for each major category of interest earning assets and interest bearing liabilities and the amount of change attributable to changes in average balances (volume) or average rates. 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.

	2011 Compared to 2010 Increase (Decrease) Due to			2010 Compared to 2009 Increase (Decrease) Due to		
	Volume	Rate	Net	Volume	Rate	Net
CHANGES IN INTEREST INCOME:						
Loans	$ 1,136	$ (2,467)	$ (1,331)	$ 15	$ (927)	$ (912)
Taxable investment securities	2,254	(584)	1,670	1,453	(894)	559
Nontaxable investment securities	886	(134)	752	(40)	(82)	(122)
Trading account securities	(168)	18	(150)	(489)	69	(420)
Federal funds sold				(1)		(1)
Other	(93)	120	27	205	(102)	103
Total changes in interest income	4,015	(3,047)	968	1,143	(1,936)	(793)
CHANGES IN INTEREST EXPENSE:						
Interest bearing demand deposits	18	20	38	24	(19)	5
Savings deposits	57	40	97	(18)	10	(8)
Time deposits	894	(1,624)	(730)	1,002	(3,057)	(2,055)
Borrowed funds	299	(705)	(406)	(171)	(406)	(577)
Total changes in interest expense	1,268	(2,269)	(1,001)	837	(3,472)	(2,635)
Net change in interest margin (FTE)	$ 2,747	$ (778)	$ 1,969	$ 306	$ 1,536	$ 1,842

During 2011, average interest earning assets increased by $97,207. This increase resulted in $4,015 of additional interest income which exceeded the $3,047 decrease in interest income caused by declines in interest rates. Interest bearing liabilities increased $86,196 at a cost of $1,268 while the decline in rates, mostly those on time deposits and borrowed funds, decreased interest expense by $2,269. The diminished interest income earned on assets resulted in a 0.17% decline in the net interest yield. Management anticipates that net interest margin yield will decline slightly during 2012 due to the following factors:

Based on the current economic conditions, management does not anticipate any changes in the target Fed funds rate in the foreseeable future. As such, changes in market rates may be unlikely. However, it is likely that the Corporation may see declines in the rates earned on interest earning assets as the interest rates on many types of loans including home equity lines of credit, residential balloon mortgages, variable rate commercial lines of credit, and investment securities with acceptable credit and interest rate risk are currently priced at or below the Corporation s current net yield on interest earning assets. Most of the potential declines would arise out of the Corporation s investment portfolio as the majority of securities that are called or mature in 2012 will be

reinvested at significantly lower rates.

Interest rates on residential mortgage loans remain at or near historical lows. This rate environment has led to strong consumer demand for fixed rate mortgage products which are generally sold to the secondary market. As a result, there has been a significant decline in balloon mortgages, which are held on the Corporation s consolidated balance sheet. As these balloon mortgages have paid off, the proceeds from these loans have been reinvested (typically in the form of available-for-sale investment securities) at lower interest rates which has adversely impacted interest income.

While the Corporation s liability sensitive balance sheet has allowed it to benefit from decreases in interest rates, it also makes the Corporation sensitive to increases in deposit and borrowing rates. As part of the Corporation s goal to minimize the potential negative impacts of possible increases in future interest rates, management has been, and continues to be, actively working to lengthen the terms of its interest bearing liabilities. This lengthening has increased the Corporation s cost of funding, reducing net interest income in the short term.

Allowance for Loan Losses

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 allowance for loan losses is management s estimation of probable losses inherent in the existing loan portfolio. Factors used to evaluate the loan portfolio, and thus to determine the current charge to expense, include recent loan loss history, financial condition of borrowers, amount of nonperforming and impaired loans, overall economic conditions and other factors. The following schedule summarizes the Corporation s chargeoff and recovery activity for the years ended December 31:

	2011	2010	2009	2008	2007
Allowance for loan losses - January 1	$ 12,373	$ 12,979	$ 11,982	$ 7,301	$ 7,605
Allowance of acquired bank				822	
Loans charged off					
Commercial and agricultural	1,984	3,731	3,081	2,137	905
Real estate mortgage	2,240	2,524	2,627	3,334	659
Consumer	552	596	934	854	582
Total loans charged off	**4,776**	**6,851**	**6,642**	**6,325**	**2,146**
Recoveries					
Commercial and agricultural	461	453	623	160	297
Real estate mortgage	177	638	546	240	49
Consumer	314	297	377	284	285
Total recoveries	**952**	**1,388**	**1,546**	**684**	**631**
Net loans charged off	3,824	5,463	5,096	5,641	1,515
Provision charged to income	3,826	4,857	6,093	9,500	1,211
Allowance for loan losses - December 31	**$ 12,375**	**$ 12,373**	**$ 12,979**	**$ 11,982**	**$ 7,301**
Year to date average loans	**$ 743,441**	**$ 725,534**	**$ 725,299**	**$ 717,040**	**$ 604,342**
Net loans charged off to average loans outstanding	**0.51%**	**0.75%**	**0.70%**	**0.79%**	**0.25%**
Total amount of loans outstanding	**$ 750,291**	**$ 735,304**	**$ 723,316**	**$ 735,385**	**$ 612,687**
Allowance for loan losses as a % of loans	**1.65%**	**1.68%**	**1.79%**	**1.63%**	**1.19%**

The Corporation originates and sells fixed rate residential real estate mortgages 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.

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As shown in the preceding table, when comparing 2011 to 2010, net loans charged off decreased by $1,639. This improvement allowed the Corporation to reduce its provision for loan losses. While there have been marked improvements in the level of net loans charged off, which has contributed to the Corporation s ability to reduce its provision for loan losses, the overall local, regional and national economies have yet to show consistent improvement.

The Corporation allocates the allowance 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 allowance for loan losses is not allocated to any one loan segment, but is instead a reflection of other qualitative risks within the Corporation s loan portfolio.

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 consolidated financial statements.

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 December 31:

	Total Past Due and Nonaccrual				
	2011	2010	2009	2008	2007
Commercial and agricultural	$ 7,420	$ 9,606	$ 8,839	$ 13,958	$ 8,746
Residential mortgage	5,297	8,119	10,296	12,418	8,357
Consumer installment	186	309	460	956	617
	$ 12,903	$ 18,034	$ 19,595	$ 27,332	$ 17,720

	2011			
	Accruing Loans Past Due			
	30-89 Days	90 Days or More	Nonaccrual	Total Past Due and Nonaccrual
Commercial and agricultural	$ 2,149	$ 466	$ 4,805	$ 7,420
Residential mortgage	3,424	289	1,584	5,297
Consumer installment	181	5		186
	$ 5,754	$ 760	$ 6,389	$ 12,903

	2010			
	Accruing Loans Past Due			
	30-89 Days	90 Days or More	Nonaccrual	Total Past Due and Nonaccrual
Commercial and agricultural	$ 5,291	$ 175	$ 4,140	$ 9,606
Residential mortgage	6,339	310	1,470	8,119
Consumer installment	308	1		309

$ 11,938	$ 486	$ 5,610	$ 18,034

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Troubled Debt Restructurings

The following table summarizes the Corporation s troubled debt restructurings as of December 31:

	2011			2010			2009			2008			2007
	Accruing Interest	Non-accrual	Total	Accruing Interest	Non-accrual	Total	Accruing Interest	Non-accrual	Total	Accruing Interest	Non-accrual	Total	Accruing Interest
Current	$ 16,125	$ 514	$ 16,639	$ 4,798	$ 499	$ 5,297	$ 2,754	$ 786	$ 3,540	$ 2,297	$ 1,355	$ 3,652	$ 517
Past due 30-89 days	1,614	429	2,043	277	26	303	107	904	1,011	268		268	115
Past due 90 days or more		74	74		163	163		426	426		630	630	53
Total	**$ 17,739**	**$ 1,017**	**$ 18,756**	**$ 5,075**	**$ 688**	**$ 5,763**	**$ 2,861**	**$ 2,116**	**$ 4,977**	**$ 2,565**	**$ 1,985**	**$ 4,550**	**$ 685**

The Corporation had no troubled debt restructurings in nonaccrual status as of December 31, 2007.

As a result of adopting the amendments in ASU No. 2011-02, the Corporation reassessed all loan restructurings that occurred on or after January 1, 2011 for identification as troubled debt restructurings (TDR s). The Corporation identified as TDR s certain loans for which the allowance for loan losses had previously been measured under a general allowance for loan losses methodology. Upon identifying those loans as TDR s, the Corporation identified them as impaired. The amendments in ASU No. 2011-02 require prospective application of the impairment measurement guidance for those loans newly identified as impaired. The Corporation s recorded investment in loans for which the allowance for credit losses was previously measured under a general allowance for credit losses methodology and are now impaired was $5,136, with a specific valuation allowance of $1,022 as of December 31, 2011.

The Corporation has taken aggressive actions 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. 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 TDR s when the modification results in terms outside of normal lending practices 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).

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The following tables summarize concessions granted by the Corporation to borrowers experiencing financial difficulties in the year ended December 31:

	2011			
	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				
Commercial real estate	1	$ 408		$
Commercial other	38	9,932	4	2,643
Total commercial	39	10,340	4	2,643
Agricultural other	8	1,321		
Residential mortgage				
Senior liens	19	2,161	17	1,754
Consumer				
Secured	6	65	1	4
Unsecured			2	20
Total consumer	6	65	3	24
Total	**72**	**$ 13,887**	**24**	**$ 4,421**

The Corporation did not restructure any loans through the forbearance of principal or accrued interest during 2011.

The Corporation has been successful in its efforts to restructure loans to reduce foreclosures. Of the 163 troubled debt restructurings granted since December 31, 2008, only 6 have defaulted.

Nonperforming Assets

The following table summarizes the Corporation s nonperforming assets as of December 31:

	2011	2010	2009	2008	2007
Nonaccrual loans	$ 6,389	$ 5,610	$ 8,522	$ 11,175	$ 4,156
Accruing loans past due 90 days or more	760	486	768	1,251	1,727
Total nonperforming loans	**7,149**	**6,096**	**9,290**	**12,426**	**5,883**
Other real estate owned	1,867	2,039	1,141	2,770	1,376
Repossessed assets	9	28	16	153	
Total nonperforming assets	**$ 9,025**	**$ 8,163**	**$ 10,447**	**$ 15,349**	**$ 7,259**
Nonperforming loans as a % of total loans	**0.95%**	**0.83%**	**1.28%**	**1.69%**	**0.96%**

Nonperforming assets as a % of total assets	**0.67%**	**0.67%**	**0.91%**	**1.35%**	**0.76%**

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 downs 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 December 31:

	2011	2010	2009	2008	2007
Commercial and agricultural	$ 4,805	$ 4,140	$ 5,810	$ 8,059	$ 1,959
Residential mortgage	1,584	1,470	2,657	3,092	2,185
Consumer installment			55	24	12
	$ 6,389	$ 5,610	$ 8,522	$ 11,175	$ 4,156

Included in nonaccrual commercial and agricultural loans was one loan with a balance of $1,900 as of December 31, 2011 and $2,679 as of December 31, 2010. As of 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, while there was a specific allocation established in the amount of $345 as of December 31, 2010. Nonaccrual commercial and agricultural loans also included one loan with a balance of $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. Commercial and agricultural nonaccrual loans included one credit with a balance of $1,800 as of December 31, 2009 which was subsequently transferred to other real estate owned in the third quarter of 2010. There were no other individually significant credits included in nonaccrual loans as of December 31, 2011, 2010, 2009, 2008, or 2007.

Included in the nonaccrual loan balances above were credits currently classified as restructured loans as of December 31:

	2011	2010	2009	2008
Commercial and agricultural	$ 520	$ 115	$ 1,692	$ 1,985
Residential mortgage	497	573	424	
	$ 1,017	$ 688	$ 2,116	$ 1,985

The Corporation had no restructured loans in nonaccrual status as of December 31, 2007.

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 charge off. 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 write downs of loans in foreclosure and 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 December 31, 2011. Management will continue to closely monitor its overall credit quality to ensure that the allowance for loan losses remains appropriate.

Noninterest Income

The following table shows the changes in noninterest income between the years ended December 31:

	2011	2010	Change $	Change %	2009	Change $	Change %
Service charges and fees							
NSF and overdraft fees	$ 2,500	$ 2,809	$ (309)	-11.0%	$ 3,187	$ (378)	-11.9%
ATM and debit card fees	1,736	1,492	244	16.4%	1,218	274	22.5%
Trust fees	979	896	83	9.3%	814	82	10.1%
Mortgage servicing fees	732	760	(28)	-3.7%	724	36	5.0%
Service charges on deposit accounts	324	333	(9)	-2.7%	344	(11)	-3.2%
Net originated mortgage servicing rights (loss) income	(293)	47	(340)	N/M	514	(467)	-90.9%
All other	140	143	(3)	-2.1%	112	31	27.7%
Total service charges and fees	**6,118**	**6,480**	**(362)**	**-5.6%**	**6,913**	**(433)**	**-6.3%**
Gain on sale of mortgage loans	**538**	**610**	**(72)**	**-11.8%**	**886**	**(276)**	**-31.2%**
Net (loss) gain on trading securities	**(78)**	**(94)**	**16**	**17.0%**	**80**	**(174)**	**N/M**
Net gain on borrowings measured at fair value	**181**	**227**	**(46)**	**-20.3%**	**289**	**(62)**	**-21.5%**
Gain on sale of available-for-sale investment securities	**3**	**348**	**(345)**	**-99.1%**	**648**	**(300)**	**-46.3%**
Other							
Earnings on corporate owned life insurance policies	609	663	(54)	-8.1%	641	22	3.4%
Brokerage and advisory fees	545	573	(28)	-4.9%	521	52	10.0%
Corporate Settlement Solutions joint venture	(182)	11	(193)	N/M	(122)	133	N/M
All other	484	482	2	0.4%	300	182	60.7%
Total other	**1,456**	**1,729**	**(273)**	**-15.8%**	**1,340**	**389**	**29.0%**
Total noninterest income	**$ 8,218**	**$ 9,300**	**$ (1,082)**	**-11.6%**	**$ 10,156**	**$ (856)**	**-8.4%**

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. NSF and overdraft fees have been steadily declining over the past two years, with the decline accelerating in the third quarter of 2010 as a result of new regulatory guidance issued by the Federal Reserve Bank. The Corporation anticipates that NSF and overdraft fees will approximate current levels in 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, these fees are expected to continue to increase as the usage of debit cards increases.

Trust fees have increased primarily due to increases in the size of the managed portfolio. As management anticipates continued growth in trust services, it anticipates trust fees to continue to increase in 2012.

Net originated mortgage servicing rights (OMSR) represent the fair value of servicing rights of loans sold to the secondary market, with changes in the fair value recorded in earnings. Changes in the fair value of OMSR are primarily driven by fluctuations in the

balance of loans sold to the secondary market and by offering rates on new residential mortgages. The losses incurred in 2011 were a result of historically low interest rates which increases the likelihood of refinancing activity, thus reducing the value of OMSR.

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As a result of lower than normal residential mortgage rates, the Corporation experienced increases in the volume of loans sold to the secondary market during 2009, leading to a corresponding increase in gains from the sale of mortgage loans in 2009. As the demand for new mortgages declined in 2010 and 2011, so did the gain from the sale of mortgage loans. The Corporation anticipates that the gain on sale of mortgages will remain at the current levels in 2012.

Fluctuations in the gains and losses related to trading securities and borrowings carried at fair value are caused by interest rate variances. Management does not anticipate any significant fluctuations in net trading activities in 2012 as significant interest rate changes are not expected.

The Corporation continually analyzes its available-for-sale investment portfolio for advantageous selling opportunities.

The Corporation s earnings from its joint venture in Corporate Settlement Solutions (a title insurance agency) have been negatively impacted by expenses incurred to enhance the services offered as well as expand their market area.

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

Noninterest Expenses

The following table shows the changes in noninterest expenses between the years ended December 31:

			Change			Change	
	2011	2010	$	%	2009	$	%
Compensation and benefits							
Leased employee salaries	$ 14,377	$ 13,697	$ 680	5.0%	$ 13,494	$ 203	1.5%
Leased employee benefits	4,902	4,837	65	1.3%	4,745	92	1.9%
All other	13	18	(5)	-27.8%	19	(1)	-5.3%
Total compensation and benefits	**19,292**	**18,552**	**740**	**4.0%**	**18,258**	**294**	**1.6%**
Occupancy							
Property taxes	470	505	(35)	-6.9%	439	66	15.0%
Utilities	462	423	39	9.2%	393	30	7.6%
Outside services	587	524	63	12.0%	433	91	21.0%
Depreciation	605	584	21	3.6%	546	38	7.0%
Building repairs	262	243	19	7.8%	288	(45)	-15.6%
All other	84	72	12	16.7%	71	1	1.4%
Total occupancy	**2,470**	**2,351**	**119**	**5.1%**	**2,170**	**181**	**8.3%**
Furniture and equipment							
Depreciation	1,916	1,938	(22)	-1.1%	1,803	135	7.5%
Computer / service contracts	1,898	1,779	119	6.7%	1,676	103	6.1%
ATM and debit card fees	629	595	34	5.7%	621	(26)	-4.2%
All other	54	32	22	68.8%	46	(14)	-30.4%
Total furniture and equipment	**4,497**	**4,344**	**153**	**3.5%**	**4,146**	**198**	**4.8%**
FDIC insurance premiums	**1,086**	**1,254**	**(168)**	**-13.4%**	**1,730**	**(476)**	**-27.5%**

Other							
Marketing and community relations	1,174	1,093	81	7.4%	894	199	22.3%
Foreclosed asset and collection	576	916	(340)	-37.1%	831	85	10.2%
Legal fees	302	382	(80)	-20.9%	415	(33)	-8.0%
Audit and SOX compliance fees	714	710	4	0.6%	546	164	30.0%
Consulting fees	386	167	219	131.1%	201	(34)	-16.9%
Directors fees	842	887	(45)	-5.1%	923	(36)	-3.9%
Amortization of deposit premium	299	338	(39)	-11.5%	375	(37)	-9.9%
Education and travel	526	499	27	5.4%	395	104	26.3%
Postage and freight	388	395	(7)	-1.8%	472	(77)	-16.3%
Printing and supplies	405	420	(15)	-3.6%	529	(109)	-20.6%
All other	1,573	1,499	74	4.9%	1,798	(299)	-16.6%
Total other	**7,185**	**7,306**	**(121)**	**-1.7%**	**7,379**	**(73)**	**-1.0%**
Total noninterest expenses	**$ 34,530**	**$ 33,807**	**$ 723**	**2.1%**	**$ 33,683**	**$ 124**	**0.4%**

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Significant changes in noninterest expenses are detailed below:

Leased employee salaries increased during 2011 due to annual merit increases and staff additions. These staff additions have allowed the Corporation to continue to grow as well as to comply with new regulations, including the Dodd-Frank Act. Leased employee benefits fluctuate from period to period primarily as a result of changes in health care related expenses. The Corporation anticipates adding to staffing levels in 2012 to ensure compliance with new regulations set forth in the Dodd-Frank Act, which is estimated to increase salary and benefits by $331.

FDIC insurance premium expense decreased in 2011 due to changes to the assessment rates on April 1, 2011. Premiums declined between 2009 and 2010 as a result of an FDIC special assessment of $479 in September 2009. Management expects FDIC insurance premiums to decline slightly in 2012 due to the changes in assessment rates.

The increase in marketing and community relations in 2011 was primarily the result of a new initiative to track customer service satisfaction as well as the enhancement of the Corporation s website. The increase in marketing and community relations expenses in 2010 was primarily related to an increase in charitable contributions. Charitable contributions were essentially unchanged between 2010 and 2011 with no significant changes expected in 2012.

While foreclosed asset and collection expenses remain at historically high levels, they have declined significantly from 2010. Management anticipates that these expenses will approximate current levels in 2012.

The Corporation s legal expenses can fluctuate from period to period based on the volume of foreclosures as well as expenses related to the Corporation s ongoing operations, including regulatory compliance. The Corporation does not anticipate any significant fluctuations in legal expenses in 2012.

Audit and SOX compliance fees fluctuate due to the timing of the performance of recurring audit procedures.

Director fees declined in 2011 due to the retirement of several directors. Director fees are expected to approximate current levels in 2012.

The Corporation places a strong emphasis on customer service. To help enhance customer service satisfaction, the Corporation has made a significant investment in various training programs. These programs coupled with the customer service tracking initiative (noted above) will increase service levels which will increase shareholder value. Management expects that education related expenses to remain at current levels in 2012.

Postage and freight expenses have declined, and are expected to continue to decline, as a result of fewer special mailings as well as an increase in the Corporation s customer s usage of electronic statements.

Printing and supplies expenses have steadily declined since 2009 as the Corporation has instituted a document imaging solution decreasing the amount of paper and related supplies. Management anticipates this trend to continue in 2012.

The increase in consulting fees is due to succession planning for key executives to help the Board of Directors and management identify, attract, and retain future leaders.

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

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ANALYSIS OF CHANGES IN FINANCIAL CONDITION

The following table shows the composition and changes in the Corporation s balance sheet as of December 31:

	2011	2010	Change $	Change %
ASSETS				
Cash and cash equivalents	$ 28,590	$ 18,109	$ 10,481	57.88%
Certificates of deposit held in other financial institutions	8,924	15,808	(6,884)	-43.55%
Trading securities	4,710	5,837	(1,127)	-19.31%
Available-for-sale securities	425,120	330,724	94,396	28.54%
Mortgage loans available-for-sale	3,205	1,182	2,023	171.15%
Loans	750,291	735,304	14,987	2.04%
Allowance for loan losses	(12,375)	(12,373)	(2)	0.02%
Premises and equipment	24,626	24,627	(1)	0.00%
Corporate owned life insurance	22,075	17,466	4,609	26.39%
Accrued interest receivable	5,848	5,456	392	7.18%
Equity securities without readily determinable fair values	17,189	17,564	(375)	-2.14%
Goodwill and other intangible assets	46,792	47,091	(299)	-0.63%
Other assets	12,930	19,015	(6,085)	-32.00%
TOTAL ASSETS	**$ 1,337,925**	**$ 1,225,810**	**$ 112,115**	**9.15%**
LIABILITIES AND SHAREHOLDERS EQUITY				
Liabilities				
Deposits	$ 958,164	$ 877,339	$ 80,825	9.21%
Borrowed funds	216,136	194,917	21,219	10.89%
Accrued interest payable and other liabilities	8,842	8,393	449	5.35%
Total liabilities	**1,183,142**	**1,080,649**	**102,493**	**9.48%**
Shareholders equity	**154,783**	**145,161**	**9,622**	**6.63%**
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	**$ 1,337,925**	**$ 1,225,810**	**$ 112,115**	**9.15%**

As shown above, the Corporation enjoyed strong balance sheet growth since December 31, 2010. The primary driver behind this growth was excellent demand for deposit products. As loan demand did not keep pace with the increase in deposits, the Corporation increased its holdings in available-for-sale investment securities.

A discussion of changes in balance sheet amounts by major categories follows:

Certificates of deposit held in other financial institutions

During 2011, the Corporation reinvested maturities of certificates of deposit held in other financial institutions into available-for-sale investment securities to increase net interest margins (as the yields on available-for-sale investment securities exceeded the potential reinvestment rates for certificates of deposits held in other financial institutions during the year). This trend is likely to continue in 2012.

Trading securities

Trading securities are carried at fair value. The Corporation s overall intent is to maintain a trading portfolio to enhance the ongoing restructuring of assets and liabilities as part of our interest rate risk management objectives (See Note 4 Trading Securities of the Consolidated Financial Statements). Due to the current interest rate environment, the Corporation has allowed this balance to decline.

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The following is a schedule of the carrying value of trading securities as of December 31:

	2011	2010	2009
States and political subdivisions	$ 4,710	$ 5,837	$ 9,962
Mortgage-backed			3,601
Total	$ 4,710	$ 5,837	$ 13,563

Available-for-sale investment securities

The primary objective of the Corporation s investing activities is to provide for safety of the principal invested. Secondary considerations include the need for earnings, liquidity, and the Corporation s overall exposure to changes in interest rates. Securities currently classified as available-for-sale are stated at fair value.

The following is a schedule of the carrying value of investment securities available-for-sale as of December 31:

	2011	2010	2009
Government sponsored enterprises	$ 397	$ 5,404	$ 19,471
States and political subdivisions	174,938	169,717	151,730
Auction rate money market preferred	2,049	2,865	2,973
Preferred stocks	5,033	6,936	7,054
Mortgage-backed securities	143,602	102,215	67,734
Collateralized mortgage obligations	99,101	43,587	10,104
Total	$ 425,120	$ 330,724	$ 259,066

Excluding those holdings in government sponsored enterprises and municipalities within the state of Michigan, there were no investments in securities of any one issuer that exceeded 10% of shareholders equity. The Corporation has a policy prohibiting investments in securities that it deems are unsuitable due to their inherent credit or market risks. Prohibited investments include stripped mortgage backed securities, zero coupon bonds, nongovernment agency asset backed securities, and structured notes. The Corporation s holdings in mortgage-backed securities and collateralized mortgage obligations include only government agencies and government sponsored agencies as the Corporation holds no investments in private label mortgage-backed securities or collateralized mortgage obligations.

The following is a schedule of maturities of available-for-sale investment securities (at fair value) and their weighted average yield as of December 31, 2011. Weighted average yields have been computed on a fully taxable-equivalent basis using a tax rate of 34%. Auction rate money market preferred securities are long term floating rate instruments for which interest rates are set at periodic auctions. At each successful auction, the Corporation has the option to sell the security at par value. Additionally, the issuers of auction rate securities generally have the right to redeem or refinance the debt. Because of their variable monthly payments, auction rate money market preferreds, preferred stocks, mortgage-backed securities, and collateralized mortgage obligations are not reported by a specific maturity group. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

	Maturing									
	Within One Year		After One Year But Within Five Years		After Five Years But Within Ten Years		After Ten Years		Securities with Variable Monthly Payments or Continual Call Dates	
	Amount	Yield (%)	Amount	Yield (%)	Amount	Yield (%)	Amount	Yield (%)	Amount	Yield (%)
Government sponsored enterprises	$		$		$ 397	7.91	$		$	
States and political subdivisions	8,441	3.24	35,904	4.12	93,189	3.87	37,404	2.84		
Mortgage-backed securities			271	5.68	73,974	1.91	69,357	1.97		
Collateralized mortgage obligations									99,101	2.76
Auction rate money market preferred									2,049	4.92
Preferred stocks									5,033	4.30
Total	**$ 8,441**	**3.24**	**$ 36,175**	**4.13**	**$ 167,560**	**3.01**	**$ 106,761**	**2.28**	**$ 106,183**	**2.88**

Loans

The largest component of earning assets is loans. The proper management of credit and market risk inherent in the loan portfolio is critical to the financial well-being of the Corporation. To control these risks, the Corporation has adopted strict underwriting standards. These standards include specific criteria against lending outside the Corporation s defined market areas, lending limits to a single borrower, and strict loan to collateral value limits. The Corporation also monitors and limits loan concentrations extended to distressed industries. The Corporation has no foreign loans and there were no concentrations greater than 10% of total loans that are not disclosed as a separate category in the following table.

The following table presents the composition of the loan portfolio for the years ended December 31:

	2011	2010	2009	2008	2007
Commercial	$ 365,714	$ 348,852	$ 340,274	$ 324,806	$ 238,306
Agricultural	74,645	71,446	64,845	58,003	47,407
Residential real estate mortgage	278,360	284,029	285,838	319,397	297,937
Installment	31,572	30,977	32,359	33,179	29,037
	$ 750,291	$ 735,304	$ 723,316	$ 735,385	$ 612,687

The following table presents the change in the loan categories for the years ended December 31:

	2011		2010		2009	
	$ Change	% Change	$ Change	% Change	$ Change	% Change
Commercial	$ 16,862	4.8%	$ 8,578	2.5%	$ 15,468	4.8%
Agricultural	3,199	4.5%	6,601	10.2%	6,842	11.8%
Residential real estate mortgage	(5,669)	-2.0%	(1,809)	-0.6%	(33,559)	-10.5%
Installment	595	1.9%	(1,382)	-4.3%	(820)	-2.5%
	$ 14,987	2.0%	$ 11,988	1.7%	$ (12,069)	-1.6%

A substantial portion of the increase in total loans as of December 31, 2008 compared to December 31, 2007 was a result of the acquisition of Greenville Financial Corporation in January 2008. Pursuant to the acquisition, the Corporation purchased gross loans totaling $88,613.

Corporate owned life insurance

During the third quarter of 2011, the Corporation purchased an additional $4,000 of corporate owned life insurance policies. The Corporation purchased these additional policies to provide additional coverage for key employees, while also generating ongoing earnings as the cash surrender values of the policies increase.

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 (see Note 1 Nature of Operations and Summary of Significant Accounting Policies of Notes to Consolidated Financial Statements).

Deposits

The main source of funds for the Corporation is deposits. The following table presents the composition of the deposit portfolio as of December 31:

	2011	2010	2009	2008	2007
Noninterest bearing deposits	$ 119,072	$ 104,902	$ 96,875	$ 97,546	$ 84,846
Interest bearing demand deposits	163,653	142,259	128,111	113,973	105,526
Savings deposits	193,902	177,817	157,020	182,523	196,682
Certificates of deposit	395,777	386,435	356,594	340,976	311,976
Brokered certificates of deposit	54,326	53,748	50,933	28,185	28,197
Internet certificates of deposit	31,434	12,178	13,119	12,427	6,246
Total	**$ 958,164**	**$ 877,339**	**$ 802,652**	**$ 775,630**	**$ 733,473**

The following table presents the change in the deposit categories for the years ended December 31:

	2011		2010		2009	
	$ Change	% Change	$ Change	% Change	$ Change	% Change
Noninterest bearing deposits	$ 14,170	13.5%	$ 8,027	8.3%	$ (671)	-0.7%
Interest bearing demand deposits	21,394	15.0%	14,148	11.0%	14,138	12.4%
Savings deposits	16,085	9.0%	20,797	13.2%	(25,503)	-14.0%
Certificates of deposit	9,342	2.4%	29,841	8.4%	15,618	4.6%

Brokered certificates of deposit	578	1.1%	2,815	5.5%	22,748	80.7%
Internet certificates of deposit	19,256	158.1%	(941)	-7.2%	692	5.6%
Total	**$ 80,825**	**9.2%**	**$ 74,687**	**9.3%**	**$ 27,022**	**3.5%**

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As shown in the preceding table, the Corporation has experienced strong deposit growth since December 30, 2010. This growth was the result of the Corporation offering products with competitive rates and terms, as well as focused marketing efforts to increase deposit market share in the communities served. While management anticipates that deposits will continue to increase in 2012, it is expected to be at a lower rate than 2011.

The following table shows the average balances and corresponding interest rates paid on deposit accounts as of December 31:

	2011		2010		2009	
	Amount	Rate	Amount	Rate	Amount	Rate
Noninterest bearing demand deposits	$ 113,726		$ 102,812		$ 94,408	
Interest bearing demand deposits	152,530	0.12%	137,109	0.11%	116,412	0.13%
Savings deposits	192,999	0.25%	169,579	0.23%	177,538	0.22%
Time deposits	467,931	2.19%	430,892	2.55%	398,356	3.27%
Total	$ 927,186		$ 840,392		$ 786,714	

The remaining maturity of time certificates and other time deposits of $100 or more as of December 31, 2011 was as follows:

Maturity	
Within 3 months	$ 42,270
Within 3 to 6 months	25,357
Within 6 to 12 months	63,423
Over 12 months	104,266
Total	**$ 235,316**

Borrowed Funds

The following table summarizes the Corporation s borrowings as of December 31:

	2011		2010	
	Amount	Rate	Amount	Rate
Federal Home Loan Bank advances	$ 142,242	3.16%	$ 113,423	3.64%
Securities sold under agreements to repurchase without stated maturity dates	57,198	0.25%	45,871	0.25%
Securities sold under agreements to repurchase with stated maturity dates	16,696	3.51%	19,623	3.28%
Federal funds purchased			16,000	0.60%
Total	**$ 216,136**	**2.42%**	**$ 194,917**	**2.56%**

The maturity and weighted average interest rates of FHLB advances are as follows as of December 31:

	2011		2010	
	Amount	Rate	Amount	Rate
Fixed rate advances due 2011	$		$ 10,086	3.96%
One year putable advances due 2011			1,000	4.75%
Fixed rate advances due 2012	17,000	2.97%	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%	5,337	4.14%
One year putable advances due 2013	5,000	3.15%	5,000	3.15%
Fixed rate advances due 2014	25,000	3.16%	25,000	3.16%
Fixed rate advances due 2015	45,000	3.30%	25,000	4.63%
Fixed rate advances due 2016	10,000	2.15%		
Fixed rate advances due 2017	20,000	2.56%	10,000	2.35%
Total	**$ 142,242**	**3.16%**	**$ 113,423**	**3.64%**

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The maturity and weighted average interest rates of securities sold under agreements to repurchase with stated maturity dates are as follows at December 31:

	2011		2010	
	Amount	Rate	Amount	Rate
Repurchase agreements due 2011	$		$ 858	1.51%
Repurchase agreements due 2012	428	2.08%	1,013	2.21%
Repurchase agreements due 2013	5,000	4.51%	5,127	4.45%
Repurchase agreements due 2014	10,869	3.12%	12,087	3.00%
Repurchase agreements due 2015	399	3.25%	538	3.25%
Total	**$ 16,696**	**3.51%**	**$ 19,623**	**3.28%**

Contractual Obligations and Loan Commitments

The Corporation has various financial obligations, including contractual obligations and commitments, which may require future cash payments. The following schedule summarizes the Corporation s non-cancelable obligations and future minimum payments as of December 31, 2011:

	Minimum Payments Due by Period				
	Due in One Year or Less	After One Year But Within Three Years	After Three Years But Within Five Years	After Five Years	Total
Deposits with no stated maturity	$ 476,627	$	$	$	$ 476,627
Certificates of deposit with stated maturities	265,299	110,092	99,094	7,052	481,537
Borrowed funds					
Short term borrowings	57,198				57,198
Long term borrowings	32,428	96,510	10,000	20,000	158,938
Total borrowed funds	89,626	96,510	10,000	20,000	216,136
Total contractual obligations	**$ 831,552**	**$ 206,602**	**$ 109,094**	**$ 27,052**	**$ 1,174,300**

The Corporation also has loan commitments that may impact liquidity. The following schedule summarizes the Corporation s loan commitments and expiration dates by period as of December 31, 2011. Since many of these commitments historically have expired without being drawn upon, the total amount of these commitments does not necessarily represent future cash requirements of the Corporation.

	Expiration Dates by Period				
	Due in One Year or Less	After One Year But Within Three Years	After Three Years But Within Five Years	After Five Years	Total
Unused commitments to extend credit	$ 61,415	$ 27,740	$ 10,591	$ 3,076	$ 102,822
Undisbursed loans	21,806				21,806
Standby letters of credit	4,461				4,461
Total loan commitments	**$ 87,682**	**$ 27,740**	**$ 10,591**	**$ 3,076**	**$ 129,089**

Capital

The capital of the Corporation consists primarily of common stock, including shares to be issued, retained earnings, and accumulated other comprehensive income. The Corporation offers dividend reinvestment and employee, director, and shareholder stock purchase plans. Under the provisions of these plans, the Corporation

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issued 115,359 shares of common stock generating $2,192 of capital during 2011, and 124,904 shares of common stock generating $2,203 of capital in 2010. The Corporation also generates capital through the Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors (the Directors Plan), its equity compensation plan (See Note 17 Benefit Plans of Notes to Consolidated Financial Statements). Pursuant to this plan, the Corporation generated $615 and $650 of capital in 2011 and 2010, respectively.

The Board of Directors has adopted a common stock repurchase plan. This plan was approved to enable the Corporation to repurchase the Corporation s common stock for reissuance to the dividend reinvestment plan, the employee stock purchase plan and for distributions from the Directors Plan. During 2011 and 2010 the Corporation repurchased 120,441 shares of common stock at an average price of $18.30 and 138,970 shares of common stock at an average price of $18.40, respectively.

Accumulated other comprehensive loss decreased $4,198 in 2011 and consists of $5,498 of unrealized gains on available-for-sale investment securities which was offset by a $1,300 increase in unrecognized pension cost. These amounts are net of tax.

The Federal Reserve Board s current recommended minimum primary capital to assets requirement is 6.0%. The Corporation s Tier 1 capital to average assets ratio, which consists of shareholders equity plus the allowance for loan losses less goodwill and acquisition intangibles, was 8.18% at December 31, 2011. There are no commitments for significant capital expenditures.

The Federal Reserve Board 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 and acquisition intangibles. The following table sets forth the percentages required under the Risk Based Capital guidelines and the Corporation s values at December 31:

	2011	2010	Required
Equity Capital	12.92%	12.72%	4.00%
Secondary Capital	1.25%	1.25%	4.00%
Total Capital	14.17%	13.97%	8.00%

Isabella Bank 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.

The Federal Reserve Board also prescribes minimum capital requirements for the Corporation s subsidiary Bank. At December 31, 2011, the Bank exceeded these minimums. For further information regarding the Bank s capital requirements, refer to Note 16 Minimum Regulatory Capital Requirements of the Notes to Consolidated Financial Statements,

Fair Value

The Corporation utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available-for-sale, trading securities, and certain liabilities are recorded at fair value on a recurring basis. Additionally, from time to time, the Corporation may be required to record at fair value other assets on a nonrecurring basis, such as loans held-for-sale, foreclosed assets, originated mortgage servicing rights, and certain other assets and liabilities. These nonrecurring fair value adjustments typically involve the application of lower of cost or market accounting or write-downs of individual assets.

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The table below represents the activity in Level 3 inputs measured on a recurring basis for the year ended December 31:

	2011	2010
Level 3 inputs - January 1	$ 9,801	$ 10,027
Calls	(1,000)	
Transfer to Level 1 inputs	(5,033)	
Transfer to Level 2 inputs	(2,049)	
Net unrealized losses on available-for-sale investment securities	(1,719)	(226)
Level 3 inputs - December 31	$	$ 9,801

Securities classified as Level 3 in 2010 included securities in less liquid markets and included auction rate money market preferred securities and preferred stocks. Due to the limited trading of these securities during 2010, the Corporation utilized a discounted cash flow analysis to determine fair values on December 31, 2010. This analysis considered the creditworthiness of the counterparty, the timing of expected future cash flows, the current volume of trading activity, and recent trade prices. The discount rates used were determined by using the interest rates of similarly rated financial institution debt based on the weighted average of a range of terms for corporate bond interest rates, which were obtained from published sources and ranged from 3.90% to 6.90% as of December 31, 2010. During 2011, the markets for these securities have normalized and established regular trading patterns. As a result of this normalization, 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 based on the trade price of similar securities as of December 31, 2011.

For further information regarding fair value measurements see Note 1, Nature of Operations and Summary of Significant Accounting Policies and Note 20, Fair Value of the Consolidated Financial Statements.

Interest Rate Sensitivity

Interest rate sensitivity is determined by the amount of earning assets and interest bearing liabilities repricing within a specific time period, and their relative sensitivity to a change in interest rates. Management strives to achieve reasonable stability in the net interest margin through periods of changing interest rates. One tool used by management to measure interest rate sensitivity is gap analysis. As shown in the following table, the gap analysis depicts the Corporation s position for specific time periods and the cumulative gap as a percentage of total assets.

Trading securities are included in the 0 to 3 month time frame due to their repricing characteristics. Fixed interest rate investment securities are scheduled according to their contractual maturity. Fixed rate loans are included in the appropriate time frame based on their scheduled amortization. Variable rate loans, which totaled $162,653 as of December 31, 2011, are included in the time frame of their earliest repricing. Time deposit liabilities are scheduled based on their contractual maturity except for variable rate time deposits in the amount of $1,559 that are included in the 0 to 3 month time frame.

Savings, NOW accounts, and money market accounts have no contractual maturity date and are believed to be predominantly noninterest rate sensitive by management. These accounts have been classified in the gap table according to their estimated withdrawal rates based upon management s analysis of deposit runoff over the past five years. Management believes this runoff experience is consistent with its expectation for the future. As of December 31, 2011, the Corporation had a negative cumulative gap within one year. A negative gap position results when more liabilities, within a specified time frame, mature or reprice than assets.

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The following table shows the time periods and the amount of assets and liabilities available for interest rate repricing as of December 31, 2011. The interest rate sensitivity information for investment securities is based on the expected prepayments and call dates versus stated maturities. For purposes of this analysis, nonaccrual loans and the allowance for loan losses are excluded.

	0 to 3 Months	4 to 12 Months	1 to 5 Years	Over 5 Years
Interest sensitive assets				
Trading securities	$ 4,710	$	$	$
Investment securities	40,976	63,583	182,965	137,596
Loans	59,872	147,565	459,290	77,175
Total	**$ 105,558**	**$ 211,148**	**$ 642,255**	**$ 214,771**
Interest sensitive liabilities				
Borrowed funds	$ 67,440	$ 22,429	$ 106,267	$ 20,000
Time deposits	74,500	191,206	208,779	7,052
Savings	19,591	47,365	103,845	23,101
Interest bearing demand	15,621	38,273	82,568	27,191
Total	**$ 177,152**	**$ 299,273**	**$ 501,459**	**$ 77,344**
Cumulative gap	$ (71,594)	$ (159,719)	$ (18,923)	$ 118,504
Cumulative gap as a % of assets	(5.35) %	(11.94) %	(1.41) %	8.86%

The following table shows the maturity of commercial and agricultural loans outstanding at December 31, 2011. Also provided are the amounts due after one year, classified according to the sensitivity to changes in interest rates.

	1 Year or Less	1 to 5 Years	Over 5 Years	Total
Commercial and agricultural	$ 120,463	$ 276,367	$ 43,529	$ 440,359
Interest sensitivity				
Loans maturing after one year that have:				
Fixed interest rates		$ 238,963	$ 32,178	
Variable interest rates		37,404	11,351	
Total		**$ 276,367**	**$ 43,529**	

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 cash equivalents, certificates of deposit held in other financial institutions, trading securities, and available-for-sale investment securities, excluding auction rate money market preferred securities and preferred stock as of December 31, 2010 due to their illiquidity. These categories totaled $467,344 or 34.9% of assets as of December 31, 2011 as compared to $360,677 or 29.4% in 2010. Liquidity is important for financial institutions because of their need to meet loan funding commitments, depositor withdrawal requests, and various other commitments discussed in the accompanying notes to consolidated financial statements. Liquidity varies significantly daily, based on customer activity.

The following table summarizes the Corporation s sources and uses of cash for the years ended December 31:

	2011	2010	$ Variance
Net cash provided by operating activities	$ 18,860	$ 26,521	$ (7,661)
Net cash used in investing activities	(105,203)	(103,877)	(1,326)
Net cash provided by financing activities	96,824	70,983	25,841
Increase (decrease) in cash and cash equivalents	10,481	(6,373)	16,854
Cash and cash equivalents January 1	18,109	24,482	(6,373)
Cash and cash equivalents December 31	$ 28,590	$ 18,109	$ 10,481

The primary source of funds for the Corporation is deposits. The Corporation emphasizes interest bearing time deposits as part of its funding strategy. 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 $110,069, based on the assets currently pledged as collateral. The Corporation has pledged eligible mortgage loans and investment securities as collateral for any such borrowings.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

The Corporation s primary market risks are interest rate risk 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. The Corporation does have a significant amount of loans extended to borrowers in agricultural production. The cash flow of such borrowers and ability to service debt is largely dependent on commodity prices. The Corporation mitigates these risks by using conservative price and production yields when calculating a borrower s available cash flow to service their debt.

Interest rate risk (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 Board, 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.

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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 other 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 mortgages, 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 ended December 31, 2011, 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 December 31, 2011 and 2010. The Corporation has no interest rate swaps, futures contracts, or other derivative financial options. The principal amounts of assets and time deposits maturing were calculated based on the contractual payment and maturity dates. Savings and NOW accounts are based on management s estimate of their future cash flows.

(dollars in thousands)				December 31, 2011				Fair Value
	2012	2013	2014	2015	2016	Thereafter	Total	12/31/11
Rate sensitive assets								
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	$ 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	$ 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%	
Rate sensitive liabilities								
Borrowed funds	$ 89,869	$ 15,000	$ 25,869	$ 45,398	$ 20,000	$ 20,000	$ 216,136	$ 227,780
Average interest rates	1.42%	3.93%	3.13%	3.30%	2.67%	2.56%	2.41%	
Savings and NOW accounts	$ 120,850	$ 78,313	$ 51,291	$ 34,006	$ 22,803	$ 50,292	$ 357,555	$ 357,555
Average interest rates	0.20%	0.19%	0.18%	0.17%	0.15%	0.15%	0.18%	
Fixed interest rate time deposits	$ 264,147	$ 62,883	$ 46,802	$ 55,493	$ 43,601	$ 7,052	$ 479,978	$ 498,085
Average interest rates	1.61%	2.67%	2.33%	2.56%	2.41%	1.48%	2.00%	
Variable interest rate time deposits	$ 1,152	$ 407	$	$	$	$	$ 1,559	$ 1,559
Average interest rates	0.67%	0.69%					0.68%	

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	December 31, 2010							
	2011	2012	2013	2014	2015	Thereafter	Total	Fair Value 12/31/10
Rate sensitive assets								
Other interest bearing assets	$ 10,550	$ 5,429	$ 960	$	$	$	$ 16,939	$ 17,039
Average interest rates	0.96%	1.82%	2.16%				1.30%	
Trading securities	$ 1,918	$ 2,366	$ 1,031	$ 522	$	$	$ 5,837	$ 5,837
Average interest rates	3.46%	2.31%	2.42%	2.47%			2.72%	
Fixed interest rate securities	$ 64,652	$ 42,984	$ 32,871	$ 29,395	$ 24,438	$ 136,384	$ 330,724	$ 330,724
Average interest rates	3.68%	3.42%	3.30%	3.33%	3.28%	3.13%	3.32%	
Fixed interest rate loans	$ 128,277	$ 121,434	$ 140,019	$ 67,423	$ 68,569	$ 66,010	$ 591,732	$ 603,435
Average interest rates	6.80%	6.63%	6.26%	6.47%	6.08%	5.83%	6.41%	
Variable interest rate loans	$ 59,536	$ 17,306	$ 22,523	$ 15,118	$ 18,830	$ 10,259	$ 143,572	$ 143,572
Average interest rates	4.94%	4.76%	4.27%	3.78%	3.69%	5.21%	4.55%	
Rate sensitive liabilities								
Borrowed funds	$ 74,151	$ 33,013	$ 15,127	$ 37,087	$ 25,539	$ 10,000	$ 194,917	$ 200,603
Average interest rates	0.62%	3.46%	2.55%	3.11%	4.60%	2.35%	2.33%	
Savings and NOW accounts	$ 74,278	$ 73,818	$ 53,174	$ 35,872	$ 24,520	$ 58,414	$ 320,076	$ 320,076
Average interest rates	0.21%	0.21%	0.20%	0.19%	0.18%	0.15%	0.19%	
Fixed interest rate time deposits	$ 215,648	$ 113,338	$ 44,269	$ 31,414	$ 39,474	$ 6,278	$ 450,421	$ 452,392
Average interest rates	1.79%	2.67%	3.35%	2.86%	2.97%	3.26%	2.36%	
Variable interest rate time deposits	$ 1,279	$ 661	$	$	$	$	$ 1,940	$ 1,940
Average interest rates	1.21%	1.06%					1.16%	

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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 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, pr 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 the subsidiaries include, but are not limited to, changes in interest rates, general economic conditions, legislative/regulatory changes, monetary and fiscal policies of the U.S. Government including policies of the U.S. Treasury, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the quality or composition of the loan or investment portfolios, demand for loan products, 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.

Item 8. Financial Statements and Supplementary Data

The following consolidated financial statements of the Corporation accompanied by the report of our independent registered public accounting firm are set forth on pages 42 through 94 of this report:

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets

Consolidated Statements of Changes in Shareholders Equity

Consolidated Statements of Income

Consolidated Statements of Comprehensive Income

Consolidated Statements of Cash Flows

Notes to Consolidated Financial Statements

The supplementary data regarding quarterly results of operations are set forth under the table headed Summary of Selected Financial Data under Item 6 on page 15 of this report.

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Report of Independent Registered Public Accounting Firm

Shareholders and Board of Directors

Isabella Bank Corporation

Mount Pleasant, Michigan

We have audited the accompanying consolidated balance sheets of ***Isabella Bank Corporation*** as of December 31, 2011 and 2010, and the related consolidated statements of changes in shareholders equity, income, comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2011. We also have audited ***Isabella Bank Corporation s*** internal control over financial reporting as of December 31, 2011, based on criteria established in the *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). ***Isabella Bank Corporation s*** management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the effectiveness of ***Isabella Bank Corporation*** **s** internal control over financial reporting, based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material misstatement exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. We believe that our audits provide a reasonable basis for our opinion.

A corporation s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements for external purposes in accordance with generally accepted accounting principles. A corporation s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the corporation; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of consolidated financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the corporation are being made only in accordance with authorizations of management and directors of the corporation; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the corporation s assets that could have a material effect on the consolidated financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of ***Isabella Bank Corporation*** as of December 31, 2011 and 2010, and the consolidated results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2011 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion ***Isabella Bank Corporation*** maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on the criteria established in the *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission.

/s/Rehmann Robson, P.C.

Saginaw, Michigan

March 6, 2012

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CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)

	December 31	
	2011	2010
ASSETS		
Cash and cash equivalents		
Cash and demand deposits due from banks	$ 24,514	$ 16,978
Interest bearing balances due from banks	4,076	1,131
Total cash and cash equivalents	**28,590**	**18,109**
Certificates of deposit held in other financial institutions	8,924	15,808
Trading securities	4,710	5,837
Available-for-sale securities (amortized cost of $414,614 in 2011 and $329,435 in 2010)	425,120	330,724
Mortgage loans available-for-sale	3,205	1,182
Loans		
Agricultural	74,645	71,446
Commercial	365,714	348,852
Consumer	31,572	30,977
Residential real estate mortgage	278,360	284,029
Total loans	**750,291**	**735,304**
Less allowance for loan losses	12,375	12,373
Net loans	**737,916**	**722,931**
Premises and equipment	24,626	24,627
Corporate owned life insurance	22,075	17,466
Accrued interest receivable	5,848	5,456
Equity securities without readily determinable fair values	17,189	17,564
Goodwill and other intangible assets	46,792	47,091
Other assets	12,930	19,015
TOTAL ASSETS	**$ 1,337,925**	**$ 1,225,810**
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits		
Noninterest bearing	$ 119,072	$ 104,902
NOW accounts	163,653	142,259
Certificates of deposit under $100 and other savings	440,123	425,981
Certificates of deposit over $100	235,316	204,197
Total deposits	**958,164**	**877,339**
Borrowed funds ($5,242 in 2011 and $10,423 in 2010 at fair value)	216,136	194,917
Accrued interest payable and other liabilities	8,842	8,393
Total liabilities	**1,183,142**	**1,080,649**
Shareholders equity		
Common stock no par value 15,000,000 shares authorized; issued and outstanding 7,589,226 (including 16,585 shares held in the Rabbi Trust) in 2011 and 7,550,074 (including 32,686 shares held in the Rabbi Trust) in 2010	134,734	133,592
Shares to be issued for deferred compensation obligations	4,524	4,682
Retained earnings	13,036	8,596

Accumulated other comprehensive income (loss)	2,489	(1,709)
Total shareholders equity	**154,783**	**145,161**
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	**$ 1,337,925**	**$ 1,225,810**

The accompanying notes are an integral part of these consolidated financial statements.

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CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(Dollars in thousands except per share data)

	Common Stock Shares Outstanding	Common Stock	Shares to be Issued for Deferred Compensation Obligations	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Totals
Balance, January 1, 2009	**7,518,856**	**$ 133,602**	**$ 4,015**	**$ 2,428**	**$ (5,569)**	**$ 134,476**
Comprehensive income				7,800	3,450	11,250
Issuance of common stock	126,059	2,664				2,664
Common stock issued for deferred compensation obligations	12,890	331	(185)			146
Share based payment awards under equity compensation plan			677			677
Common stock purchased for deferred compensation obligations		(767)				(767)
Common stock repurchased pursuant to publicly announced repurchase plan	(122,612)	(2,387)				(2,387)
Cash dividends ($0.70 per share)				(5,256)		(5,256)
Balance, December 31, 2009	**7,535,193**	**133,443**	**4,507**	**4,972**	**(2,119)**	**140,803**
Comprehensive income				9,045	410	9,455
Issuance of common stock	124,953	2,683				2,683
Common stock issued for deferred compensation obligations	28,898	537	(475)			62
Share based payment awards under equity compensation plan			650			650
Common stock purchased for deferred compensation obligations		(514)				(514)
Common stock repurchased pursuant to publicly announced repurchase plan	(138,970)	(2,557)				(2,557)
Cash dividends ($0.72 per share)				(5,421)		(5,421)
Balance, December 31, 2010	**7,550,074**	**133,592**	**4,682**	**8,596**	**(1,709)**	**145,161**
Comprehensive income				10,210	4,198	14,408
Issuance of common stock	120,336	3,075				3,075
Common stock issued for deferred compensation obligations	39,257	697	(773)			(76)
Share based payment awards under equity compensation plan			615			615
Common stock purchased for deferred compensation obligations		(426)				(426)
Common stock repurchased pursuant to publicly announced repurchase plan	(120,441)	(2,204)				(2,204)
Cash dividends ($0.76 per share)				(5,770)		(5,770)
Balance, December 31, 2011	**7,589,226**	**$ 134,734**	**$ 4,524**	**$ 13,036**	**$ 2,489**	**$ 154,783**

The accompanying notes are an integral part of these consolidated financial statements.

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CONSOLIDATED STATEMENTS OF INCOME

(Dollars in thousands except per share data)

	Year Ended December 31		
	2011	2010	2009
Interest income			
Loans, including fees	$ 45,463	$ 46,794	$ 47,706
Investment securities			
Taxable	6,941	5,271	4,712
Nontaxable	4,806	4,367	4,623
Trading account securities	189	306	687
Federal funds sold and other	506	479	377
Total interest income	**57,905**	**57,217**	**58,105**
Interest expense			
Deposits	10,935	11,530	13,588
Borrowings	5,268	5,674	6,251
Total interest expense	**16,203**	**17,204**	**19,839**
Net interest income	**41,702**	**40,013**	**38,266**
Provision for loan losses	3,826	4,857	6,093
Net interest income after provision for loan losses	**37,876**	**35,156**	**32,173**
Noninterest income			
Service charges and fees	6,118	6,480	6,913
Gain on sale of mortgage loans	538	610	886
Net (loss) gain on trading securities	(78)	(94)	80
Net gain on borrowings measured at fair value	181	227	289
Gain on sale of available-for-sale investment securities	3	348	648
Other	1,456	1,729	1,340
Total noninterest income	**8,218**	**9,300**	**10,156**
Noninterest expenses			
Compensation and benefits	19,292	18,552	18,258
Occupancy	2,470	2,351	2,170
Furniture and equipment	4,497	4,344	4,146
FDIC insurance premiums	1,086	1,254	1,730
Other	7,185	7,306	7,379
Total noninterest expenses	**34,530**	**33,807**	**33,683**
Income before federal income tax expense	**11,564**	**10,649**	**8,646**
Federal income tax expense	1,354	1,604	846
NET INCOME	**$ 10,210**	**$ 9,045**	**$ 7,800**
Earnings per share			
Basic	**$ 1.35**	**$ 1.20**	**$ 1.04**
Diluted	**$ 1.31**	**$ 1.17**	**$ 1.01**

Cash dividends per basic share	**$ 0.76**	**$ 0.72**	**$ 0.70**

The accompanying notes are an integral part of these consolidated financial statements.

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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Dollars in thousands)

	Year Ended December 31		
	2011	2010	2009
Net income	**$ 10,210**	**$ 9,045**	**$ 7,800**
Unrealized holding gains on available-for-sale securities:			
Unrealized gains arising during the year	9,220	1,156	3,415
Reclassification adjustment for net realized gains included in net income	(3)	(348)	(648)
Net unrealized gains	9,217	808	2,767
Tax effect	(3,719)	(351)	436
Unrealized gains, net of tax	5,498	457	3,203
(Increase) reduction of unrecognized pension costs	(1,971)	(72)	374
Tax effect	671	25	(127)
Net unrealized (loss) gain on defined benefit pension plan	(1,300)	(47)	247
Other comprehensive income, net of tax	**4,198**	**410**	**3,450**
Comprehensive income	**$ 14,408**	**$ 9,455**	**$ 11,250**

The accompanying notes are an integral part of these consolidated financial statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

	Year Ended December 31		
	2011	2010	2009
OPERATING ACTIVITIES			
Net income	$ 10,210	$ 9,045	$ 7,800
Reconciliation of net income to net cash provided by operations:			
Provision for loan losses	3,826	4,857	6,093
Impairment of foreclosed assets	82	180	157
Depreciation	2,521	2,522	2,349
Amortization and impairment of originated mortgage servicing rights	714	543	683
Amortization of acquisition intangibles	299	338	375
Net amortization of available-for-sale securities	1,689	1,153	741
Gain on sale of available-for-sale securities	(3)	(348)	(648)
Net unrealized losses (gains) on trading securities	78	94	(80)
Net gain on sale of mortgage loans	(538)	(610)	(886)
Net unrealized gains on borrowings measured at fair value	(181)	(227)	(289)
Increase in cash value of corporate owned life insurance	(609)	(642)	(641)
Realized gain on redemption of corporate owned life insurance		(21)	
Share-based payment awards under equity compensation plan	615	650	677
Deferred income tax expense (benefit)	389	179	(641)
Origination of loans held for sale	(57,584)	(72,106)	(153,388)
Proceeds from loan sales	56,099	73,815	152,891
Net changes in operating assets and liabilities which provided (used) cash:			
Trading securities	1,049	7,632	8,292
Accrued interest receivable	(392)	376	490
Other assets	147	(1,914)	(6,331)
Accrued interest payable and other liabilities	449	1,005	581
Net cash provided by operating activities	**18,860**	**26,521**	**18,225**
INVESTING ACTIVITIES			
Net change in certificates of deposit held in other financial institutions	6,884	(10,428)	(4,805)
Activity in available-for-sale securities			
Maturities, calls, and sales	78,152	85,273	130,580
Purchases	(165,017)	(156,928)	(140,517)
Loan principal originations and collections, net	(20,743)	(21,319)	4,437
Proceeds from sales of foreclosed assets	2,041	2,778	4,145
Purchases of premises and equipment	(2,520)	(3,232)	(3,035)
Purchases of corporate owned life insurance	(4,000)	(175)	
Proceeds from the redemption of corporate owned life insurance		154	11
Net cash used in investing activities	**(105,203)**	**(103,877)**	**(9,184)**
FINANCING ACTIVITIES			
Acceptances and withdrawals of deposits, net	$ 80,825	$ 74,687	$ 27,022
Increase (decrease) in other borrowed funds	21,400	2,043	(28,960)
Cash dividends paid on common stock	(5,770)	(5,421)	(5,256)
Proceeds from issuance of common stock	2,302	2,208	2,479
Common stock repurchased	(1,507)	(2,020)	(2,056)
Common stock purchased for deferred compensation obligations	(426)	(514)	(767)

Net cash provided by (used in) financing activities	**96,824**	**70,983**	**(7,538)**
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	**10,481**	**(6,373)**	**1,503**
Cash and cash equivalents at beginning of period	18,109	24,482	22,979
CASH AND CASH EQUIVALENTS AT END OF PERIOD	**$ 28,590**	**$ 18,109**	**$ 24,482**
SUPPLEMENTAL CASH FLOWS INFORMATION:			
Interest paid	$ 16,239	$ 17,344	$ 20,030
Federal income taxes paid	878	1,261	2,237
SUPPLEMENTAL NONCASH INFORMATION:			
Transfers of loans to foreclosed assets	$ 1,932	$ 3,868	$ 2,536
Common stock issued for deferred compensation obligations	773	475	185
Common stock repurchased from an associated grantor trust (Rabbi Trust)	(697)	(537)	(33)

The accompanying notes are an integral part of these consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands except per share amounts)

NOTE 1 NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION AND CONSOLIDATION: The consolidated financial statements include the accounts of Isabella Bank Corporation (the Corporation), a financial services holding company, and its wholly owned subsidiaries, Isabella Bank (the Bank), Financial Group Information Services, and IB&T Employee Leasing, LLC. All intercompany balances and accounts have been eliminated in consolidation.

NATURE OF OPERATIONS: Isabella Bank Corporation is a financial services holding company offering a wide array of financial products and services in several mid-Michigan counties. Its banking subsidiary, Isabella Bank, offers banking services through 25 locations, 24 hour banking services locally and nationally through shared automatic teller machines, 24 hour online banking, and direct deposits to businesses, institutions, and individuals. Lending services offered include commercial loans, agricultural loans, residential real estate loans, and consumer loans. Deposit services include interest and noninterest bearing checking accounts, savings accounts, money market accounts, and certificates of deposit. Other related financial products include trust and investment services, safe deposit box rentals, and credit life insurance. Active competition, principally from other commercial banks, savings banks and credit unions, exists in all of the Corporation s principal markets. The Corporation s results of operations can be significantly affected by changes in interest rates or changes in the local economic environment.

Financial Group Information Services provides information technology services to Isabella Bank Corporation and its subsidiaries.

IB&T Employee Leasing provides payroll services, benefit administration, and other human resource services to Isabella Bank Corporation and its subsidiaries.

USE OF ESTIMATES: In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the consolidated balance sheet and reported amounts of revenues and expenses during the reporting year. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the fair value of certain available-for-sale investment securities, the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans, valuation of goodwill and other intangible assets, and determinations of assumptions in accounting for the defined benefit pension plan.

FAIR VALUE MEASUREMENTS: Fair value refers to the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants in the market in which the reporting entity transacts such sales or transfers based on the assumptions market participants would use when pricing an asset or liability. Assumptions are developed based on prioritizing information within a fair value hierarchy that gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data, such as the reporting entity s own data. The Corporation may choose to measure eligible items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value measurement option has been elected are reported in earnings at each subsequent reporting date. The fair value option (i) may be applied instrument by instrument, with certain exceptions, allowing the Corporation to record identical financial assets and liabilities at fair value or by another measurement basis permitted under generally accepted accounting principles, (ii) is irrevocable (unless a new election date occurs) and (iii) is applied only to entire instruments and not to portions of instruments.

For assets and liabilities recorded at fair value, it is the Corporation s policy to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements for those financial instruments for which there is an active market. In cases where the market for a financial asset or liability is not active, the Corporation includes appropriate risk adjustments that market participants would make for nonperformance and liquidity risks when developing fair value measurements. Fair value measurements for assets and liabilities for which limited or no observable market data exists are accordingly based primarily upon estimates, are often calculated based on the economic and competitive environment, the characteristics of the asset or liability and other factors. Therefore, the results cannot be determined with precision and may not be realized in an actual sale or immediate settlement of the asset or liability. Additionally, there may be inherent weaknesses in any calculation technique, and changes in the underlying assumptions used, including discount rates and estimates of future cash flows, could significantly affect the results of current or future values.

The Corporation utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Investment securities available-for-sale, trading securities, and certain liabilities are recorded at fair value on a recurring basis. Additionally, from time to time, the Corporation may be required to record other assets at fair value on a nonrecurring basis, such as mortgage loans available-for-sale, impaired loans, foreclosed assets, originated mortgage servicing rights, goodwill, and certain other assets and liabilities. These nonrecurring fair value adjustments typically involve the application of lower of cost or market accounting or write downs of individual assets.

Fair Value Hierarchy

Under fair value measurement and disclosure authoritative guidance, the Corporation groups assets and liabilities measured at fair value into three levels, based on the markets in which the assets and liabilities are traded, and the reliability of the assumptions used to determine fair value, based on the prioritization of inputs in the valuation techniques. These levels are:

Level 1: Valuation is based upon quoted prices for identical instruments traded in active markets.

Level 2: Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model based valuation techniques for which all significant assumptions are observable in the market.

Level 3: Valuation is generated from model based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability.

The asset s or liability s fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. Valuation techniques maximize the use of observable inputs and minimize the use of unobservable inputs. Transfers between measurement levels are recognized at the end of reporting periods.

For a further discussion of fair value considerations, refer to Note 20 to the consolidated financial statements.

SIGNIFICANT GROUP CONCENTRATIONS OF CREDIT RISK: Most of the Corporation s activities conducted are with customers located within the central Michigan area. A significant amount of its outstanding loans are secured by commercial and residential real estate. Other than these types of loans, there is no significant concentration to any other industry or any one customer.

CASH AND CASH EQUIVALENTS: For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash and balances due from banks, federal funds sold, and other deposit accounts. Generally, federal funds sold are for a one day period. The Corporation maintains deposit accounts in various financial institutions which generally exceed federally insured limits or are not insured. Management does not believe the Company is exposed to any significant interest, credit or other financial risk as a result of these deposits.

CERTIFICATES OF DEPOSIT HELD IN OTHER FINANCIAL INSTITUTIONS: Certificates of deposits held in other financial institutions consist of interest bearing certificates of deposit that mature within 3 years and are carried at cost.

TRADING SECURITIES: The Corporation engages in trading activities of its own accounts. Securities that are held principally for resale in the near term are recorded in the trading assets account at fair value with changes in fair value recorded in noninterest income. Interest income is included in net interest income.

AVAILABLE-FOR-SALE INVESTMENT SECURITIES: All purchases of investment securities are generally classified as available-for-sale. However, classification of investment securities as either held to maturity or trading may be elected by management of the Corporation. Securities classified as available-for-sale are recorded at fair value, with unrealized gains and losses, net of the effect of deferred income taxes, excluded from earnings and reported in other comprehensive income. Auction rate money market preferred securities and preferred stocks are considered equity securities for federal income tax purposes, and as such, no estimated federal income tax impact is expected or recorded. Auction rate money market preferred securities and preferred stock are recorded at fair value, with unrealized gains and losses, considered not other-than-temporary, excluded from earnings and reported in other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Realized gains and losses on the sale of available-for-sale investment securities are determined using the specific identification method.

Investment securities are reviewed quarterly for possible other-than-temporary impairment (OTTI). In determining whether an other-than-temporary impairment exists for debt securities, management must assert that: (a) it does not have the intent to sell the security; and (b) it is more likely than not it will not have to sell the security before recovery of its cost basis. If these conditions are not met, the Corporation must recognize an other-than-temporary impairment charge through earnings for the difference between the debt security s amortized cost basis and its fair value, and such amount is included in noninterest income. For debt securities that do not meet the above criteria, and the Corporation does not expect to recover the security s amortized cost basis, the security is considered other-than-temporarily impaired. For these debt securities, the Corporation separates the total impairment into the credit risk loss component and the amount of the loss related to market and other risk factors. In order to determine the amount of the credit loss for a debt security, the Corporation calculates the recovery value by performing a discounted cash flow analysis based on the current cash flows and future cash flows management expects to recover. The amount of the total other-than-temporary impairment related to the credit risk is recognized in earnings and is included in noninterest income. The amount of the total other-than-temporary impairment related to other risk factors is recognized as a component of other comprehensive income. For debt securities that have recognized an other-than-temporary impairment through earnings, if through subsequent evaluation there is a significant increase in the cash flow expected, the difference between the amortized cost basis and the cash flows expected to be collected is accreted as interest income.

Available-for-sale equity securities are reviewed for other-than-temporary impairment at each reporting date. This evaluation considers a number of factors including, but not limited to, the length of time and extent to which the fair value has been less than cost, the financial condition and near term prospects of the issuer, and management s ability and intent to hold the securities until fair value recovers. If it is determined that management does not have the ability and intent to hold the securities until recovery or that there are conditions that indicate that a security may not recover in value then the difference between the fair value and the cost of the security is recognized in earnings and is included in noninterest income. No such losses for debt or equity securities were recognized in 2011, 2010, or 2009.

LOANS: Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their outstanding principal balance adjusted for any charge-offs, the allowance for loans losses, and any deferred fees or costs on originated loans. Interest income on loans is accrued over the term of the loan based on the principal amount outstanding. Loan origination fees and certain direct loan origination costs are capitalized and recognized as a component of interest income over the term of the loan using the level yield method.

The accrual of interest on agricultural, commercial and mortgage loans is 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 non-accrual 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 when all principal and interest amounts contractually due are brought current and future payments are reasonably assured. 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.

ALLOWANCE FOR LOAN LOSSES: The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of the loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses 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 allowance consists of specific, general and unallocated components. The specific component relates to loans that are deemed to be impaired. For such loans that are also analyzed for specific allowance allocations, an allowance is established when the discounted cash flows or collateral value or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers non classified loans and is based on historical loss experience. 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.

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;

2. The loan has been classified as a troubled debt restructuring; or

3. The loan is in nonaccrual status.

Impairment is measured on a loan by loan basis for agricultural and commercial 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.

LOANS HELD FOR SALE: Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or fair value as determined by aggregating outstanding commitments from investors or current investor yield requirements. Net unrealized losses, if any, are recognized through a valuation allowance of which the provision is accounted for in other noninterest expenses in the consolidated statements of income.

Mortgage loans held for sale are sold with the mortgage servicing rights retained by the Corporation. The carrying value of mortgage loans sold is reduced by the cost allocated to the associated mortgage servicing rights. Gains or losses on sales of mortgage loans are recognized based on the difference between the selling price and the carrying value of the related mortgage loans sold.

TRANSFERS OF FINANCIAL ASSETS: Transfers of financial assets, including mortgage loans and participation loans are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is determined to be surrendered when 1) the assets have been legally isolated from the Corporation, 2) the transferee obtains the right (free of conditions that constrain it from taking advantage of the right) to pledge or exchange the transferred assets and 3) the Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity. Other than servicing, the Corporation has no substantive continuing involvement related to these loans.

SERVICING: Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of financial assets. The Corporation has no purchased servicing rights. For sales of mortgage loans, a portion of the cost of originating the loan is allocated to the servicing right based on relative fair value. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses.

Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights into tranches based on predominant risk characteristics, such as interest rate, loan type, and investor type. Impairment is recognized through a valuation allowance for an individual tranche, to the extent that fair value is less than the capitalized amount for the tranche. If the Corporation later determines that all or a portion of the impairment no longer exists for a particular tranche, a reduction of the valuation allowance may be recorded as an increase to income. Capitalized servicing rights are reported in other assets and are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. The unpaid principal balance of mortgages serviced for others was $304,626 and $309,882 with capitalized servicing rights of $2,374 and $2,667 at December 31, 2011 and 2010, respectively.

Servicing fee income is recorded for fees earned for servicing loans for others. The fees are based on a contractual percentage of the outstanding principal; or a fixed amount per loan and are recorded as income when earned. The Corporation recorded servicing fee revenue of $732, $760, and $724 related to residential mortgage loans serviced for others during 2011, 2010, and 2009, respectively and is included in other non interest income.

LOANS ACQUIRED THROUGH TRANSFER: Authoritative accounting guidance related to acquired loans requires that a valuation allowance for loans acquired in a transfer, including in a business combination, reflect only losses incurred after acquisition, and should not be recorded at acquisition. This standard applies to any loan acquired in a transfer that shows evidence of credit quality deterioration since it was originated.

FORECLOSED ASSETS: Assets acquired through, or in lieu, of loan foreclosure are held for sale and are initially recorded at the lower of the Corporation s carrying amount or fair value less estimated selling costs at the date of transfer, establishing a new cost basis. Any write downs based on the asset s fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, property held for sale is carried at the lower of the new cost basis or fair value less costs to sell. Impairment losses on property to be held and used are measured at the amount by which the carrying amount of property exceeds its fair value. Costs relating to holding these assets are expensed as incurred. Valuations are periodically performed by management, and any subsequent write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of a property to the lower of the Corporation s carrying amount or fair value less costs to sell. Foreclosed assets of $1,876 and $2,067 as of December 31, 2011 and 2010, respectively, are included in Other Assets on the accompanying consolidated balance sheets.

PREMISES AND EQUIPMENT: Land is carried at cost. Buildings and equipment are carried at cost, less accumulated depreciation which is computed principally by the straight-line method based upon the estimated useful lives of the related assets, which range from 3 to 40 years. Major improvements are capitalized and

appropriately amortized based upon the useful lives of the related assets or the expected terms of the leases, if shorter, using the straight-line method. Maintenance, repairs and minor alterations are charged to current operations as expenditures occur. Management annually reviews these assets to determine whether carrying values have been impaired.

FDIC INSURANCE PREMIUM: In 2009, the Corporation was required to prepay quarterly FDIC risk-based assessments for the fourth quarter of 2009 and each of the quarters in the years ending December 31, 2010, 2011 and 2012. The assessments for 2010 through 2012, which had a carrying balance of $2,588 and $3,586 as of December 31, 2011 and 2010, respectively, have been recorded as a prepaid asset in the accompanying consolidated balance sheets in Other Assets, and will be expensed on a ratable basis quarterly through December 31, 2012.

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 December 31:

	2011	2010
Federal Home Loan Bank Stock	$ 7,380	$ 7,596
Investment in Corporate Settlement Solutions	6,611	6,793
Federal Reserve Bank Stock	1,879	1,879
Investment in Valley Financial Corporation	1,000	1,000
Other	319	296
Total	**$ 17,189**	**$ 17,564**

EQUITY COMPENSATION PLAN: At December 31, 2011, the Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors (the Directors Plan) had 218,023 shares eligible to be issued to participants, for which an associated grantor trust (Rabbi Trust) held 16,585 shares. The Corporation had 224,663 shares to be issued in 2010, with 32,686 shares held in the Rabbi Trust. Compensation costs relating to share based payment transactions are recognized in the consolidated financial statements as the services are rendered, with the cost measured based on the fair value of the equity or liability instruments issued (see Equity Compensation Plan in Note 17.) The Corporation has no other share-based compensation plans.

CORPORATE OWNED LIFE INSURANCE: The Corporation has purchased life insurance policies on key members of management. In the event of death of one of these individuals, the Corporation would receive a specified cash payment equal to the face value of the policy. Such policies are recorded at their cash surrender value, or the amount that can be realized on the balance sheet dates. Increases in cash surrender value in excess of single premiums paid are reported as Other Noninterest Income.

As of December 31, 2011 and 2010, the present value of the post retirement benefits payable by the Corporation to the covered employees was estimated to be $2,633 and $2,573, respectively, and is included in Accrued Interest Payable and Other Liabilities on the consolidated balance sheets. The periodic policy maintenance costs were $60 and $68 for 2011 and 2010, respectively.

ACQUISITION INTANGIBLES AND GOODWILL: The Corporation previously acquired branch facilities and related deposits in business combinations accounted for as a purchase. The acquisitions included amounts related to the valuation of customer deposit relationships (core deposit intangibles). Core deposit intangibles arising from acquisitions are included in Other Assets and are being amortized over their estimated lives and evaluated for potential impairment on at least an annual basis. Goodwill, which is included in Other Assets, represents the excess of purchase price over identifiable assets, is not amortized but is evaluated for 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.

OFF BALANCE SHEET CREDIT RELATED FINANCIAL INSTRUMENTS: In the ordinary course of business, the Corporation has entered into commitments to extend credit, including commitments under credit card arrangements, home equity lines of credit, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded only when funded.

FEDERAL INCOME TAXES: Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax assets or liability is determined based on the tax effects of the temporary differences between the book and tax bases on the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws. Valuation allowances are established, where necessary, to reduce deferred tax assets to the amount expected to be realized. Income tax expense is the tax payable or refundable for the year plus or minus the change during the year in deferred tax assets and liabilities.

The Corporation analyzes its filing positions in the jurisdictions where it is required to file income tax returns, as well as all open tax years in these jurisdictions. The Corporation has also elected to retain its existing accounting policy with respect to the treatment of interest and penalties attributable to income taxes, and continues to reflect any charges for such, to the extent they arise, as a component of its noninterest expenses.

MARKETING COSTS: Marketing costs are expensed as incurred (see Note 11).

RECLASSIFICATIONS: Certain amounts reported in the 2010 and 2009 consolidated financial statements have been reclassified to conform with the 2011 presentation.

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 Directors Plan, see Note 17.

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

	2011	2010	2009
Average number of common shares outstanding for basic calculation	7,572,841	7,541,676	7,517,276
Average potential effect of shares in the Directors Plan (1)	194,634	187,744	181,319
Average number of common shares outstanding used to calculate diluted earnings per common share	7,767,475	7,729,420	7,698,595
Net income	$ 10,210	$ 9,045	$ 7,800
Earnings per share			
Basic	**$ 1.35**	**$ 1.20**	**$ 1.04**
Diluted	**$ 1.31**	**$ 1.17**	**$ 1.01**

(1) Exclusive of shares held in the Rabbi Trust

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NOTE 3 ACCOUNTING STANDARDS UPDATES

Recently Adopted Accounting Standards Updates

Accounting Standards Update (ASU) No. 2010-06: *Improving Disclosures about Fair Value Measurement*

In January 2010, ASU No. 2010-06 amended Accounting Standards Codification (ASC) Topic 820 Fair Value Measurements and Disclosures to add new disclosures for: (1) significant transfers in and out of Level 1 and Level 2 fair value measurements and the reasons for the transfers and (2) presenting separately information about purchases, sales, issuances and settlements for Level 3 fair value instruments (as opposed to reporting activity as net).

ASU No. 2010-06 also clarified existing disclosures by requiring reporting entities to provide fair value measurement disclosures for each class of assets and liabilities and to provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements.

The new authoritative guidance was effective for interim and annual periods beginning after December 15, 2009 except for the disclosures about purchases, sales, issuances and settlements in the rollforward of activity in Level 3 fair value measurements, which was effective for interim and annual periods beginning after December 15, 2010. The new guidance did not have a significant impact on the Corporation s consolidated financial statements.

ASU No. 2011-01: *Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20*.

In January 2011, ASU No. 2011-01 amended ASC Topic 310, Receivables to temporarily delay the effective date of new disclosures related to troubled debt restructurings as required in ASU No. 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, which was initially intended to be effective for interim and annual periods ending after December 15, 2010. The effective date of the new disclosures about troubled debt restructurings was delayed to coordinate with the newly issued guidance for determining what constitutes a troubled debt restructuring (ASU No. 2011-02). The new disclosures were effective for interim and annual periods beginning on or after June 15, 2011 and increased the level of reporting disclosures related to troubled debt restructurings.

ASU No. 2011-02: *A Creditor s Determination of Whether a Restructuring Is a Troubled Debt Restructuring*.

In April 2011, ASU No. 2011-02 amended ASC Topic 310, Receivables to clarify authoritative guidance as to what loan modifications constitute concessions, and would therefore be considered a troubled debt restructuring. Classification as a troubled debt restructuring will automatically classify such loans as impaired. ASU No. 2011-02 clarifies that:

- If a debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the modified debt, the modification would be considered to be at a below-market rate, which may indicate that the creditor has granted a concession.
- A modification that results in a temporary or permanent increase in the contractual interest rate cannot be presumed to be at a rate that is at or above a market rate and therefore could still be considered a concession.
- A creditor must consider whether a borrower s default is probable on any of its debt in the foreseeable future when assessing financial difficulty.
- A modification that results in an insignificant delay in payments is not a concession.

In addition, ASU No. 2011-02 clarifies that a creditor is precluded from using the effective interest rate test in the debtor s guidance on modification of payables (ASC Topic 470, Debt) when evaluating whether a modification constitutes a troubled debt restructuring. The new authoritative guidance was effective for interim and annual

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periods beginning on or after June 15, 2011 and increased the volume of loans that the Corporation classified as troubled debt restructurings and required additional disclosures (see Note 6 Loans and Allowance for Loan Losses).

ASU No. 2011-08: Testing Goodwill for Impairment

In September 2011, ASU No. 2011-08 amended ASC Topic 350, Goodwill and Other to simplify the testing of goodwill impairments. This update will allow for a qualitative assessment of goodwill to determine whether or not it is necessary to perform the two-step impairment test described in ASC Topic 350. While the new authoritative guidance is effective for fiscal years beginning after December 15, 2011, the Corporation elected to early adopt the guidance as of December 31, 2011. The new guidance did not have any impact on the Corporation s consolidated financial statements.

Pending 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 is effective for interim and annual periods beginning on or after December 15, 2011 and is not expected to 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 is effective for interim and annual periods beginning on or after December 15, 2011 and is not expected to have a significant impact on the Corporation s consolidated financial statements.

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.

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The new authoritative guidance is effective for interim and annual periods beginning on or after December 15, 2011 and is not expected to have a significant impact on Corporation s consolidated financial statements since the Corporation has always elected to present a separate statement of comprehensive income.

NOTE 4 TRADING SECURITIES

Trading securities, at fair value, consist of the following investments at December 31:

	2011	2012
States and political subdivisions	$ 4,710	$ 5,837

Included in the net trading losses of $78 during 2011, were $60 of net trading losses on securities that relate to the Corporation s trading portfolio as of December 31, 2011. Included in net trading gains of $94 during 2010, were $74 of net trading gains on securities that relate to the Corporation s trading portfolio as of December 31, 2010.

NOTE 5 AVAILABLE-FOR-SALE INVESTMENT SECURITIES

The amortized cost and fair value of available-for-sale investment securities, with gross unrealized gains and losses, are as follows as of December 31:

	2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized 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
Total	**$ 414,614**	**$ 13,522**	**$ 3,016**	**$ 425,120**

	2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	$ 5,394	$ 10	$	$ 5,404
States and political subdivisions	167,328	3,349	960	169,717
Auction rate money market preferred	3,200		335	2,865
Preferred stocks	7,800		864	6,936
Mortgage-backed securities	101,096	1,633	514	102,215
Collateralized mortgage obligations	44,617	103	1,133	43,587
Total	**$ 329,435**	**$ 5,095**	**$ 3,806**	**$ 330,724**

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The amortized cost and fair value of available-for-sale securities by contractual maturity at December 31, 2011 are as follows:

	Maturing					
	Due in One Year or Less	After One Year But Within Five Years	After Five Years But Within Ten Years	After Ten Years	Securities With Variable Monthly Payments or Continual Call Dates	Total
Government sponsored enterprises	$	$	$ 395	$	$	$ 395
States and political subdivisions	8,381	34,610	87,436	36,405		166,832
Auction rate money market preferred					3,200	3,200
Preferred stocks					6,800	6,800
Mortgage-backed securities					140,842	140,842
Collateralized mortgage obligations					96,545	96,545
Total amortized cost	**$ 8,381**	**$ 34,610**	**$ 87,831**	**$ 36,405**	**$ 247,387**	**$ 414,614**
Fair value	**$ 8,441**	**$ 35,904**	**$ 93,586**	**$ 37,404**	**$ 249,785**	**$ 425,120**

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 the sale of available-for-sale debt securities is as follows during the years ended December 31:

	2011	2010	2009
Proceeds from sales of securities	$ 8,877	$ 18,303	$ 32,204
Gross realized gains	$ 3	$ 351	$ 648
Gross realized losses		(3)	
Net realized gains	$ 3	$ 348	$ 648
Applicable income tax expense	$ 1	$ 118	$ 220

The cost basis used to determine the realized gains or losses of securities sold was the amortized cost of the individual investment security as of the trade date.

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

	2011	
	Less Than Twelve Months	Over Twelve Months

	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Total Unrealized Losses
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
Total	**$ 98**	**$ 25,701**	**$ 2,918**	**$ 7,082**	**$ 3,016**
Number of securities in an unrealized loss position:		**6**		**6**	**12**

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	2010				
	Less Than Twelve Months		Over Twelve Months		
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Total Unrealized Losses
States and political subdivisions	$ 960	$ 29,409	$	$	$ 960
Auction rate money market preferred			335	2,865	335
Preferred stocks			864	2,936	864
Mortgage-backed securities	514	38,734			514
Collateralized mortgage obligations	1,133	33,880			1,133
Total	**$ 2,607**	**$ 102,023**	**$ 1,199**	**$ 5,801**	**$ 3,806**
Number of securities in an unrealized loss position:		**82**		**4**	**86**

As a result of market conditions associated with certain auction rate money market preferred investment securities, $7,800 of the Corporation s initial investment of $11,000 converted to preferred stocks with debt like characteristics in 2009. Due to the limited trading of these securities in 2009 and 2010, the Corporation utilized a discounted cash flow analysis to determine fair values on December 31, 2010. This analysis considered the creditworthiness of the counterparty, the timing of expected future cash flows, the current volume of trading activity, and recent trade prices. The discount rates used were determined by using the interest rates of similarly rated financial institution s debt based on the weighted average of a range of terms for corporate bond interest rates, which were obtained from published sources and ranged from 3.90% to 6.90% as of December 31, 2010. During 2011, the markets for these securities have normalized and established regular trading patterns. As such, the Corporation determined the fair value for these securities based on quoted prices for identical securities, or based on quoted prices for similar securities as of December 31, 2011.

As of December 31, 2011 and December 31, 2010, management conducted an analysis to determine whether all securities currently in an unrealized loss position, including auction rate money market preferred securities and preferred stocks, 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 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?
- Has the duration of the investment been extended?

As of December 31, 2011, 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 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. As a result, the Corporation has not recognized an other-than-temporary impairment related to these declines in fair value.

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

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Corporation will not have to sell the securities before recovery of their cost basis, management does not believe that the values of any such securities are other-than-temporarily impaired as of as of December 31, 2011 or 2010.

NOTE 6 LOANS AND ALLOWANCE FOR LOAN LOSSES (ALLL)

The Corporation grants commercial, agricultural, residential, 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 mortgage 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.

The accrual of interest on agricultural, commercial and mortgage 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 mortgage 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 mortgages 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 Bank 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 allowance.

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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Allowance for Loan Losses

A summary of changes in the allowance for loan losses (ALLL) and the recorded investment in loans by segments follows:

	Allowance for Credit Losses and Recorded Investment in Loans Year Ended December 31, 2011					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
Allowance for loan losses						
January 1, 2011	$ 6,048	$ 1,033	$ 3,198	$ 605	$ 1,489	$ 12,373
Loans charged off	(1,863)	(121)	(2,240)	(552)		(4,776)
Recoveries	460	1	177	314		952
Provision for loan losses	1,639	90	1,845	266	(14)	3,826
December 31, 2011	**$ 6,284**	**$ 1,003**	**$ 2,980**	**$ 633**	**$ 1,475**	**$ 12,375**
Allowance for loan losses as of December 31, 2011						
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
Total	**$ 6,284**	**$ 1,003**	**$ 2,980**	**$ 633**	**$ 1,475**	**$ 12,375**
Loans as of December 31, 2011						
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
Total	**$ 365,714**	**$ 74,645**	**$ 278,360**	**$ 31,572**		**$ 750,291**

	Allowance for Credit Losses and Recorded Investment in Loans Year Ended December 31, 2010					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
Allowance for loan losses						
January 1, 2010	$ 5,531	$ 731	$ 3,590	$ 626	$ 2,501	$ 12,979
Loans charged off	(3,731)		(2,524)	(596)		(6,851)
Recoveries	452	1	638	297		1,388
Provision for loan losses	3,796	301	1,494	278	(1,012)	4,857
December 31, 2010	**$ 6,048**	**$ 1,033**	**$ 3,198**	**$ 605**	**$ 1,489**	**$ 12,373**
Allowance for loan losses as of December 31, 2010						
Individually evaluated for impairment	$ 490	$ 558	$ 732	$	$	$ 1,780
Collectively evaluated for impairment	5,558	475	2,466	605	1,489	10,593
Total	**$ 6,048**	**$ 1,033**	**$ 3,198**	**$ 605**	**$ 1,489**	**$ 12,373**
Loans as of December 31, 2010						
Individually evaluated for impairment	$ 4,939	$ 2,196	$ 4,865	$ 48		$ 12,048
Collectively evaluated for impairment	343,913	69,250	279,164	30,929		723,256

Total	**$ 348,852**	**$ 71,446**	**$ 284,029**	**$ 30,977**	**$ 735,304**

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Following is a summary of changes in the ALLL for the year ended December 31, 2009:

January 1, 2009	$ 11,982
Loans charged off	(6,642)
Recoveries	1,546
Provision for loan losses	6,093
December 31, 2009	**$ 12,979**

Credit Quality Indicators

The following table displays the credit quality indicators for commercial and agricultural credit exposures based on internally assigned credit ratings as of December 31:

	2011					
	Commercial			Agricultural		
	Real Estate	Other	Total	Real Estate	Other	Total
Rating						
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
Total	**$ 258,095**	**$ 107,619**	**$ 365,714**	**$ 44,683**	**$ 29,962**	**$ 74,645**

	2010					
	Commercial			Agricultural		
	Real Estate	Other	Total	Real Estate	Other	Total
Rating						
2 - High quality	$ 10,995	$ 13,525	$ 24,520	$ 3,792	$ 1,134	$ 4,926
3 - High satisfactory	74,912	30,322	105,234	11,247	3,235	14,482
4 - Low satisfactory	119,912	57,403	177,315	22,384	14,862	37,246
5 - Special mention	19,560					