

ISABELLA BANK CORP  
Form DEF 14A  
April 11, 2013  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**SCHEDULE 14A**

**Proxy Statement Pursuant to Section 14(a) of the**  
**Securities Exchange Act of 1934**

**(Amendment No. )**

Filed by the Registrant

Filed by a Party other than the Registrant

Check the appropriate box:

- Preliminary Proxy Statement
- Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))**
- Definitive Proxy Statement
- Definitive Additional Materials
- Soliciting Material Pursuant to §240.14a-12

**ISABELLA BANK CORPORATION**  
(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

- No fee required.
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4) Date Filed:

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**ISABELLA BANK CORPORATION**

**401 N. Main St.**

**Mt. Pleasant, Michigan 48858**

**NOTICE OF THE ANNUAL MEETING OF SHAREHOLDERS**

**To Be Held May 7, 2013**

Notice is hereby given that the Annual Meeting of Shareholders of Isabella Bank Corporation will be held on Tuesday, May 7, 2013 at 5:00 p.m. Eastern Daylight Time, at the Comfort Inn, 2424 S. Mission Street, Mt. Pleasant, Michigan. The meeting is for the purpose of considering and acting upon the following items of business:

1. The election of four directors.
2. To transact such other business as may properly come before the meeting, or any adjournment or adjournments thereof.

The Board of Directors has fixed March 26, 2013 as the record date for determination of shareholders entitled to notice of, and to vote at, the meeting or any adjournments thereof.

Your vote is important. Even if you plan to attend the meeting, please date and sign the enclosed proxy form, indicate your choice with respect to the matters to be voted upon, and return it promptly in the enclosed envelope. Note that if stock is held in more than one name, all parties should sign the proxy form.

By order of the Board of Directors

Debra Campbell, Secretary

Dated: April 11, 2013

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**ISABELLA BANK CORPORATION**

**401 N. Main St.**

**Mt. Pleasant, Michigan 48858**

**PROXY STATEMENT**

**General Information**

As used in this Proxy Statement, references to the Corporation, we, our, us, and similar terms refer solely to the parent holding company, Isabella Bank Corporation. References to the Consolidated Corporation refer to consolidated entity consisting of Isabella Bank Corporation and its subsidiaries, and references to Isabella Bank or the Bank refer to Isabella Bank Corporation's subsidiary, Isabella Bank.

This Proxy Statement is furnished in connection with the solicitation of proxies, to be voted at our Annual Meeting of Shareholders (the Annual Meeting) which is to be held on Tuesday, May 7, 2013 at 5:00 p.m. at the Comfort Inn, 2424 S. Mission Street, Mt. Pleasant, Michigan, or at any adjournment or adjournments thereof, for the purposes set forth in the accompanying Notice of Annual Meeting of Shareholders and in this Proxy Statement.

This Proxy Statement has been mailed on April 11, 2013 to all holders of record of common stock as of the record date. If a shareholder's shares are held in the name of a broker, bank or other nominee, then that party should give the shareholder instructions for voting the shareholder's shares.

**Voting at the Meeting**

We have fixed the close of business on March 26, 2013 as the record date for the determination of shareholders entitled to notice of, and to vote at, the Annual Meeting and any adjournment thereof. We have only one class of common stock and no preferred stock. As of March 26, 2013, there were 7,670,669 shares of stock outstanding. Each outstanding share entitles the holder thereof to one vote on each separate matter presented for vote at the meeting. You may vote on matters that are properly presented at the Annual Meeting by either attending the meeting and casting a vote, or by signing and returning the enclosed proxy. If the enclosed proxy is executed and returned, it may be revoked by you at any time before it is exercised at the Annual Meeting. You are encouraged to date and sign the enclosed proxy, indicate your choice, and return it to us.

We will hold the Annual Meeting if a majority of the shares of common stock entitled to vote are represented in person or by proxy. If you sign and return the proxy, those shares will be counted to determine if there is a quorum, even if you abstain or fail to vote on any of the proposals.

Your broker may not vote on the election of directors if you do not furnish instructions for such proposals. You should use the voting instruction card provided by us to instruct the broker to vote the shares, or else your shares will be considered broker non-votes. Broker non-votes are shares held by brokers or nominees as to which voting instructions have not been received from the shares' beneficial owner or the individual entitled to vote those shares and the broker or nominee does not have discretionary voting power under rules applicable to broker-dealers. Under these rules, Proposal 1 is not an item on which brokerage firms may vote in their discretion on your behalf unless you have furnished voting instructions.

At this year's Annual Meeting, you will elect four directors to serve for a term of three years. You may vote in favor, against, or withhold votes for any or all nominees. Directors are elected by a plurality of the votes cast at the annual meeting. Shares not voted, including broker non-votes, have no effect on the elections.

**Proposal 1-Election of Directors**

On December 19, 2012, James C. Fabiano and Dale D. Weburg retired from the Board of Directors (the Board) and the number of directors was reduced to 12. The Board is divided into three classes, with the directors in each class being elected for a term of three years. At the Annual Meeting, Thomas L. Kleinhardt, Joseph LaFramboise, Wilson C. Lauer, and Sarah R. Opperman, whose terms expire at the Annual Meeting, have been nominated for election through 2016 for the reasons described below.

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Except as otherwise specified, proxies will be voted for election of the four nominees. If a nominee becomes unable or unwilling to serve, proxies will be voted for such other person, if any, as shall be designated. However, we know of no reason to anticipate that this will occur. The four nominees who receive the greatest number of votes cast will be elected directors. Each of the nominees has agreed to serve as a director if elected.

Nominees and current directors, including their principal occupation for the last five or more years, age, and length of service as a director, are listed below.

**We unanimously recommend that you vote FOR the election of each of the nominees.**

**Director Qualifications**

Board members are highly qualified and represent your best interests. We select nominees who:

Have extensive business leadership

Bring a diverse perspective and experience

Are independent and collegial

Have high ethical standards and have demonstrated sound business judgment

Are willing and able to commit the significant time and effort to effectively fulfill their responsibilities

Are active in and knowledgeable of their respective communities

Each nominee and current director possess these qualities and provides a diverse complement of specific business skills, experience, and knowledge including extensive financial and accounting experience, knowledge of banking, small business operating experience, and specific knowledge of customer market segments including agriculture, oil and gas, health care, manufacturing, and retail.

The following describes the key qualifications each director brings to the Board, in addition to the general qualifications described above and the information included in the biographical summaries provided below.

| Director             | Professional Standing in Chosen Field | Expertise in financial or related field | Audit Committee | Civic involvement | Leadership and team building skills | Diversity by race, gender, and cultural diversity | Geographical diversity | Finance | Tech-nology | Market-ing | Gov-ernance | Entre-preneurial skills | Human Resources | Bank business segment representation |
|----------------------|---------------------------------------|---|-----------------|-------------------|-------------------------------------|---|------------------------|---------|-------------|------------|-------------|-------------------------|-----------------|--------------------------------------|
| David J. Maness      | X                                     |   |                 | X                 | X                                   |   |                        |         | X           |            |             | X                       |                 | X                                    |
| Dennis P. Angner     | X                                     | X                                       |                 | X                 | X                                   |   |                        | X       | X           |            | X           |                         |                 |                                      |
| Jeffrey J. Barnes    | X                                     |   |                 | X                 | X                                   |   | X                      |         |             |            |             | X                       |                 | X                                    |
| Richard J. Barz      | X                                     | X                                       |                 | X                 | X                                   |   |                        | X       |             | X          |             |                         | X               |                                      |
| Sandra L. Caul       | X                                     |   |                 | X                 | X                                   | X   |                        |         |             |            |             |                         | X               | X                                    |
| G. Charles Hubscher  | X                                     | X                                       |                 | X                 | X                                   |   |                        |         |             |            |             | X                       |                 | X                                    |
| Thomas L. Kleinhardt | X                                     |   |                 | X                 | X                                   |   | X                      |         |             | X          |             | X                       |                 | X                                    |

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|                    |   |   |   |   |   |   |   |   |   |   |   |   |
|--------------------|---|---|---|---|---|---|---|---|---|---|---|---|
| Joseph LaFramboise | X |   |   | X | X |   | X |   |   | X |   |   |
| Wilson C. Lauer    | X |   |   | X | X |   | X |   |   |   | X | X |
| W. Joseph Manifold | X | X | X | X | X |   |   | X | X |   |   |   |
| W. Michael McGuire | X | X | X | X | X |   | X | X | X |   | X |   |
| Sarah R. Opperman  | X |   |   | X | X | X | X |   |   | X | X | X |

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The following table identifies individual Board members serving on each of our standing committees:

| <b>Director</b>      | <b>Audit</b>   | <b>Nominating<br/>and Corporate<br/>Governance</b> | <b>Compensation<br/>and Human<br/>Resource</b> |
|----------------------|----------------|--|--|
| David J. Maness      | X <sup>o</sup> | X <sup>o</sup>                                     | X <sup>c</sup>                                 |
| Dennis P. Angner     |                |  |  |
| Jeffrey J. Barnes    | X              |  | X  |
| Richard J. Barz      |                |  |  |
| Sandra L. Caul       |                |  | X  |
| G. Charles Hubscher  | X              |  | X  |
| Thomas L. Kleinhardt |                |  | X  |
| Joseph LaFramboise   | X              | X  | X  |
| Wilson C. Lauer      |                |  | X  |
| W. Joseph Manifold   | X <sup>c</sup> | X  | X  |
| W. Michael McGuire   | X              | X <sup>c</sup>                                     | X  |
| Sarah R. Opperman    |                |  | X  |

C Chairperson

O Ex-Officio

**Director Nominees for Terms Ending in 2016**

*Thomas L. Kleinhardt* (age 58) has been a director of the Bank since 1998 and was appointed to the Board effective January 1, 2010.

Mr. Kleinhardt is President of McGuire Chevrolet, is active in the Clare Kiwanis Club, and coaches the girls Varsity Basketball team at Farwell High School.

*Joseph LaFramboise* (age 63) has been a director of the Bank since 2007, and was appointed to the Board effective January 1, 2010. He is a retired Sales and Marketing Executive of Ford Motor Company. Mr. LaFramboise is an Ambassador of Eagle Village in Evart, Michigan.

*Wilson C. Lauer* (age 63) was appointed to the Board on July 1, 2012. Mr. Lauer has served as a director for the Isabella Bank-Breckenridge Division Board since 1997 and owns Lauer Farms LLC, a 2,500 acre cash crop business. Mr. Lauer has served several different community organizations including the Ithaca School District Board, the Gratiot Economic Development Board, and Farm Bureau's County and State Policy Development Committees.

*Sarah R. Opperman* (age 53) was appointed to the Board on July 1, 2012. Ms. Opperman is the owner of Opperman Consulting, LLC, which provides public affairs counsel for corporate clients. She was previously employed for 28 years by The Dow Chemical Company, where she held leadership roles in public and government affairs. She was inducted into the CMU Journalism Hall of Fame and is a recipient of the Dow Genesis Award for Excellence in People Development. Ms. Opperman serves on the CMU Board of Trustees, the CMU Research Corporation Board of Directors, and the MidMichigan Health Corporate Board of Directors.

**Current Directors with Terms Ending in 2014**

*Dennis P. Angner* (age 57) has been a director of the Corporation and the Bank since 2000. Mr. Angner has been principally employed by the Consolidated Corporation since 1984 and has served as President of the Corporation since December 30, 2001 and CFO since January 1, 2010. Mr. Angner served as Chief Executive Officer of the Corporation from December 30, 2001 through December 31, 2009. He is a past Chair of the Michigan Bankers Association and is currently serving as vice chairman of its taxation committee, is a member of the American Bankers Association Government Relations Council, and served on the Central Michigan American Red Cross board for over 20 years.



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*Dr. Jeffrey J. Barnes* (age 50) has been a director of the Bank since 2007 and of the Corporation since 2010. Dr. Barnes is a physician and shareholder in Lansing Ophthalmology PC. He is a former member of the Central Michigan Community Hospital Board of Directors.

*G. Charles Hubscher* (age 59) has been a director of the Bank since 2004 and of the Corporation since 2010. Mr. Hubscher is President of Hubscher and Son, Inc., a sand and gravel producer. He is a director of the National Stone and Gravel Association, the Michigan Aggregates Association, serves on the Board of Trustees for the Mt. Pleasant Area Community Foundation, and is a member of the Zoning Board of Appeals for Deerfield Township.

*David J. Maness* (age 59) has been a director of the Bank since 2003 and of the Corporation since 2004. Mr. Maness has served as chairman of the board for the Corporation and the Bank since 2010. He is President of Maness Petroleum, a geological and geophysical consulting services company. Mr. Maness is currently serving as a director for the Michigan Oil & Gas Association, and he previously served on the Mt. Pleasant Public Schools Board of Education.

*W. Joseph Manifold* (age 61) has been a director of the Corporation since 2003 and of the Bank since January 1, 2010. Mr. Manifold is CFO of Federal Broach Holdings LLC, a holding company which operates several manufacturing companies. Previously, he was a senior manager with Ernst & Young Certified Public Accounting firm working principally on external bank audits and was CFO of the Delfield Company. Prior to joining the Board, Mr. Manifold served on the Isabella Community Credit Union Board and was Chairman of the Mt. Pleasant Public Schools Board of Education.

**Current Directors with Terms Ending in 2015**

*Richard J. Barz* (age 64) has been a director of the Bank since 2000 and of the Corporation since 2002. Mr. Barz has been employed by the Consolidated Corporation since 1972 and has been Chief Executive Officer of the Corporation since 2010 and President and CEO of the Bank from 2001 to July 2012. Mr. Barz has been very active in community organizations and events. He is a past chairman of the Central Michigan Community Hospital Board of Directors, is the current chairman of the Middle Michigan Development Corporation Board of Directors, and serves on several boards and committees for Central Michigan University and various volunteer organizations throughout mid-Michigan.

*Sandra L. Caul* (age 69) has been a director of the Bank since 1994 and of the Corporation since 2005. Ms. Caul is Vice Chairperson of the Central Michigan Community Hospital Board of Directors, Chairperson of the Mid Michigan Community College Advisory Board, a board member for Central Michigan Community Mental Health Facilities, a member of the Central Michigan Health Advisory Board for Central Michigan University and Chairperson for the Central Michigan University College of Medicine regional division fund raising effort. She also sits on the board of the Central Michigan American Red Cross. Ms. Caul retired in January 2005 as a state representative of the Michigan State House of Representatives. Ms. Caul is a registered nurse.

*W. Michael McGuire* (age 63) has been a director of the Corporation since 2007 and of the Bank since January 1, 2010. Mr. McGuire is currently an attorney and the Director of the Office of the Corporate Secretary and Assistant Secretary of The Dow Chemical Company, a manufacturer of chemicals, plastics and agricultural products, headquartered in Midland, Michigan.

Each of the directors has been engaged in their stated professions for more than five years.

**Other Named Executive Officers**

*Steven D. Pung* (age 63), President of the Bank and a member of the Board of Directors of Financial Group Information Services (a wholly owned subsidiary of the Corporation) has been employed by the Bank since 1978. Timothy M. Miller (age 61), President of the Breckenridge Division of the Bank and a member of its Board of Directors, has been an employee of the Bank since 1985. David J. Reetz (age 52), Senior Vice President and Chief Lending Officer of the Bank, has been employed by the Bank since 1987.

All officers serve at the pleasure of the Board.

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**Corporate Governance**

**Director Independence**

We have adopted the director independence standards as defined under of the NASDAQ Stock Market Rules. We have determined that Jeffrey J. Barnes, Sandra L. Caul, G. Charles Hubscher, Thomas L. Kleinhardt, Joseph LaFramboise, Wilson C Lauer, David J. Maness, W. Joseph Manifold, W. Michael McGuire, and Sarah R. Opperman are independent directors. Former directors James C. Fabiano and Dale D. Weburg, who retired from the Board on December 19, 2012, were also determined to be independent directors. Richard J. Barz is not independent as he is employed as CEO of the Corporation. Dennis P. Angner is not independent as he is employed as President and CFO of the Corporation.

**Board Leadership Structure and Risk Oversight**

Our Governance policy provides that only directors who are deemed to be independent as set forth by NASDAQ and SEC rules are eligible to hold the office of chairperson. Additionally, the chairpersons of Board established committees must also be independent directors. It is our belief that having a separate chairperson and CEO best serves the interest of the shareholders. The Board elects its chairperson at the first Board meeting following the annual meeting. Independent members of the Board meet without inside directors at least twice per year.

Management is responsible for our day-to-day risk management and the Board's role is to engage in informed oversight. The Board utilizes committees to oversee risks associated with compensation and governance. Financial Group Information Services, our information processing subsidiary, is responsible for overseeing risks associated with information technology. The Isabella Bank Board of Directors is responsible for overseeing credit, investment, interest rate, and trust risks. The chairpersons of the respective boards or committees report on their activities on a regular basis.

Our Audit Committee is responsible for overseeing the integrity of our consolidated financial statements, the independent auditors' qualifications and independence, the performance of our internal audit function and those of independent auditors, our system of internal controls, our financial reporting and system of disclosure controls, and our compliance with legal and regulatory requirements and with our Code of Business Conduct and Ethics.

**Committees of the Board of Directors and Meeting Attendance**

The Board met 12 times during 2012. All incumbent directors attended 75% or more of the meetings held in 2012. The Board has an Audit Committee, a Nominating and Corporate Governance Committee, and a Compensation and Human Resource Committee.

***Audit Committee***

The Audit Committee is composed of independent directors. Information regarding the functions performed by the Committee, its membership, and the number of meetings held during the year, is set forth in the Report of the Audit Committee included elsewhere in this proxy statement. The Audit Committee is governed by a written charter approved by the Board, which is available on the Bank's website: [www.isbellabank.com](http://www.isbellabank.com).

In accordance with the provisions of the Sarbanes-Oxley Act of 2002, directors Manifold and McGuire meet the requirements of Audit Committee Financial Expert and have been so designated. The Committee also consists of directors Barnes, Hubscher, LaFramboise, and Maness (ex-officio).

***Nominating and Corporate Governance Committee***

We have a standing Nominating and Corporate Governance Committee consisting of independent directors. The Committee consists of directors LaFramboise, Maness (ex-officio), Manifold, and McGuire. The Nominating and Corporate Governance Committee held one meeting in 2012, with all directors attending the

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meeting. The Board has approved a Nominating and Corporate Governance Committee Charter which is available on the Bank's website [www.isabellabank.com](http://www.isabellabank.com).

The Nominating and Corporate Governance Committee is responsible for evaluating and recommending individuals for nomination to the Board for approval. The Committee in evaluating nominees, including incumbent directors and any nominees put forth by shareholders, considers business experience, skills, character, judgment, leadership experience, and their knowledge of the geographical markets, business segments or other criteria the Committee deems relevant and appropriate based on the current composition of the Board. The Committee considers diversity in identifying members with respect to our geographical markets served and the business experience of the nominee.

The Nominating and Corporate Governance Committee will consider, as potential nominees persons recommended by shareholders. Recommendations should be submitted in writing to the Secretary of the Corporation, 401 N. Main St., Mt. Pleasant, Michigan 48858 and include the shareholder's name, address and number of shares of the Corporation owned by the shareholder. The recommendation should also include the name, age, address and qualifications of the candidate. Recommendations for the 2014 Annual Meeting of Shareholders should be delivered no later than December 12, 2013. The Nominating and Corporate Governance Committee evaluates all potential director nominees in the same manner, whether the nominations are received from a shareholder, or otherwise.

### ***Compensation and Human Resource Committee***

The Compensation and Human Resource Committee is responsible for reviewing and recommending to the our Board the compensation of the Chief Executive Officer and other executive officers, benefit plans and the overall percentage increase in salaries. The committee consists of independent directors Maness, Barnes, Caul, Hubscher, Kleinhardt, LaFramboise, Lauer, Manifold, McGuire, and Opperman. The committee held two meetings during 2012 with all directors in attendance. This Committee is governed by a written charter approved by the Board that is available on the Bank's website [www.isabellabank.com](http://www.isabellabank.com).

### ***Communications with the Board***

Shareholders may communicate with the Board by sending written communications to the attention of the Corporation's Secretary, Isabella Bank Corporation, 401 N. Main St., Mt. Pleasant, Michigan 48858. Communications will be forwarded to the Board or the appropriate committee, as soon as practicable.

### ***Code of Ethics***

Our Code of Business Conduct and Ethics, which is applicable to the CEO and CFO, is available on the Bank's website [www.isabellabank.com](http://www.isabellabank.com).

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**Report of the Audit Committee**

The Audit Committee oversees the financial reporting process on behalf of the Board. The 2012 Committee consisted of directors Barnes, Hubscher, LaFramboise, Maness, Manifold, and McGuire.

The Audit Committee is responsible for pre-approving all auditing services and permitted non-audit services by our independent auditors, or any other auditing or accounting firm, if those fees are reasonably expected to exceed 5.0% of the current year agreed upon fee for independent audit services, except as noted below. The Audit Committee has established general guidelines for the permissible scope and nature of any permitted non-audit services in connection with its annual review of the audit plan and reviews the guidelines with the Board of Directors.

Management has the primary responsibility for the consolidated financial statements and the reporting process including the systems of internal controls. In fulfilling its oversight responsibilities, the Audit Committee reviewed the audited consolidated financial statements in the Annual Report with management including a discussion of the quality, not just the acceptability, of the accounting principles, the reasonableness of significant judgments, and the clarity of disclosures in the consolidated financial statements. The Audit Committee also reviewed with management and the independent auditors, management's assertion on the design and effectiveness of the Corporation's internal control over financial reporting as of December 31, 2012.

The Audit Committee reviewed with our independent auditors, who are responsible for expressing an opinion on the conformity of those audited consolidated financial statements with accounting principles generally accepted in the United States of America, their judgments as to the quality, not just the acceptability, of our accounting principles and such other matters as are required to be discussed with the Audit Committee by the standards of the Public Company Accounting Oversight Board (United States), including those described in AU Section 380

Communication with Audit Committees, as may be modified or supplemented. In addition, the Audit Committee has received the written disclosures and the letter from the independent auditors required by PCAOB Rule 3526, Communication with Audit Committees Concerning Independence, as may be modified or supplemented, and has discussed with the independent auditor the independent auditors' independence.

The Audit Committee discussed with our internal and independent auditors the overall scope and plans for their respective audits. The Audit Committee meets with the internal and external independent auditors, with and without management present, to discuss the results of their examinations, their evaluations of our internal controls, and the overall quality of our financial reporting process. The Audit Committee held five meetings during 2012, and all committee members attended 75% or more of the meetings.

In reliance on the reviews and discussions referred to above, the Audit Committee recommended to the Board of Directors (and the Board has approved) that the audited consolidated financial statements be included in the Annual Report on Form 10-K for the year ended December 31, 2012 for filing with the Securities and Exchange Commission. The Audit Committee has appointed Rehmann Robson LLC as the independent auditors for the 2013 audit.

Respectfully submitted,

W. Joseph Manifold, Audit Committee Chairperson

Jeffrey J. Barnes

G. Charles Hubscher

Joseph LaFramboise

David J. Maness

W. Michael McGuire

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### **Compensation Discussion and Analysis**

The Compensation and Human Resource Committee is responsible for reviewing and recommending the compensation and benefits for the CEO, President and CFO, and executive officers. The Committee evaluates and approves our executive officer and senior management compensation plans, policies, and programs. The CEO, Richard J. Barz, conducts annual performance reviews for Named Executive Officers, excluding himself. Mr. Barz recommends an appropriate salary to the Committee based on the performance review and the officer's years of service along with competitive market data.

#### **Compensation Objectives**

The Committee considers asset growth with the safety and soundness objectives and earnings per share to be the primary ratios in measuring financial performance. Our philosophy is to maximize long-term return to shareholders consistent with safe and sound banking practices, while maintaining the commitment to superior customer and community service. We believe that the performance of executive officers in managing the business should be the basis for determining overall compensation. Consideration is also given to overall economic conditions and current competitive forces in the market place. The objectives of the Committee are to effectively balance salaries and potential compensation to an officer's individual management responsibilities and encourage each of them to realize their potential for future contributions. The objectives are designed to attract and retain high performing executive officers who will provide leadership while attaining earnings and performance goals.

#### **What the Compensation Programs are Designed to Reward**

Our compensation programs are designed to reward dedicated and conscientious employment, loyalty in terms of continued employment, attainment of job related goals and overall profitability. In measuring an executive officer's contributions, the Committee considers numerous factors including, among other things, our growth in terms of asset size and increase in earnings per share. In rewarding loyalty and long-term service, we provide attractive retirement benefits.

#### **Review of Risks Associated with Compensation Plans**

Based on an analysis conducted by management and reviewed by the Committee, we do not believe that compensation programs for employees are reasonably likely to have a material short or long term adverse effect on our operating results.

#### **Use of Consultants**

In 2012, the Committee directly engaged the services of Blanchard Consulting Group, an independent compensation consulting firm, to assist with a total compensation review for the top three executive officers of the Consolidated Corporation (CEO, President and CFO, and Bank President). Blanchard Consulting Group does not perform any additional services for us or any members of senior management. In addition, Blanchard Consulting Group does not have any other personal or business relationships with any Board members or officers. During 2011, the Committee did not employ any services of outside compensation or benefit consultants to assist it in compensation-related initiatives.

#### **Elements of Compensation**

Our executive compensation program has consisted primarily of base salary and benefits, annual performance incentives, benefits and perquisites, and participation in our retirement plans.

#### **How Elements Fit into Overall Compensation Objectives**

Individual elements of our compensation objectives are structured to reward strong financial performance, continued service, and to incentivize our leaders to excel in the future. We continually review our compensation objectives to ensure that they are sufficient to attract and retain exceptional officers.

**Table of Contents****Why Each of the Elements of Compensation is Chosen and How We Determine Amounts for Each Element**

*Base Salaries*, which include director fees for certain executive officers, are set to provide competitive levels of compensation to attract and retain officers with strong leadership skills. Each officer's performance, current compensation, and responsibilities are considered by the Committee when establishing base salaries. We also believe it is best to pay sufficient base salary because we believe an over-reliance on equity incentive compensation could potentially skew incentives toward short-term maximization of shareholder value as opposed to building long-term shareholder value. Competitive base salary encourages management to operate in a safe and sound manner even when incentive goals may prove unattainable.

The Committee's approach to determining the annual base salary of executive officers is to offer competitive salaries in comparison with other comparable financial institutions. The Committee utilized both an independent compensation consultant, Blanchard Consulting Group, and a survey prepared by the Michigan Bankers Association of similar sized Michigan based financial institutions. The independent compensation consultant established a benchmark peer group of 15 mid-west financial institutions in non-urban areas with comparable average assets size (\$900 million - \$2 billion), number of branch locations, return on average assets (year-ended 2011 ROAA of .38% or greater), and nonperforming assets. The Michigan Bankers Association 2012 compensation survey was based on the compensation information provided by these organizations for 2011. Specific factors used to decide where an executive officer's salary should be within the established range include the historical financial performance, financial performance outlook, years of service, and job performance. The Committee targeted total compensation for the CEO, the President & CFO, and Bank President to approximate the median of the range obtained from the Michigan Bankers Association compensation survey as well as any ranges obtained from the independent compensation consultant. Compensation for other named executive officers was based on the ranges provided by the Michigan Bankers Association survey.

*Annual Performance Incentives* are used to reward executive officers based on our overall financial performance. This element of the compensation program is included in the overall compensation in order to reward employees above and beyond their base salaries when our performance and profitability exceed established annual targets. The inclusion of this modest incentive encourages management to be creative and diligent in managing to achieve specific financial goals without incurring inordinate risks. Annual performance incentives paid in 2012 were determined by reference to seven performance measures that related to services performed in 2011. The maximum award that may be granted to each eligible employee equals 10% of the employee's base salary (the *Maximum Award*).

The payment of 35% of the *Maximum Award* ( *personal performance goals* ) is based on the achievement of goals set for each individual. An analysis is conducted by the CEO. The CEO makes a recommendation to the Committee for the appropriate amount for each individual executive officer. The Committee reviews, modifies if necessary, and approves the recommendations of the CEO. The Committee reviews the performance of the CEO. The Committee uses the following factors as quantitative measures of corporate performance in determining annual cash bonus amounts to be paid:

Peer group financial performance compensation

1 and 5 year shareholder returns

Earnings per share and earnings per share growth

Budgeted as compared to actual annual operating performance

Community and industry involvement

Results of audit and regulatory exams

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Other strategic goals as established by the Board

Each of the executive officers who were eligible to participate in 2011 accomplished their personal performance goals and were accordingly paid 35% of the 2011 Maximum Award in 2012.

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The payment of the remaining 65% of the Maximum Award ( corporate performance goals ) was conditioned on the achievement of targets in the following six categories:

- (1) Earnings per share (weighted 40%).
- (2) Net operating expenses to average assets (weighted 15%).
- (3) Fully Taxable Equivalent ( FTE ) net interest margin, excluding loan fees (weighted 10%).
- (4) In-market deposit growth (weighted 10%).
- (5) Loan growth (weighted 15%).
- (6) Exceeding peer group return on average assets (weighted 10%).

The following chart provides the 2011 target for each corporate performance goal, as well as the performance attained for each target.

| Target  | 2011 Targets |         |         |         | 2011 Performance | Target % Obtained |
|---|--------------|---------|---------|---------|------------------|-------------------|
|   | 25.00%       | 50.00%  | 75.00%  | 100.00% |                  |                   |
| Earning per share                             | \$ 1.31      | \$ 1.33 | \$ 1.35 | \$ 1.37 | \$ 1.39          | 100%              |
| Net operating expenses to average assets      | 1.69%        | 1.68%   | 1.67%   | 1.64%   | 1.61%            | 100%              |
| FTE Net Interest Margin                       | 3.72%        | 3.74%   | 3.76%   | 3.78%   | 3.68%            | 0%                |
| In market deposit growth                      | 4.50%        | 5.00%   | 5.50%   | 6.00%   | 7.12%            | 100%              |
| Loan growth                                   | 3.00%        | 3.50%   | 4.00%   | 4.50%   | 0.78%            | 0%                |
| Exceeding peer group return on average assets | 1.01%        | 1.04%   | 1.06%   | 1.09%   | 0.98%            | 0%                |

**Benefits and Perquisites.** Executive officers are eligible for all of the benefits made available to full-time employees (such as health insurance, group term life insurance and disability insurance) on the same basis as other full-time employees and are subject to the same sick leave and other employee policies.

We also provide our executive officers with certain additional perquisites, which we believe are appropriate in order to attract and retain the proper quality of talent for these positions and to recognize that similar executive perquisites are commonly offered by comparable financial institutions. We maintain a plan for qualified officers to provide death benefits to each participant. Insurance policies, designed primarily to fund death benefits, have been purchased on the life of each participant with the Bank as the sole owner and beneficiary of the policies. We believe that perquisites provided to our executive officers in 2012 represented a reasonable percentage of each executive's total compensation package and are consistent, in the aggregate, with perquisites provided to executive officers of comparable financial institutions. A description and the cost of these perquisites are included in footnotes 2 and 3 in the Summary Compensation Table appearing on page 12.

**Retirement Plans.** Our retirement plans are designed to assist executives in providing themselves with a financially secure retirement. The retirement plans include a 401(k) plan, a frozen defined benefit pension plan, a frozen non-leveraged employee stock ownership plan (ESOP), and a retirement bonus plan.

We have a 401(k) plan, in which substantially all employees are eligible to participate. Employees may contribute up to 50% of their compensation subject to certain limits based on federal tax laws. We provide an annual 3.0% of compensation safe harbor contribution for all eligible employees and matching contributions equal to 50% of the first 4.0% of an employee's compensation contributed to the plan during the



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year. Employees are 100% vested in the safe harbor contributions and are 0% vested through their first two years of employment and are 100% vested after 6 years through a laddered vesting schedule of service for matching contributions.

Our defined benefit pension plan was curtailed effective March 1, 2007 and the current participants' accrued benefits were frozen as of that date. Participation in the plan was limited to eligible employees as of December 31, 2006.

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Our non-leveraged ESOP was frozen effective December 31, 2006 to new participants. Contributions to the plan are discretionary and approved by the Board.

The retirement bonus plan is a nonqualified plan of deferred compensation benefits for eligible employees effective January 1, 2007. Benefit amounts are determined pursuant to the payment schedule adopted at the sole and exclusive discretion of the Board.

**Compensation and Human Resource Committee Report**

The Compensation and Human Resource Committee Report does not constitute soliciting material and should not be deemed filed or incorporated by reference into any other Corporation filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent the Corporation specifically incorporates this Report by reference therein.

The Compensation and Human Resource Committee, which includes all of the independent directors of the Board, has reviewed and discussed the Compensation Discussion and Analysis required by Item 402(b) of SEC Regulation S-K with management, and based on such review and discussion, the Compensation and Human Resource Committee recommended to the Board that the Compensation Discussion and Analysis be included in this Proxy Statement and the Annual Report on Form 10-K.

Submitted by the Compensation and Human Resource Committee of the Board:

David J. Maness, Chairperson

Jeffrey J. Barnes

Sandra L. Caul

G. Charles Hubscher

Thomas L. Kleinhardt

Joseph LaFramboise

Wilson C. Lauer

W. Joseph Manifold

W. Michael McGuire

Sarah R. Opperman

**Table of Contents****Executive Officers**

Executive officers are compensated in accordance with their employment with the applicable entity. The following table shows information on compensation earned in each of the last three fiscal years ended December 31, 2012, for the CEO, the CFO, and our three other most highly compensated executive officers.

**Summary Compensation Table**

| Name and principal position   | Year | Salary<br>\$(1) | Bonus<br>(\$) | Change in pension   | All other<br>compensation<br>\$(3) | Total (\$) |
|-------------------------------|------|-----------------|---------------|---|------------------------------------|------------|
|                               |      |                 |               | value and<br>non-qualified<br>deferred<br>compensation<br>earnings<br>\$(2) |                                    |            |
| Richard J. Barz               | 2012 | \$ 396,325      | \$ 25,106     | \$ 123,578  | \$ 35,615                          | \$ 580,624 |
| CEO                           | 2011 | 375,225         | 26,535        | 181,143   | 37,627                             | 620,530    |
| Isabella Bank Corporation     | 2010 | 357,600         | 24,706        | 116,364   | 34,856                             | 533,526    |
| Dennis P. Angner              | 2012 | \$ 357,335      | \$ 23,628     | \$ 131,266  | \$ 28,208                          | \$ 540,437 |
| President and CFO             | 2011 | 355,625         | 26,100        | 163,672   | 28,542                             | 573,939    |
| Isabella Bank Corporation     | 2010 | 352,600         | 24,706        | 103,340   | 27,922                             | 508,568    |
| Steven D. Pung                | 2012 | \$ 195,128      | \$ 13,333     | \$ 67,361   | \$ 30,111                          | \$ 305,933 |
| President                     | 2011 | 167,362         | 12,719        | 98,915  | 27,732                             | 249,378    |
| Isabella Bank                 | 2010 | 143,632         | 10,572        | 62,288  | 32,886                             | 249,378    |
| Timothy M. Miller             | 2012 | \$ 186,459      | \$ 11,804     | \$ 10,000   | \$ 16,676                          | \$ 224,939 |
| President of the Breckenridge | 2011 | 181,986         | 13,046        | 17,000  | 15,070                             | 227,102    |
| Division of Isabella Bank     | 2010 | 179,309         | 12,370        | 9,000   | 14,709                             | 215,388    |
| David J. Reetz                | 2012 | \$ 129,397      | \$ 9,708      | \$ 45,361   | \$ 17,138                          | \$ 201,604 |
| Sr. Vice President and CLO    | 2011 | 125,640         | 8,612         | 61,944  | 15,077                             | 211,273    |
| Isabella Bank                 | 2010 | 123,910         | 9,165         | 36,429  | 13,694                             | 183,198    |

- (1) Includes compensation voluntarily deferred under our 401(k) plan. Directors fees are also included, for calendar years 2012, 2011 and 2010 respectively as follows: Richard J. Barz \$51,325, \$50,225, and \$52,600; Dennis P. Angner \$51,325, \$49,625, and \$52,600; Steven D. Pung \$900, \$900, and \$900; and Timothy M. Miller \$10,400, \$10,650, and \$11,300.
- (2) Represents the aggregate non-cash change in the actuarial present value of the noted executive's accumulated benefit under the Isabella Bank Corporation Pension Plan for calendar years 2012, 2011, and 2010 as follows: Richard J. Barz \$83,000, \$143,000, and \$81,000; Dennis P. Angner \$64,000, \$109,000, and \$53,000; Steven D. Pung \$44,000, \$77,000, and \$42,000; Timothy M. Miller \$10,000, \$17,000, and \$9,000; David J. Reetz \$25,000, \$43,000 and \$19,000; this also includes the non-cash change in the Isabella Bank Corporation Retirement Bonus Plan for calendar years 2012, 2011, and 2010 as follows: Richard J. Barz \$40,578, \$38,143, and \$35,364; Dennis P. Angner \$67,266, \$54,672, and \$50,340; Steven D. Pung \$23,361, \$21,915, and \$20,288; and David J. Reetz \$20,361, \$18,944 and \$17,429.
- (3) For all named executives all other compensation includes 401(k) matching contributions. For Richard J. Barz, Steven D. Pung, and David J. Reetz this also includes club dues and auto allowance. For Dennis P. Angner and Timothy M. Miller, this also includes auto allowance.

**Table of Contents****2012 Pension Benefits**

The following table indicates the present value of accumulated benefits as of December 31, 2012 for each named executive in the summary compensation table.

| Name              | Plan name                                       | Number of years of vesting service as of 01/01/12 (#) | Present value of accumulated benefit (\$) | Payments during last fiscal year |
|-------------------|---|---|---|----------------------------------|
| Richard J. Barz   | Isabella Bank Corporation Pension Plan          | 41  | \$ 988,000                                | \$                               |
|                   | Isabella Bank Corporation Retirement Bonus Plan | 41  | 349,652                                   |                                  |
| Dennis P. Angner  | Isabella Bank Corporation Pension Plan          | 29  | 555,000                                   |                                  |
|                   | Isabella Bank Corporation Retirement Bonus Plan | 29  | 397,471                                   |                                  |
| Steven D. Pung    | Isabella Bank Corporation Pension Plan          | 34  | 505,000                                   |                                  |
|                   | Isabella Bank Corporation Retirement Bonus Plan | 34  | 190,906                                   |                                  |
| Timothy M. Miller | Isabella Bank Corporation Pension Plan          | 12  | 106,000                                   |                                  |
| David J. Reetz    | Isabella Bank Corporation Pension Plan          | 26  | 187,000                                   |                                  |
|                   | Isabella Bank Corporation Retirement Bonus Plan | 26  | 129,683                                   |                                  |

*Defined benefit pension plan.* We sponsor the Isabella Bank Corporation Pension Plan, a frozen defined benefit pension plan. The curtailment, which was effective March 1, 2007, froze the current participant's accrued benefits as of that date and limited participation in the plan to eligible employees as of December 31, 2006. Due to the curtailment of the plan, the number of years of credited service was frozen. As such, the years of credited service for the plan may differ from the participant's actual years of service.

Annual contributions are made to the plan as required by accepted actuarial principles, applicable federal tax laws, and to pay expenses related to operating and maintaining the plan. The amount of contributions on behalf of any one participant cannot be separately or individually computed.

Pension plan benefits are based on years of service and the employee's five highest consecutive years of compensation out of the last ten years of service, through December 31, 2006.

A participant may earn a benefit for up to 35 years of accredited service. Earned benefits are 100% vested after five years of service. Benefit payments normally start when a participant reaches age 65. A participant with more than five years of service may elect to take early retirement benefits anytime after reaching age 55. Benefits payable under early retirement are reduced actuarially for each month prior to age 65 in which benefits begin.

Dennis P. Angner, Richard J. Barz, Steven D. Pung, and Timothy M. Miller are eligible for early retirement under the plan. Under the provisions of the plan, participants are eligible for early retirement after reaching the age of 55 with at least 5 years of service. The early retirement benefit amount is the accrued benefit payable at normal retirement date reduced by 5/9% for each of the first 60 months and 5/18% for each of the next 60 months that the benefit commencement date precedes the normal retirement date.

*Retirement bonus plan.* We sponsor the Isabella Bank Corporation Retirement Bonus Plan. This nonqualified plan is intended to provide eligible employees with additional retirement benefits. To be eligible, the employee needed to be an employee on January 1, 2007, and be a participant in our frozen Executive Supplemental Income Agreement. Participants must also be an officer with at least 10 years of service as of December 31, 2006. We have sole and exclusive discretion to add new participants to the plan by authorizing such participation pursuant to action of the Board.

An initial amount was credited for each eligible employee as of January 1, 2007. Subsequent amounts have been credited on each allocation date thereafter as defined in the plan. The amount of the initial allocation and the annual allocation shall be determined pursuant to the payment schedule adopted at our sole and exclusive discretion, as set forth in the plan.

Richard J. Barz, Dennis P. Angner, and Steven D. Pung are eligible for early retirement under the plan. Under the provisions of the plan, participants are eligible for early retirement upon attaining 55 years of age. There is no difference between the calculation of benefits payable upon early retirement and normal retirement.



**Table of Contents****2012 Nonqualified Deferred Compensation**

| <b>Name</b>       | <b>Executive contributions in last FY (\$)</b> | <b>Aggregate earnings in last FY (\$)</b> | <b>Aggregate balance at last FYE (\$)</b> |
|-------------------|--|---|---|
| Richard J. Barz   | \$ 30,012                                      | \$ 6,695                                  | \$ 195,952                                |
| Dennis P. Angner  | 38,225   | 8,870                                     | 259,060                                   |
| Steven D. Pung    | 900  | 292                                       | 8,431                                     |
| Timothy M. Miller | 3,275  | 1,289                                     | 36,904                                    |
| David J. Reetz    | N/A  | N/A                                       | N/A                                       |

Directors are required to defer at least 25% of their earned board fees into the Directors Plan and may defer up to 100% of their earned fees based on their annual election. These amounts are reflected in the above table. Under the plan, these deferred fees are converted on a quarterly basis into shares of our common stock based on the fair market value of shares at that time. Shares credited to a participant's account are eligible for stock and cash dividends as paid.

Distribution from the plan occurs when the participant retires from the Board, attains age 70, or upon the occurrence of certain other events. Distributions must take the form of shares of our common stock. Any common stock issued under the plan will be considered restricted stock under the Securities Act of 1933, as amended.

**Potential Payments Upon Termination or Change in Control**

The estimated amounts payable to each named executive officer upon severance from employment, retirement, termination upon death or disability or termination following a change in control are described below. For all termination scenarios, the amounts assume such termination took place as of December 31, 2012.

**Any Severance of Employment**

Regardless of the manner in which a named executive officer's employment terminates, he or she is entitled to receive amounts earned during his or her term of employment. Such amounts include:

Amounts accrued and vested through the Defined Benefit Pension Plan.

Amounts accrued and vested through the Retirement Bonus Plan.

Amounts deferred in the Directors Plan.

Unused vacation pay.

**Retirement**

In the event of the retirement of an executive officer, the officer would receive the benefits identified above. As of December 31, 2012, the named executive officers listed had no unused vacation days.

**Death or Disability**

In the event of death or disability of an executive officer, in addition to the benefits listed above, the executive officer will also receive payments under our life insurance plan or under our disability plan as appropriate.

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In addition to potential payments upon termination available to all employees, the estates for the executive officers listed below would receive the following payments upon death:

| <b>Name</b>       | <b>While an<br/>Active<br/>Employee</b> | <b>Subsequent to<br/>Retirement</b> |
|-------------------|---|-------------------------------------|
| Richard J. Barz   | \$ 690,000                              | \$ 345,000                          |
| Dennis P. Angner  | 612,000                                 | 306,000                             |
| Steven D. Pung    | 388,400                                 | 194,200                             |
| Timothy M. Miller | 314,000                                 | 157,000                             |
| David J. Reetz    | 258,800                                 | 129,400                             |

**Table of Contents****Change in Control**

We currently do not have a change in control agreement with any of the executive officers; provided, however, pursuant to the Retirement Bonus Plan each participant would become 100% vested in their benefit under the plan if, following a change in control, they voluntarily terminate employment or are terminated without just cause.

**Director Compensation**

The following table summarizes the Compensation of each non-employee director who served on the Board during 2012.

| Name                 | Fees<br>earned or<br>paid in<br>cash<br>(\$) |
|----------------------|--|
| Jeffrey J. Barnes    | 27,825                                       |
| Sandra L. Caul       | 34,225                                       |
| James C. Fabiano     | 35,525                                       |
| G. Charles Hubscher  | 32,925                                       |
| Thomas L. Kleinhardt | 38,425                                       |
| Joseph LaFramboise   | 34,425                                       |
| Wilson C. Lauer      | 20,975                                       |
| David J. Maness      | 57,925                                       |
| W. Joseph Manifold   | 30,025                                       |
| W. Michael McGuire   | 37,625                                       |
| Sarah R. Opperman    | 14,325                                       |
| Dale D. Weburg       | 37,325                                       |

We paid \$1,350 per board meeting plus a retainer of \$6,000 to each member during 2012. Members of the Audit Committee were paid \$500 per audit committee meeting attended. Members of the Nominating and Corporate Governance Committee were paid \$200 per meeting attended. The chairperson of the Board is paid a retainer of \$39,000 and the chairperson for the Audit Committee is paid a retainer of \$4,000.

Pursuant to the Directors' Plan, directors are required to defer at least 25% of board fees into the plan. Under the Directors' Plan, deferred directors' fees are converted on a quarterly basis into shares of our common stock, based on the fair market value of a share of our common stock at that time. Shares of stock credited to a participant's account are eligible for cash and stock dividends as paid. Directors deferred \$458,893 under the Directors' Plan in 2012.

Upon a participant's attainment of age 70, retirement from the Board, or the occurrence of certain other events, they are eligible to receive a lump-sum, in-kind distribution of all of the stock that is then credited to their account. The plan does not allow for cash settlement. Stock issued under the Directors' Plan is restricted stock under the Securities Act of 1933, as amended.

We established a Rabbi Trust (the Trust) to fund the Directors' Plan. The Trust is an irrevocable grantor trust to which we may contribute assets for the limited purpose of funding a nonqualified deferred compensation plan. Although we may not reach the assets of the Trust for any purpose other than meeting its obligations under the Directors' Plan, the assets of the Trust remain subject to the claims of our creditors. We may contribute cash or common stock to the Trust from time to time for the sole purpose of funding the Directors' Plan. The Trust will use any cash that we may contribute to purchase shares of our common stock on the open market through our brokerage services department.



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We transferred \$459,193 to the Trust in 2012, which held 5,130 shares of our common stock for settlement as of December 31, 2012. As of December 31, 2012, there were 165,436 shares of stock credited to participants' accounts, which credits are unfunded as of such date to the extent that they are in excess of the stock and cash that has been credited to the Trust. All amounts are unsecured claims against our general assets. The net cost of this benefit was \$170,688 in 2012.

The following table displays the cumulative number of equity shares credited to the accounts of active directors pursuant to the terms of the Directors' Plan as of December 31, 2012:

| <b>Name</b>          | <b># of shares of stock credited</b> |
|----------------------|--------------------------------------|
| Dennis P. Angner     | 11,911                               |
| Jeffrey J. Barnes    | 5,914                                |
| Richard J. Barz      | 9,009                                |
| Sandra L. Caul       | 18,783                               |
| G. Charles Hubscher  | 9,079                                |
| Thomas L. Kleinhardt | 15,358                               |
| Joseph LaFramboise   | 6,476                                |
| Wilson C. Lauer      | 1,501                                |
| David J. Maness      | 18,897                               |
| W. Joseph Manifold   | 11,291                               |
| W. Michael McGuire   | 6,512                                |
| Sarah R. Opperman    | 619                                  |

**Compensation and Human Resource Committee Interlocks and Insider Participation**

The Compensation and Human Resource Committee is responsible for reviewing and recommending the compensation of the CEO and other executive officers, benefit plans and the overall percentage increase in salaries. The committee consists of directors Maness, Barnes, Caul, Hubscher, Kleinhardt, LaFramboise, Lauer, Manifold, McGuire, and Opperman.

**Indebtedness of and Transactions with Management**

Certain directors and officers and members of their families were loan customers of the Bank, or have been directors or officers of corporations, members or managers of limited liability companies, or partners of partnerships which have had transactions with the Bank. In our opinion, all such transactions were made in the ordinary course of business and were substantially on the same terms, including collateral and interest rates, as those prevailing at the same time for comparable transactions with customers not related to the Bank. These transactions do not involve more than normal risk of collectability or present other unfavorable features. Total loans to these customers were approximately \$6,598,000 as of December 31, 2012. We address transactions with related parties in our Code of Business Conduct and Ethics Policy. Conflicts of interest are prohibited, except under board approved guidelines.

**Security Ownership of Certain Beneficial Owners and Management**

As of March 26, 2013, we do not have any person who is known to be the beneficial owner of more than 5% of our common stock.

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The following table sets forth certain information as of March 26, 2013 as to our common stock owned beneficially by each director and director nominee, by each named executive officer, and by all directors, director nominees and executive officers as a group. The shares to be credited under the Directors' Plan are not included in the table below.

| Name of Owner  | Amount and Nature of Beneficial Ownership |                                    |                            | Percentage of Common Stock Outstanding |
|--|---|------------------------------------|----------------------------|--|
|  | Sole Voting and Investment Powers         | Shared Voting or Investment Powers | Total Beneficial Ownership |  |
| Dennis P. Angner*  | 19,378                                    |                                    | 19,378                     | 0.25%                                  |
| Jeffrey J. Barnes  |   | 6,040                              | 6,040                      | 0.08%                                  |
| Richard J. Barz*   | 19,579                                    |                                    | 19,579                     | 0.26%                                  |
| Sandra L. Caul   |   | 10,609                             | 10,609                     | 0.14%                                  |
| G. Charles Hubscher  | 29,865                                    | 3,646                              | 33,511                     | 0.44%                                  |
| Thomas L. Kleinhardt   |   | 31,991                             | 31,991                     | 0.42%                                  |
| Joseph LaFramboise   | 200                                       | 969                                | 1,169                      | 0.02%                                  |
| Wilson C. Lauer  | 187                                       |                                    | 187                        | 0.00%                                  |
| David J. Maness  | 497                                       | 1,100                              | 1,597                      | 0.02%                                  |
| W. Joseph Manifold   | 4,827                                     |                                    | 4,827                      | 0.06%                                  |
| W. Michael McGuire   | 116,462                                   |                                    | 116,462                    | 1.52%                                  |
| Timothy M. Miller  | 287                                       | 3,723                              | 4,010                      | 0.05%                                  |
| Sarah R. Opperman  | 449                                       |                                    | 449                        | 0.01%                                  |
| Steven D. Pung   | 10,092                                    | 9,115                              | 19,207                     | 0.25%                                  |
| David J. Reetz   | 9,100                                     | 187                                | 9,287                      | 0.12%                                  |
| All Directors, nominees and Executive Officers as a Group (15) persons | 210,923                                   | 67,380                             | 278,303                    | 3.64%                                  |

\* Trustees of the ESOP who vote ESOP stock.

**Independent Registered Public Accounting Firm**

The Audit Committee has appointed Rehmann Robson LLC as our independent auditors for the year ending December 31, 2013.

A representative of Rehmann Robson LLC is expected to be present at the Annual Meeting to respond to appropriate questions from shareholders and to make any comments Rehmann Robson LLC believes are appropriate.

**Fees for Professional Services Provided by Rehmann Robson LLC**

The following table shows the aggregate fees billed by Rehmann Robson LLC for the audit and other services provided for 2012 and 2011.

|                    | 2012       | 2011       |
|--------------------|------------|------------|
| Audit fees         | \$ 263,180 | \$ 253,920 |
| Audit related fees | 28,250     | 17,510     |
| Tax fees           | 25,950     | 20,175     |
| Total              | \$ 317,380 | \$ 291,605 |

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The audit fees were for performing the integrated audit of our consolidated annual financial statements and the internal control attestation report related to the Federal Deposit Insurance Corporation Improvement Act, review of interim quarterly financial statements included in our Forms 10-Q, and services that are normally provided by Rehmann Robson LLC in connection with statutory and regulatory filings or engagements.

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The audit related fees are typically for various discussions related to the adoption and interpretation of new accounting pronouncements. During 2012, this includes fees for procedures related to nonrecurring regulatory filings. Also included are fees for auditing of our employee benefit plans.

The tax fees were for the preparation of our state and federal tax returns and for consultation on various tax matters.

The Audit Committee has considered whether the services provided by Rehmann Robson LLC, other than the audit fees, are compatible with maintaining Rehmann Robson LLC's independence and believes that the other services provided are compatible.

## **Pre-Approval Policies and Procedures**

All audit and non-audit services over \$5,000 to be performed by Rehmann Robson LLC must be approved in advance by the Audit Committee if those fees are reasonably expected to exceed 5.0% of the current year agreed upon fee for independent audit services. As permitted by the SEC's rules, the Audit Committee has authorized its chairperson to pre-approve audit, audit-related, tax and non-audit services, provided that such approved service is reported to the full Audit Committee at its next meeting.

As early as practicable in each calendar year, the independent auditor provides to the Audit Committee a schedule of the audit and other services that the independent auditor expects to provide or may provide during the next twelve months. The schedule will be specific as to the nature of the proposed services, the proposed fees, timing, and other details that the Audit Committee may request. The Audit Committee will by resolution authorize or decline the proposed services. Upon approval, this schedule will serve as the budget for fees by specific activity or service for the next twelve months.

A schedule of additional services proposed to be provided by the independent auditor, or proposed revisions to services already approved, along with associated proposed fees, may be presented to the Audit Committee for their consideration and approval at any time. The schedule will be specific as to the nature of the proposed service, the proposed fee, and other details that the Audit Committee may request. The Audit Committee will by resolution authorize or decline authorization for each proposed new service.

Applicable SEC rules and regulations permit waiver of the pre-approval requirements for services other than audit, review or attest services if certain conditions are met. Out of the services characterized above as audit-related, tax and professional services, none were billed pursuant to these provisions in 2012 and 2011 without pre-approval.

## **Shareholder Proposals**

Any proposals which you intend to present at the next annual meeting must be received before December 12, 2013 to be considered for inclusion in our proxy statement and proxy for that meeting. Proposals should be made in accordance with Securities and Exchange Commission Rule 14a-8.

## **Directors Attendance at the Annual Meeting of Shareholders**

Our directors are encouraged to attend the annual meeting of shareholders. At the 2012 annual meeting, all directors were in attendance.

## **Section 16(a) Beneficial Ownership Reporting Compliance**

Section 16(a) of the Securities Exchange Act of 1934 requires our directors and certain officers and persons who own more than 10% of our common stock, to file with the SEC initial reports of ownership and reports of changes in ownership of our common stock. These officers, directors, and greater than 10% shareholders are required by SEC regulation to furnish us with copies of these reports.

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To our knowledge, based solely on review of the copies of such reports furnished, during the year ended December 31, 2012 all Section 16(a) filing requirements were satisfied, with respect to the applicable officers, directors, and greater than 10% beneficial owners with the exception of directors Lauer and Opperman. Directors Lauer and Opperman did not file their Form 3s, which were due on July 16, 2012, until July 19, 2012.

**Other Matters**

We will bear the cost of soliciting proxies. In addition to solicitation by mail, officers and other employees may solicit proxies by telephone or in person, without compensation other than their regular compensation.

**As to Other Business Which May Come Before the Meeting**

We do not intend to bring any other business before the meeting for action. However, if any other business should be presented for action, it is the intention of the persons named in the enclosed form of proxy to vote in accordance with their judgment on such business.

By order of the Board of Directors

Debra Campbell, Secretary

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**Isabella Bank Corporation**

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**Table of Contents****SUMMARY OF SELECTED FINANCIAL DATA**

(Dollars in thousands except per share data)

|                                       | 2012       | 2011       | 2010       | 2009       | 2008       |
|---------------------------------------|------------|------------|------------|------------|------------|
| <b>INCOME STATEMENT DATA</b>          |            |            |            |            |            |
| Interest income                       | \$ 56,401  | \$ 57,905  | \$ 57,217  | \$ 58,105  | \$ 61,385  |
| Interest expense                      | 13,423     | 16,203     | 17,204     | 19,839     | 25,606     |
| Net interest income                   | 42,978     | 41,702     | 40,013     | 38,266     | 35,779     |
| Provision for loan losses             | 2,300      | 3,826      | 4,857      | 6,093      | 9,500      |
| Noninterest income                    | 11,530     | 8,218      | 9,300      | 10,156     | 7,802      |
| Noninterest expenses                  | 37,639     | 34,530     | 33,807     | 33,683     | 30,704     |
| Federal income tax expense            | 2,363      | 1,354      | 1,604      | 846        | (724)      |
| Net Income                            | \$ 12,206  | \$ 10,210  | \$ 9,045   | \$ 7,800   | \$ 4,101   |
| <b>PER SHARE</b>                      |            |            |            |            |            |
| Basic earnings                        | \$ 1.61    | \$ 1.35    | \$ 1.20    | \$ 1.04    | \$ 0.55    |
| Diluted earnings                      | 1.56       | 1.31       | 1.17       | 1.01       | 0.53       |
| Dividends                             | 0.80       | 0.76       | 0.72       | 0.70       | 0.65       |
| Market value*                         | 21.75      | 23.70      | 17.30      | 18.95      | 25.50      |
| Tangible book value*                  | 14.72      | 13.90      | 13.22      | 12.67      | 12.27      |
| <b>BALANCE SHEET DATA</b>             |            |            |            |            |            |
| At end of period                      |            |            |            |            |            |
| Loans                                 | \$ 772,753 | \$ 750,291 | \$ 735,304 | \$ 723,316 | \$ 735,385 |
| Total assets                          | 1,430,639  | 1,337,925  | 1,225,810  | 1,143,944  | 1,139,263  |
| Deposits                              | 1,017,667  | 958,164    | 877,339    | 802,652    | 775,630    |
| Shareholders equity                   | 164,489    | 154,783    | 145,161    | 140,803    | 134,476    |
| Average balance                       |            |            |            |            |            |
| Loans                                 | \$ 754,304 | \$ 743,441 | \$ 725,534 | \$ 725,299 | \$ 717,040 |
| Total assets                          | 1,381,083  | 1,287,195  | 1,182,930  | 1,127,634  | 1,113,102  |
| Deposits                              | 984,927    | 927,186    | 840,392    | 786,714    | 817,041    |
| Shareholders equity                   | 160,682    | 151,379    | 145,304    | 137,910    | 142,597    |
| <b>PERFORMANCE RATIOS</b>             |            |            |            |            |            |
| Return on average total assets        | 0.88%      | 0.79%      | 0.76%      | 0.69%      | 0.37%      |
| Return on average shareholders equity | 7.60%      | 6.74%      | 6.22%      | 5.66%      | 2.88%      |
| Return on average tangible equity     | 11.41%     | 10.30%     | 9.51%      | 8.53%      | 4.41%      |
| Net interest margin yield (FTE)       | 3.70%      | 3.87%      | 4.04%      | 4.06%      | 3.87%      |
| Loan to deposit*                      | 75.93%     | 78.31%     | 83.81%     | 90.12%     | 94.81%     |
| Nonperforming loans to total loans*   | 1.00%      | 0.95%      | 0.83%      | 1.28%      | 1.69%      |
| Nonperforming assets to total assets* | 0.68%      | 0.67%      | 0.67%      | 0.91%      | 1.35%      |
| ALLL to nonperforming loans*          | 154.39%    | 173.10%    | 202.97%    | 139.71%    | 96.42%     |
| <b>CAPITAL RATIOS</b>                 |            |            |            |            |            |
| Shareholders equity to assets*        | 11.50%     | 11.57%     | 11.84%     | 12.31%     | 11.80%     |
| Tier 1 capital to average assets*     | 8.29%      | 8.18%      | 8.24%      | 8.60%      | 8.42%      |
| Tier 1 risk-based capital*            | 13.23%     | 12.92%     | 12.44%     | 12.80%     | 12.30%     |
| Total risk-based capital*             | 14.48%     | 14.17%     | 13.69%     | 14.06%     | 13.50%     |

\* At end of period

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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, 2012 and 2011, 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, 2012. We also have audited *Isabella Bank Corporation's* internal control over financial reporting as of December 31, 2012, 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, 2012 and 2011, and the consolidated results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2012 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, 2012, based on criteria established in the *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission.

Rehmann Robson LLC

Saginaw, Michigan

March 11, 2013





**Table of Contents****CONSOLIDATED BALANCE SHEETS**

(Dollars in thousands)

|   | December 31, 2013   |                     |
|---|---------------------|---------------------|
|   | 2012                | 2011                |
| <b>ASSETS</b>   |                     |                     |
| Cash and cash equivalents   |                     |                     |
| Cash and demand deposits due from banks   | \$ 22,634           | \$ 24,514           |
| Interest bearing balances due from banks  | 2,286               | 4,076               |
| <b>Total cash and cash equivalents</b>  | <b>24,920</b>       | <b>28,590</b>       |
| Certificates of deposit held in other financial institutions  | 4,465               | 8,924               |
| Trading securities  | 1,573               | 4,710               |
| AFS securities (amortized cost of \$490,420 in 2012 and \$414,614 in 2011)  | 504,010             | 425,120             |
| Mortgage loans available-for-sale   | 3,633               | 3,205               |
| Loans   |                     |                     |
| Commercial  | 371,505             | 365,714             |
| Agricultural  | 83,606              | 74,645              |
| Residential real estate   | 284,148             | 278,360             |
| Consumer  | 33,494              | 31,572              |
| <b>Total loans</b>  | <b>772,753</b>      | <b>750,291</b>      |
| Less allowance for loan losses  | 11,936              | 12,375              |
| <b>Net loans</b>  | <b>760,817</b>      | <b>737,916</b>      |
| Premises and equipment  | 25,787              | 24,626              |
| Corporate owned life insurance  | 22,773              | 22,075              |
| Accrued interest receivable   | 5,227               | 5,848               |
| Equity securities without readily determinable fair values  | 18,118              | 17,189              |
| Goodwill and other intangible assets  | 46,532              | 46,792              |
| Other assets  | 12,784              | 12,930              |
| <b>TOTAL ASSETS</b>   | <b>\$ 1,430,639</b> | <b>\$ 1,337,925</b> |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |                     |                     |
| Deposits  |                     |                     |
| Noninterest bearing   | \$ 143,735          | \$ 119,072          |
| NOW accounts  | 181,259             | 163,653             |
| Certificates of deposit under \$100 and other savings   | 455,546             | 440,123             |
| Certificates of deposit over \$100  | 237,127             | 235,316             |
| <b>Total deposits</b>   | <b>1,017,667</b>    | <b>958,164</b>      |
| Borrowed funds (\$0 in 2012 and \$5,242 in 2011 at fair value)  | 241,001             | 216,136             |
| Accrued interest payable and other liabilities  | 7,482               | 8,842               |
| <b>Total liabilities</b>  | <b>1,266,150</b>    | <b>1,183,142</b>    |
| Shareholders equity   |                     |                     |
| Common stock no par value 15,000,000 shares authorized; issued and outstanding 7,671,846 shares (including 5,130 shares held in the Rabbi Trust) in 2012 and 7,589,226 shares (including 16,585 shares held in the Rabbi Trust) in 2011 | 136,580             | 134,734             |
| Shares to be issued for deferred compensation obligations   | 3,734               | 4,524               |

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|  |                     |                     |
|--|---------------------|---------------------|
| Retained earnings                                | 19,168              | 13,036              |
| Accumulated other comprehensive income           | 5,007               | 2,489               |
| <b>Total shareholders equity</b>                 | <b>164,489</b>      | <b>154,783</b>      |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b> | <b>\$ 1,430,639</b> | <b>\$ 1,337,925</b> |

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

**Table of Contents****CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY**

(Dollars in thousands except per share data)

|  | Common Stock<br>Shares<br>Outstanding | Common<br>Stock | Shares to be<br>Issued for<br>Deferred<br>Compensation<br>Obligations | Retained<br>Earnings | Accumulated Other<br>Comprehensive<br>(Loss) Income | Totals     |
|--|---------------------------------------|-----------------|---|----------------------|---|------------|
| Balances, January 1, 2010  | 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<br>compensation obligations                                     | 28,898                                | 537             | (475)   |                      |   | 62         |
| Share based payment awards under equity<br>compensation plan                                     |                                       |                 | 650   |                      |   | 650        |
| Common stock purchased for deferred<br>compensation obligations                                  |                                       | (514)           |   |                      |   | (514)      |
| Common stock repurchased pursuant to<br>publicly announced repurchase plan                       | (138,970)                             | (2,557)         |   |                      |   | (2,557)    |
| Cash dividends (\$0.72 per share)  |                                       |                 |   | (5,421)              |   | (5,421)    |
| Balances, 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<br>compensation obligations                                     | 39,257                                | 697             | (773)   |                      |   | (76)       |
| Share based payment awards under equity<br>compensation plan                                     |                                       |                 | 615   |                      |   | 615        |
| Common stock purchased for deferred<br>compensation obligations                                  |                                       | (426)           |   |                      |   | (426)      |
| Common stock repurchased pursuant to<br>publicly announced repurchase plan                       | (120,441)                             | (2,204)         |   |                      |   | (2,204)    |
| Cash dividends (\$0.76 per share)  |                                       |                 |   | (5,770)              |   | (5,770)    |
| Balances, December 31, 2011  | 7,589,226                             | 134,734         | 4,524   | 13,036               | 2,489   | 154,783    |
| Comprehensive income   |                                       |                 |   | 12,206               | 2,518   | 14,724     |
| Issuance of common stock   | 124,530                               | 2,898           |   |                      |   | 2,898      |
| Common stock issued for deferred<br>compensation obligations                                     | 41,676                                | 814             | (814)   |                      |   |            |
| Common stock transferred from the<br>Rabbi Trust to satisfy deferred compensation<br>obligations |                                       | 619             | (619)   |                      |   |            |
| Share based payment awards under equity<br>compensation plan                                     |                                       |                 | 643   |                      |   | 643        |
| Common stock purchased for deferred<br>compensation obligations                                  |                                       | (505)           |   |                      |   | (505)      |
| Common stock repurchased pursuant to<br>publicly announced repurchase plan                       | (83,586)                              | (1,980)         |   |                      |   | (1,980)    |
| Cash dividends (\$0.80 per share)  |                                       |                 |   | (6,074)              |   | (6,074)    |
| Balances, December 31, 2012  | 7,671,846                             | \$ 136,580      | \$ 3,734  | \$ 19,168            | \$ 5,007  | \$ 164,489 |

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



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

(Dollars in thousands except per share data)

|  | Year Ended December 31 |                  |                 |
|--|------------------------|------------------|-----------------|
|  | 2012                   | 2011             | 2010            |
| <b>Interest income</b>                                     |                        |                  |                 |
| Loans, including fees                                      | \$ 43,396              | \$ 45,463        | \$ 46,794       |
| AFS securities   |                        |                  |                 |
| Taxable  | 7,555                  | 6,941            | 5,271           |
| Nontaxable   | 4,870                  | 4,806            | 4,367           |
| Trading securities   | 94                     | 189              | 306             |
| Federal funds sold and other                               | 486                    | 506              | 479             |
| <b>Total interest income</b>                               | <b>56,401</b>          | <b>57,905</b>    | <b>57,217</b>   |
| <b>Interest expense</b>                                    |                        |                  |                 |
| Deposits   | 9,131                  | 10,935           | 11,530          |
| Borrowings   | 4,292                  | 5,268            | 5,674           |
| <b>Total interest expense</b>                              | <b>13,423</b>          | <b>16,203</b>    | <b>17,204</b>   |
| <b>Net interest income</b>                                 | <b>42,978</b>          | <b>41,702</b>    | <b>40,013</b>   |
| Provision for loan losses                                  | 2,300                  | 3,826            | 4,857           |
| <b>Net interest income after provision for loan losses</b> | <b>40,678</b>          | <b>37,876</b>    | <b>35,156</b>   |
| <b>Noninterest income</b>                                  |                        |                  |                 |
| Service charges and fees                                   | 6,432                  | 6,118            | 6,480           |
| Gain on sale of mortgage loans                             | 1,576                  | 538              | 610             |
| Gain on sale of available-for-sale investment securities   | 1,119                  | 3                | 348             |
| Earnings on corporate owned life insurance policies        | 698                    | 609              | 663             |
| Other  | 1,705                  | 950              | 1,199           |
| <b>Total noninterest income</b>                            | <b>11,530</b>          | <b>8,218</b>     | <b>9,300</b>    |
| <b>Noninterest expenses</b>                                |                        |                  |                 |
| Compensation and benefits                                  | 21,227                 | 19,292           | 18,552          |
| Occupancy  | 2,519                  | 2,470            | 2,351           |
| Furniture and equipment                                    | 4,560                  | 4,497            | 4,344           |
| Available-for-sale impairment loss                         |                        |                  |                 |
| Total other-than-temporary impairment loss                 | 486                    |                  |                 |
| Portion of loss reported in other comprehensive income     | (204)                  |                  |                 |
| Net available-for-sale impairment loss                     | 282                    |                  |                 |
| Other  | 9,051                  | 8,271            | 8,560           |
| <b>Total noninterest expenses</b>                          | <b>37,639</b>          | <b>34,530</b>    | <b>33,807</b>   |
| <b>Income before federal income tax expense</b>            | <b>14,569</b>          | <b>11,564</b>    | <b>10,649</b>   |
| Federal income tax expense                                 | 2,363                  | 1,354            | 1,604           |
| <b>NET INCOME</b>  | <b>\$ 12,206</b>       | <b>\$ 10,210</b> | <b>\$ 9,045</b> |

**Earnings per share**

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|                                       |                |                |                |
|---------------------------------------|----------------|----------------|----------------|
| Basic                                 | \$ 1.61        | \$ 1.35        | \$ 1.20        |
| Diluted                               | \$ 1.56        | \$ 1.31        | \$ 1.17        |
| <b>Cash dividends per basic share</b> | <b>\$ 0.80</b> | <b>\$ 0.76</b> | <b>\$ 0.72</b> |

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

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

(Dollars in thousands)

|   | Year Ended December 31 |                  |                 |
|---|------------------------|------------------|-----------------|
|   | 2012                   | 2011             | 2010            |
| <b>Net income</b>   | <b>\$ 12,206</b>       | <b>\$ 10,210</b> | <b>\$ 9,045</b> |
| Unrealized holding gains on available-for-sale securities:                |                        |                  |                 |
| Unrealized gains arising during the year                                  | 3,921                  | 9,220            | 1,156           |
| Reclassification adjustment for net realized gains included in net income | (1,119)                | (3)              | (348)           |
| Reclassification adjustment for impairment loss included in net income    | 282                    |                  |                 |
| Net unrealized gains  | 3,084                  | 9,217            | 808             |
| Tax effect(1)   | (348)                  | (3,719)          | (351)           |
| Unrealized gains, net of tax  | 2,736                  | 5,498            | 457             |
| Increase in unrecognized pension costs                                    | (329)                  | (1,971)          | (72)            |
| Tax effect  | 111                    | 671              | 25              |
| Net unrealized loss on defined benefit pension plan                       | (218)                  | (1,300)          | (47)            |
| <b>Other comprehensive income, net of tax</b>                             | <b>2,518</b>           | <b>4,198</b>     | <b>410</b>      |
| <b>Comprehensive income</b>   | <b>\$ 14,724</b>       | <b>\$ 14,408</b> | <b>\$ 9,455</b> |

(1) See Note 12 Federal Income Taxes for tax effect reconciliation.

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



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

(Dollars in thousands)

|   | Year Ended December 31 |                  |                  |
|---|------------------------|------------------|------------------|
|   | 2012                   | 2011             | 2010             |
| <b>OPERATING ACTIVITIES</b>   |                        |                  |                  |
| Net income  | \$ 12,206              | \$ 10,210        | \$ 9,045         |
| Reconciliation of net income to net cash provided by operations:            |                        |                  |                  |
| Provision for loan losses   | 2,300                  | 3,826            | 4,857            |
| Impairment of foreclosed assets   | 166                    | 82               | 180              |
| Depreciation  | 2,417                  | 2,521            | 2,522            |
| Amortization and impairment of originated mortgage servicing rights         | 787                    | 714              | 543              |
| Amortization of acquisition intangibles                                     | 260                    | 299              | 338              |
| Net amortization of available-for-sale securities                           | 2,277                  | 1,689            | 1,153            |
| Available-for-sale security impairment loss                                 | 282                    |                  |                  |
| Gain on sale of available-for-sale securities                               | (1,119)                | (3)              | (348)            |
| Net unrealized losses on trading securities                                 | 52                     | 78               | 94               |
| Net gain on sale of mortgage loans  | (1,576)                | (538)            | (610)            |
| Net unrealized gains on borrowings measured at fair value                   | (33)                   | (181)            | (227)            |
| Increase in cash value of corporate owned life insurance                    | (698)                  | (609)            | (642)            |
| Realized gain on redemption of corporate owned life insurance               |                        |                  | (21)             |
| Share-based payment awards under equity compensation plan                   | 643                    | 615              | 650              |
| Deferred income tax expense   | 616                    | 389              | 179              |
| Origination of loans held for sale  | (99,353)               | (57,584)         | (72,106)         |
| Proceeds from loan sales  | 100,501                | 56,099           | 73,815           |
| Net changes in operating assets and liabilities which provided (used) cash: |                        |                  |                  |
| Trading securities  | 3,085                  | 1,049            | 7,632            |
| Accrued interest receivable   | 621                    | (392)            | 376              |
| Other assets  | (2,610)                | 147              | (1,914)          |
| Accrued interest payable and other liabilities                              | (1,360)                | 449              | 1,005            |
| <b>Net cash provided by operating activities</b>                            | <b>19,464</b>          | <b>18,860</b>    | <b>26,521</b>    |
| <b>INVESTING ACTIVITIES</b>   |                        |                  |                  |
| Net change in certificates of deposit held in other financial institutions  | 4,459                  | 6,884            | (10,428)         |
| Activity in available-for-sale securities                                   |                        |                  |                  |
| Sales   | 40,677                 | 8,877            | 18,303           |
| Maturities and calls  | 89,112                 | 69,275           | 66,970           |
| Purchases   | (207,035)              | (165,017)        | (156,928)        |
| Loan principal originations, net  | (27,103)               | (20,743)         | (21,319)         |
| Proceeds from sales of foreclosed assets                                    | 1,594                  | 2,041            | 2,778            |
| Purchases of premises and equipment   | (3,578)                | (2,520)          | (3,232)          |
| Purchases of corporate owned life insurance                                 |                        | (4,000)          | (175)            |
| <b>Net cash used in investing activities</b>                                | <b>(101,874)</b>       | <b>(105,203)</b> | <b>(103,877)</b> |
| <b>FINANCING ACTIVITIES</b>   |                        |                  |                  |
| Acceptances and withdrawals of deposits, net                                | 59,503                 | 80,825           | \$ 74,687        |
| Increase in other borrowed funds  | 24,898                 | 21,400           | 2,043            |
| Cash dividends paid on common stock   | (6,074)                | (5,770)          | (5,421)          |
| Proceeds from issuance of common stock                                      | 2,279                  | 2,302            | 2,208            |
| Common stock repurchased  | (1,361)                | (1,507)          | (2,020)          |
| Common stock purchased for deferred compensation obligations                | (505)                  | (426)            | (514)            |

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|  |                  |                  |                  |
|--|------------------|------------------|------------------|
| <b>Net cash provided by financing activities</b>                 | <b>78,740</b>    | <b>96,824</b>    | <b>70,983</b>    |
| <b>(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>          | <b>(3,670)</b>   | <b>10,481</b>    | <b>(6,373)</b>   |
| Cash and cash equivalents at beginning of year                   | 28,590           | 18,109           | 24,482           |
| <b>CASH AND CASH EQUIVALENTS AT END OF YEAR</b>                  | <b>\$ 24,920</b> | <b>\$ 28,590</b> | <b>\$ 18,109</b> |
| <b>SUPPLEMENTAL CASH FLOWS INFORMATION:</b>                      |                  |                  |                  |
| Interest paid  | \$ 13,639        | \$ 16,239        | \$ 17,344        |
| Federal income taxes paid  | 2,357            | 878              | 1,261            |
| <b>SUPPLEMENTAL NONCASH INVESTING AND FINANCING INFORMATION:</b> |                  |                  |                  |
| Transfers of loans to foreclosed assets                          | \$ 1,902         | \$ 1,932         | \$ 3,868         |
| Common stock issued for deferred compensation obligations        | 619              | 773              | 475              |
| Common stock repurchased from the Rabbi Trust                    | (619)            | (697)            | (537)            |

See notes to interim condensed consolidated financial statements.

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**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, a financial services holding company, and its wholly owned subsidiaries, Isabella Bank and Financial Group Information Services. 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. Our banking subsidiary, Isabella Bank, offers banking services through 26 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 our principal markets. Our 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 our subsidiaries.

**USE OF ESTIMATES:** In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, we are 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 ALLL, the fair value of certain AFS 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. We 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 us 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 our 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, we include 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

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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.

We utilize fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Investment securities AFS, trading securities, and certain liabilities are recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record other assets at fair value on a nonrecurring basis, such as mortgage loans AFS, impaired loans, foreclosed assets, OMSR, 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, we group 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 further discussion of fair value considerations, refer to Note 20 Fair Value.

**SIGNIFICANT GROUP CONCENTRATIONS OF CREDIT RISK:** Most of our activities conducted are with customers located within the central Michigan area. A significant amount of our 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. We maintain deposit accounts in various financial institutions which generally exceed federally insured limits or are not insured. We do not believe we are 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:** We engage in trading activities of our 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.

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**AFS SECURITIES:** Purchases of investment securities are generally classified as AFS. However, we may elect to classify securities as either held to maturity or trading. Securities classified as AFS 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. Included in AFS securities are auction rate money market preferreds and preferred stocks. These investments 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 stocks are recorded at fair value, with unrealized gains and losses 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 AFS securities are determined using the specific identification method.

AFS securities are reviewed quarterly for possible OTTI. In determining whether an OTTI exists for debt securities, we must assert that: (a) we do not have the intent to sell the security; and (b) it is more likely than not we will not have to sell the security before recovery of its cost basis. If these conditions are not met, we must recognize an OTTI 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 we do not expect to recover the security's amortized cost basis, the security is considered other-than-temporarily impaired. For these debt securities, we separate 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, we calculate the recovery value by performing a discounted cash flow analysis based on the current cash flows and future cash flows we expect to recover. The amount of the total OTTI related to the credit risk is recognized in earnings and is included in noninterest income. The amount of the total OTTI related to other risk factors is recognized as a component of other comprehensive income. For debt securities that have recognized an OTTI 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.

AFS equity securities are reviewed for OTTI 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 our ability and intent to hold the securities until fair value recovers. If it is determined that we do 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.

**LOANS:** Loans that we have 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 ALLL, 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 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 ALLL. 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.

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**ALLOWANCE FOR LOAN LOSSES:** 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 allowance when we believe the uncollectibility of the loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

We evaluate the ALLL on a regular basis and is based upon our periodic review of the collectability 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 ALLL 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 we believe affect our estimate of probable losses based on qualitative factors. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

1. There has been a charge-off of its principal balance;
2. The loan has been classified as a TDR; or
3. The loan is in nonaccrual status.

Impairment is measured on a loan by loan basis for commercial and agricultural 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 held 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, would be recognized as a component of other noninterest expenses.

Mortgage loans held for sale are sold with the mortgage servicing rights retained by us. 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 us, 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) we do not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity. Other than servicing, we have 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. We have 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

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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 we later determine 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 \$303,351 and \$304,626 with capitalized servicing rights of \$2,285 and \$2,374 at December 31, 2012 and 2011, 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. We recorded servicing fee revenue of \$757, \$732, and \$760 related to residential mortgage loans serviced for others during 2012, 2011, and 2010, respectively and is included in other noninterest 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 our 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 ALLL. 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. We periodically perform valuations 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 our carrying amount or fair value less costs to sell. Foreclosed assets of \$2,018 and \$1,876 as of December 31, 2012 and 2011, respectively, are included in other assets.

**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. We annually review these assets to determine whether carrying values have been impaired.

**FDIC INSURANCE PREMIUM:** Included in other assets were prepaid FDIC assessments of \$1,804 and \$2,588 as of December 31, 2012 and 2011, respectively.

**EQUITY SECURITIES WITHOUT READILY DETERMINABLE FAIR VALUES:** Included in equity securities without readily determinable fair values are FHLB Stock and FRB Stock as well as our ownership interests in Corporate Settlement Solutions and Valley Financial Corporation. The investment in Corporate Settlement Solutions, a title insurance company, was made in the 1st quarter 2007. The Corporation is not the managing entity of Corporate Settlement Solutions, LLC, and accounts for its investment in that entity under the equity method of accounting. Valley Financial Corporation is the parent company of 1st State Bank in Saginaw, Michigan, which is a de novo bank that opened in 2005. The Corporation made investments in Valley Financial Corporation in 2004 and in 2007.

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Equity securities without readily determinable fair values consist of the following as of December 31:

|  | 2012      | 2011      |
|--|-----------|-----------|
| Federal Home Loan Bank Stock                 | \$ 7,850  | \$ 7,380  |
| Investment in Corporate Settlement Solutions | 7,040     | 6,611     |
| Federal Reserve Bank Stock                   | 1,879     | 1,879     |
| Investment in Valley Financial Corporation   | 1,000     | 1,000     |
| Other  | 349       | 319       |
| Total  | \$ 18,118 | \$ 17,189 |

**EQUITY COMPENSATION PLAN:** At December 31, 2012, the Directors Plan had 170,566 shares eligible to be issued to participants, for which the Rabbi Trust held 5,130 shares. We had 218,023 shares to be issued in 2011, with 16,585 shares held in the Rabbi Trust. Compensation costs relating to share based payment transactions are recognized as the services are rendered, with the cost measured based on the fair value of the equity or liability instruments issued (see Note 17 Benefit Plans ). We have no other equity-based compensation plans.

**CORPORATE OWNED LIFE INSURANCE:** We have purchased life insurance policies on key members of management. In the event of death of one of these individuals, we 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, 2012 and 2011, the present value of the post retirement benefits payable by us to the covered employees was estimated to be \$2,657 and \$2,633, respectively, and is included in accrued interest payable and other liabilities . The periodic policy maintenance costs were \$24, \$60, and \$68 for 2012, 2011, and 2010, respectively and is included in other noninterest expenses.

**ACQUISITION INTANGIBLES AND GOODWILL:** We 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 goodwill and other intangible assets are being amortized over their estimated lives and evaluated for potential impairment on at least an annual basis. Goodwill represents the excess of purchase price over identifiable assets, is not amortized but is evaluated for impairment on at least an annual basis. Acquisition intangibles and goodwill are 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 is more likely than not to be impaired, we perform a cash flow valuation to determine the extent of the potential impairment. This valuation method requires a significant degree of our 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, we have 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.



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

**MARKETING COSTS:** Marketing costs are expensed as incurred (see Note 11 Other Noninterest Expenses ).

**RECLASSIFICATIONS:** Certain amounts reported in the 2011 and 2010 consolidated financial statements have been reclassified to conform with the 2012 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 year. 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 we may issue relate solely to outstanding shares in the Directors Plan, see Note 17 Benefit Plans.

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

|   | 2012           | 2011           | 2010           |
|---|----------------|----------------|----------------|
| Average number of common shares outstanding for basic calculation                               | 7,604,303      | 7,572,841      | 7,541,676      |
| Average potential effect of shares in the Directors Plan(1)                                     | 195,063        | 194,634        | 187,744        |
| Average number of common shares outstanding used to calculate diluted earnings per common share | 7,799,366      | 7,767,475      | 7,729,420      |
| Net income  | \$ 12,206      | \$ 10,210      | \$ 9,045       |
| <b>Earnings per share</b>   |                |                |                |
| <b>Basic</b>  | <b>\$ 1.61</b> | <b>\$ 1.35</b> | <b>\$ 1.20</b> |
| <b>Diluted</b>  | <b>\$ 1.56</b> | <b>\$ 1.31</b> | <b>\$ 1.17</b> |

(1) Exclusive of shares held in the Rabbi Trust

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

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

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

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

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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 shareholders' equity.

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

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

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

Application of premiums and discounts in a fair value measurement.

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

### **ASU No. 2011-05: *Presentation of Comprehensive Income***

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

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

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

In August 2012, ASU No. 2012-02 amended ASC Topic 350, *Goodwill and Other* to simplify the testing of intangible assets with indefinite lives. This update will allow for a qualitative assessment of intangible assets with indefinite lives to determine whether or not it is necessary to perform the impairment test described in ASC Topic 350. While the new authoritative guidance was effective for fiscal years beginning after September 15, 2012, we elected to early adopt the guidance as of December 31, 2012. This standard did not have any impact on our consolidated financial statements.

### ***Pending Accounting Standards Updates***

### **ASU No. 2012-06: *Business Combinations (Topic 805): Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution***

In October 2012, ASU No. 2012-06 amended ASC Topic 805, *Business Combinations* to clarify the applicable guidance for subsequently measuring an indemnification asset recognized as part of a government assisted acquisition of a financial institution. The new authoritative guidance is effective for fiscal years beginning after December 15, 2012 and at this time is not expected to have any impact on our consolidated financial statements.

## **NOTE 4 TRADING SECURITIES**

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

|                                   | 2012     | 2011     |
|-----------------------------------|----------|----------|
| States and political subdivisions | \$ 1,573 | \$ 4,710 |

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Included in net trading losses of \$52 during 2012, were \$18 of net trading losses on securities that relate to our trading portfolio as of December 31, 2012. Included in net trading gains of \$78 during 2011, were \$60 of net trading gains on securities that relate to our trading portfolio as of December 31, 2011.

**NOTE 5 AFS SECURITIES**

The amortized cost and fair value of AFS securities, with gross unrealized gains and losses, are as follows as of December 31:

|                                     | Amortized<br>Cost | 2012                         |                               | Fair<br>Value     |
|-------------------------------------|-------------------|------------------------------|-------------------------------|-------------------|
|                                     |                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |                   |
| Government sponsored enterprises    | \$ 25,668         | \$ 108                       | \$                            | \$ 25,776         |
| States and political subdivisions   | 174,118           | 9,190                        | 565                           | 182,743           |
| Auction rate money market preferred | 3,200             |                              | 422                           | 2,778             |
| Preferred stocks                    | 6,800             |                              | 437                           | 6,363             |
| Mortgage-backed securities          | 152,256           | 3,199                        | 110                           | 155,345           |
| Collateralized mortgage obligations | 128,378           | 2,627                        |                               | 131,005           |
| <b>Total</b>                        | <b>\$ 490,420</b> | <b>\$ 15,124</b>             | <b>\$ 1,534</b>               | <b>\$ 504,010</b> |

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

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The amortized cost and fair value of AFS securities by contractual maturity at December 31, 2012 are as follows:

|                                     | Maturing                     |   |   |                       | Securities<br>With<br>Variable<br>Monthly<br>Payments<br>or<br>Noncontractual<br>Maturities |                   | Total |
|-------------------------------------|------------------------------|---|---|-----------------------|---|-------------------|-------|
|                                     | After One<br>Year<br>or Less | After Five<br>Years<br>But<br>Within<br>Five<br>Years | After Ten<br>Years<br>But<br>Within<br>Ten<br>Years | After<br>Ten<br>Years |   |                   |       |
| Government sponsored enterprises    | \$                           | \$ 72   | \$ 25,596   | \$                    | \$  | \$ 25,668         |       |
| States and political subdivisions   | 11,670                       | 36,157  | 86,062  | 40,229                |   | 174,118           |       |
| Auction rate money market preferred |                              |   |   |                       | 3,200   | 3,200             |       |
| Preferred stocks                    |                              |   |   |                       | 6,800   | 6,800             |       |
| Mortgage-backed securities          |                              |   |   |                       | 152,256   | 152,256           |       |
| Collateralized mortgage obligations |                              |   |   |                       | 128,378   | 128,378           |       |
| <b>Total amortized cost</b>         | <b>\$ 11,670</b>             | <b>\$ 36,229</b>                                      | <b>\$ 111,658</b>                                   | <b>\$ 40,229</b>      | <b>\$ 290,634</b>   | <b>\$ 490,420</b> |       |
| <b>Fair value</b>                   | <b>\$ 11,746</b>             | <b>\$ 37,759</b>                                      | <b>\$ 117,884</b>                                   | <b>\$ 41,130</b>      | <b>\$ 295,491</b>   | <b>\$ 504,010</b> |       |

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

As auction rate money market preferreds and preferred stocks have noncontractual maturities 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 AFS securities is as follows during the years ended December 31:

|                                       | 2012      | 2011     | 2010      |
|---------------------------------------|-----------|----------|-----------|
| Proceeds from sales AFS of securities | \$ 40,677 | \$ 8,877 | \$ 18,303 |
| Gross realized gains                  | \$ 1,119  | \$ 3     | \$ 351    |
| Gross realized losses                 |           |          | (3)       |
| Net realized gains                    | \$ 1,119  | \$ 3     | \$ 348    |
| Applicable income tax expense         | \$ 380    | \$ 1     | \$ 118    |

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

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Information pertaining to AFS 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:

|                                     | Less Than Twelve Months       |                  | 2012<br>Over Twelve Months    |                 | Total<br>Unrealized<br>Losses |
|-------------------------------------|-------------------------------|------------------|-------------------------------|-----------------|-------------------------------|
|                                     | Gross<br>Unrealized<br>Losses | Fair<br>Value    | Gross<br>Unrealized<br>Losses | Fair<br>Value   |                               |
| States and political subdivisions   | \$ 80                         | \$ 5,019         | \$ 485                        | \$ 2,352        | \$ 565                        |
| Auction rate money market preferred |                               |                  | 422                           | 2,778           | 422                           |
| Preferred stocks                    |                               |                  | 437                           | 3,363           | 437                           |
| Mortgage-backed securities          | 110                           | 25,499           |                               |                 | 110                           |
| <b>Total</b>                        | <b>\$ 190</b>                 | <b>\$ 30,518</b> | <b>\$ 1,344</b>               | <b>\$ 8,493</b> | <b>\$ 1,534</b>               |

**Number of securities in an unrealized loss position:** 15 6 21

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

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

As of December 31, 2012 and 2011, we conducted an analysis to determine whether any AFS securities currently in an unrealized loss position, should be considered 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 the issuer will be unable to pay the amount when due?

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

Has the duration of the investment been extended?

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



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

|               | <b>Discounted<br/>Cash Flow Method</b> |
|---------------|--|
| Ratings       |  |
| Fitch         | Not Rated                              |
| Moody's       | Caa3                                   |
| S&P           | A                                      |
| Seniority     | Senior                                 |
| Discount rate | LIBOR + 5.64%                          |

|   | <b>Credit Yield<br/>Analysis Method</b> |
|---|---|
| Credit discount rate                                    | LIBOR + 4.00%                           |
| Average observed discounts based on closed transactions | 17.06%                                  |

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

A rollforward of credit related impairment recognized in earnings on AFS securities was as follows:

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

There were no credit losses recognized in earnings on AFS securities during 2011.

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

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

We grant commercial, agricultural, residential real estate, and consumer loans to customers situated primarily in Clare, Gratiot, Isabella, Mecosta, Midland, Montcalm, and Saginaw counties in Michigan. The ability of borrowers to honor their repayment obligations is often dependent upon the real estate, agricultural, light manufacturing, retail, gaming and tourism, higher education, and general economic conditions of this region. Substantially all of the consumer and residential real estate loans are secured by various items of property, while commercial and agricultural loans are secured primarily by real estate, business assets, and personal guarantees; a portion of loans are unsecured. Commercial and agricultural loans include loans for commercial real estate, commercial operating loans, farmland and agricultural production, and states and political subdivisions. Repayment of these loans is often dependent upon the successful operation and management of a business; thus, these loans generally involve greater risk than other types of lending. We minimize our risk by limiting the amount of loans to any one borrower to \$12,500. Borrowers with credit needs of more than \$12,500 are serviced through the use of loan participations with other commercial banks. Commercial and agricultural real estate loans generally require loan-to-value limits of 80% or less. Depending upon the type of loan, past credit history, and current operating results, we may require borrowers to pledge accounts receivable, inventory, and property and equipment. Personal guarantees are generally required from the owners of closely held corporations, partnerships, and sole proprietorships. In addition, we require annual financial statements, prepare cash flow analyses, and review credit reports as deemed necessary.



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

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

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

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

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

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

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

**Allowance for Loan Losses  
Year Ended December 31, 2012**

|                           | Commercial      | Agricultural  | Residential<br>Real<br>Estate | Consumer      | Unallocated   | Total            |
|---------------------------|-----------------|---------------|-------------------------------|---------------|---------------|------------------|
| January 1, 2012           | \$ 6,284        | \$ 1,003      | \$ 2,980                      | \$ 633        | \$ 1,475      | \$ 12,375        |
| Loans charged off         | (1,672)         |               | (1,142)                       | (542)         |               | (3,356)          |
| Recoveries                | 240             |               | 122                           | 255           |               | 617              |
| Provision for loan losses | 2,010           | (596)         | 1,667                         | 320           | (1,101)       | 2,300            |
| <b>December 31, 2012</b>  | <b>\$ 6,862</b> | <b>\$ 407</b> | <b>\$ 3,627</b>               | <b>\$ 666</b> | <b>\$ 374</b> | <b>\$ 11,936</b> |

**Allowance for Loan Losses and Recorded Investment in Loans  
As of December 31, 2012**

|                                       | Commercial        | Agricultural     | Residential<br>Real<br>Estate | Consumer         | Unallocated   | Total             |
|---------------------------------------|-------------------|------------------|-------------------------------|------------------|---------------|-------------------|
| <b>ALLL</b>                           |                   |                  |                               |                  |               |                   |
| Individually evaluated for impairment | \$ 2,050          | \$ 91            | \$ 1,796                      | \$               | \$            | \$ 3,937          |
| Collectively evaluated for impairment | 4,812             | 316              | 1,831                         | 666              | 374           | 7,999             |
| <b>Total</b>                          | <b>\$ 6,862</b>   | <b>\$ 407</b>    | <b>\$ 3,627</b>               | <b>\$ 666</b>    | <b>\$ 374</b> | <b>\$ 11,936</b>  |
| <b>Loans</b>                          |                   |                  |                               |                  |               |                   |
| Individually evaluated for impairment | \$ 14,456         | \$ 723           | \$ 10,704                     | \$ 75            |               | \$ 25,958         |
| Collectively evaluated for impairment | 357,049           | 82,883           | 273,444                       | 33,419           |               | 746,795           |
| <b>Total</b>                          | <b>\$ 371,505</b> | <b>\$ 83,606</b> | <b>\$ 284,148</b>             | <b>\$ 33,494</b> |               | <b>\$ 772,753</b> |

**Allowance for Loan Losses  
Year Ended December 31, 2011**

|                           | Commercial      | Agricultural    | Residential<br>Real<br>Estate | Consumer      | Unallocated     | Total            |
|---------------------------|-----------------|-----------------|-------------------------------|---------------|-----------------|------------------|
| 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            |
| <b>December 31, 2011</b>  | <b>\$ 6,284</b> | <b>\$ 1,003</b> | <b>\$ 2,980</b>               | <b>\$ 633</b> | <b>\$ 1,475</b> | <b>\$ 12,375</b> |

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**Allowance for Loan Losses and Recorded Investment in Loans  
As of December 31, 2011**

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

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

| Rating              | 2012              |                     |                   |                  |                       |                  |
|---------------------|-------------------|---------------------|-------------------|------------------|-----------------------|------------------|
|                     | Real Estate       | Commercial<br>Other | Total             | Real Estate      | Agricultural<br>Other | Total            |
| 2 High quality      | \$ 25,209         | \$ 15,536           | \$ 40,745         | \$ 2,955         | \$ 2,313              | \$ 5,268         |
| 3 High satisfactory | 83,805            | 28,974              | 112,779           | 16,972           | 11,886                | 28,858           |
| 4 Low satisfactory  | 127,423           | 45,143              | 172,566           | 27,291           | 15,437                | 42,728           |
| 5 Special mention   | 16,046            | 1,692               | 17,738            | 1,008            | 3,191                 | 4,199            |
| 6 Substandard       | 20,029            | 2,224               | 22,253            | 1,167            | 1,217                 | 2,384            |
| 7 Vulnerable        | 1,512             | 2,294               | 3,806             |                  |                       |                  |
| 8 Doubtful          | 1,596             | 22                  | 1,618             |                  | 169                   | 169              |
| <b>Total</b>        | <b>\$ 275,620</b> | <b>\$ 95,885</b>    | <b>\$ 371,505</b> | <b>\$ 49,393</b> | <b>\$ 34,213</b>      | <b>\$ 83,606</b> |

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



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

**1. EXCELLENT Substantially Risk Free**

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

High liquidity, strong cash flow, low leverage.

Unquestioned ability to meet all obligations when due.

Experienced management, with management succession in place.

Secured by cash.

**2. HIGH QUALITY Limited Risk**

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

Favorable liquidity and leverage ratios.

Ability to meet all obligations when due.

Management with successful track record.

Steady and satisfactory earnings history.

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

Access to alternative financing.

Well defined primary and secondary source of repayment.

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

**3. HIGH SATISFACTORY Reasonable Risk**

Credit with satisfactory financial condition and further characterized by:

Working capital adequate to support operations.

Cash flow sufficient to pay debts as scheduled.

Management experience and depth appear favorable.

Loan performing according to terms.

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

**4. LOW SATISFACTORY Acceptable Risk**

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

Would include most start-up businesses.

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

Management's abilities are apparent, yet unproven.

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

Loan structure generally in accordance with policy.



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If secured, loan collateral coverage is marginal.

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

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

**5. SPECIAL MENTION Criticized**

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

Downward trend in sales, profit levels, and margins.

Impaired working capital position.

Cash flow is strained in order to meet debt repayment.

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

Shrinking equity cushion.

Diminishing primary source of repayment and questionable secondary source.

Management abilities are questionable.

Weak industry conditions.

Litigation pending against the borrower.

Collateral or guaranty offers limited protection.

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

**6. SUBSTANDARD Classified**

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

Sustained losses have severely eroded the equity and cash flow.

Deteriorating liquidity.

Serious management problems or internal fraud.

Original repayment terms liberalized.

Likelihood of bankruptcy.

Inability to access other funding sources.

Reliance on secondary source of repayment.

Litigation filed against borrower.

Collateral provides little or no value.

Requires excessive attention of the loan officer.

Borrower is uncooperative with loan officer.

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**7. VULNERABLE Classified**

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

Insufficient cash flow to service debt.

Minimal or no payments being received.

Limited options available to avoid the collection process.

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

**8. DOUBTFUL Workout**

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

Normal operations are severely diminished or have ceased.

Seriously impaired cash flow.

Original repayment terms materially altered.

Secondary source of repayment is inadequate.

Survivability as a going concern is impossible.

Collection process has begun.

Bankruptcy petition has been filed.

Judgments have been filed.

Portion of the loan balance has been charged-off.

**9. LOSS Charge off**

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

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

Fraudulently overstated assets and/or earnings.

Collateral has marginal or no value.

Debtor cannot be located.

Over 120 days delinquent.

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Our primary credit quality indicators for residential real estate and consumer loans is the individual loans past due aging. The following tables summarize our past due and current loans as of December 31:

|                                      | 2012                               |               |                       |                 |                                     |                   |                   |       |
|--------------------------------------|------------------------------------|---------------|-----------------------|-----------------|-------------------------------------|-------------------|-------------------|-------|
|                                      | Accruing Interest<br>and Past Due: |               |                       | Nonaccrual      | Total<br>Past Due<br>and<br>Current |                   |                   | Total |
|                                      | 30-59<br>Days                      | 60-89<br>Days | 90 Days<br>or<br>More |                 | Nonaccrual                          | Current           | Total             |       |
| <b>Commercial</b>                    |                                    |               |                       |                 |                                     |                   |                   |       |
| Commercial real estate               | \$ 1,304                           | \$ 161        | \$ 63                 | \$ 2,544        | \$ 4,072                            | \$ 271,548        | \$ 275,620        |       |
| Commercial other                     | 606                                |               | 40                    | 2,294           | 2,940                               | 92,945            | 95,885            |       |
| <b>Total commercial</b>              | <b>1,910</b>                       | <b>161</b>    | <b>103</b>            | <b>4,838</b>    | <b>7,012</b>                        | <b>364,493</b>    | <b>371,505</b>    |       |
| <b>Agricultural</b>                  |                                    |               |                       |                 |                                     |                   |                   |       |
| Agricultural real estate             |                                    |               |                       |                 |                                     | 49,393            | 49,393            |       |
| Agricultural other                   | 90                                 |               |                       | 169             | 259                                 | 33,954            | 34,213            |       |
| <b>Total agricultural</b>            | <b>90</b>                          |               |                       | <b>169</b>      | <b>259</b>                          | <b>83,347</b>     | <b>83,606</b>     |       |
| <b>Residential real estate</b>       |                                    |               |                       |                 |                                     |                   |                   |       |
| Senior liens                         | 2,000                              | 346           | 320                   | 2,064           | 4,730                               | 223,532           | 228,262           |       |
| Junior liens                         | 232                                |               |                       | 50              | 282                                 | 16,207            | 16,489            |       |
| Home equity lines of credit          | 237                                |               |                       | 182             | 419                                 | 38,978            | 39,397            |       |
| <b>Total residential real estate</b> | <b>2,469</b>                       | <b>346</b>    | <b>320</b>            | <b>2,296</b>    | <b>5,431</b>                        | <b>278,717</b>    | <b>284,148</b>    |       |
| <b>Consumer</b>                      |                                    |               |                       |                 |                                     |                   |                   |       |
| Secured                              | 127                                | 33            | 4                     |                 | 164                                 | 28,118            | 28,282            |       |
| Unsecured                            | 31                                 | 3             | 1                     |                 | 35                                  | 5,177             | 5,212             |       |
| <b>Total consumer</b>                | <b>158</b>                         | <b>36</b>     | <b>5</b>              |                 | <b>199</b>                          | <b>33,295</b>     | <b>33,494</b>     |       |
| <b>Total</b>                         | <b>\$ 4,627</b>                    | <b>\$ 543</b> | <b>\$ 428</b>         | <b>\$ 7,303</b> | <b>\$ 12,901</b>                    | <b>\$ 759,852</b> | <b>\$ 772,753</b> |       |

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|                                      | Accruing Interest<br>and Past Due: |               |                    | 2011            |  | Current           | Total             |
|--------------------------------------|------------------------------------|---------------|--------------------|-----------------|--|-------------------|-------------------|
|                                      | 30-59<br>Days                      | 60-89<br>Days | 90 Days<br>or More | Nonaccrual      | Total<br>Past Due<br>and<br>Nonaccrual |                   |                   |
|                                      |                                    |               |                    |                 | Nonaccrual                             |                   |                   |
| <b>Commercial</b>                    |                                    |               |                    |                 |  |                   |                   |
| Commercial real estate               | \$ 1,721                           | \$            | \$ 364             | \$ 4,176        | \$ 6,261                               | \$ 251,834        | \$ 258,095        |
| Commercial other                     | 388                                | 38            | 3                  | 25              | 454                                    | 107,165           | 107,619           |
| <b>Total commercial</b>              | <b>2,109</b>                       | <b>38</b>     | <b>367</b>         | <b>4,201</b>    | <b>6,715</b>                           | <b>358,999</b>    | <b>365,714</b>    |
| <b>Agricultural</b>                  |                                    |               |                    |                 |  |                   |                   |
| Agricultural real estate             |                                    |               | 99                 | 189             | 288                                    | 44,395            | 44,683            |
| Agricultural other                   |                                    | 2             |                    | 415             | 417                                    | 29,545            | 29,962            |
| <b>Total agricultural</b>            |                                    | <b>2</b>      | <b>99</b>          | <b>604</b>      | <b>705</b>                             | <b>73,940</b>     | <b>74,645</b>     |
| <b>Residential real estate</b>       |                                    |               |                    |                 |  |                   |                   |
| Senior liens                         | 2,668                              | 336           | 124                | 1,292           | 4,420                                  | 213,181           | 217,601           |
| Junior liens                         | 203                                | 32            | 40                 | 94              | 369                                    | 20,877            | 21,246            |
| Home equity lines of credit          | 185                                |               | 125                | 198             | 508                                    | 39,005            | 39,513            |
| <b>Total residential real estate</b> | <b>3,056</b>                       | <b>368</b>    | <b>289</b>         | <b>1,584</b>    | <b>5,297</b>                           | <b>273,063</b>    | <b>278,360</b>    |
| <b>Consumer</b>                      |                                    |               |                    |                 |  |                   |                   |
| Secured                              | 127                                | 31            | 5                  |                 | 163                                    | 26,011            | 26,174            |
| Unsecured                            | 20                                 | 3             |                    |                 | 23                                     | 5,375             | 5,398             |
| <b>Total consumer</b>                | <b>147</b>                         | <b>34</b>     | <b>5</b>           |                 | <b>186</b>                             | <b>31,386</b>     | <b>31,572</b>     |
| <b>Total</b>                         | <b>\$ 5,312</b>                    | <b>\$ 442</b> | <b>\$ 760</b>      | <b>\$ 6,389</b> | <b>\$ 12,903</b>                       | <b>\$ 737,388</b> | <b>\$ 750,291</b> |

**Impaired Loans**

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

1. There has been a charge-off of its principal balance (in whole or in part);
2. The loan has been classified as a TDR; or
3. The loan is in nonaccrual status.

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

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

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The following is a summary of information pertaining to impaired loans as of and for the year ended December 31:

|   | Outstanding<br>Balance | Unpaid<br>Principal<br>Balance | 2012<br>Valuation<br>Allowance | Average<br>Outstanding<br>Balance | Interest<br>Income<br>Recognized |
|---|------------------------|--------------------------------|--------------------------------|-----------------------------------|----------------------------------|
| <b>Impaired loans with a valuation allowance</b>          |                        |                                |                                |                                   |                                  |
| Commercial real estate                                    | \$ 7,295               | \$ 7,536                       | \$ 1,653                       | \$ 6,155                          | \$ 237                           |
| Commercial other  | 2,140                  | 2,140                          | 397                            | 1,437                             | 93                               |
| Agricultural real estate                                  | 91                     | 91                             | 32                             | 413                               |                                  |
| Agricultural other  | 420                    | 420                            | 59                             | 1,555                             | 54                               |
| Residential real estate senior liens                      | 10,450                 | 11,654                         | 1,783                          | 8,860                             | 405                              |
| Residential real estate junior liens                      | 72                     | 118                            | 13                             | 134                               | 6                                |
| <b>Total impaired loans with a valuation allowance</b>    | <b>20,468</b>          | <b>21,959</b>                  | <b>3,937</b>                   | <b>18,554</b>                     | <b>795</b>                       |
| <b>Impaired loans without a valuation allowance</b>       |                        |                                |                                |                                   |                                  |
| Commercial real estate                                    | 3,749                  | 4,408                          |                                | 5,867                             | 321                              |
| Commercial other  | 1,272                  | 1,433                          |                                | 819                               | 87                               |
| Agricultural real estate                                  |                        |                                |                                | 183                               |                                  |
| Agricultural other  | 212                    | 332                            |                                | 201                               | 4                                |
| Residential real estate senior liens                      |                        | 18                             |                                | 1                                 | 1                                |
| Home equity lines of credit                               | 182                    | 482                            |                                | 190                               | 16                               |
| Consumer secured  | 75                     | 84                             |                                | 90                                | 6                                |
| <b>Total impaired loans without a valuation allowance</b> | <b>5,490</b>           | <b>6,757</b>                   |                                | <b>7,351</b>                      | <b>435</b>                       |
| <b>Impaired loans</b>                                     |                        |                                |                                |                                   |                                  |
| Commercial  | 14,456                 | 15,517                         | 2,050                          | 14,278                            | 738                              |
| Agricultural  | 723                    | 843                            | 91                             | 2,352                             | 58                               |
| Residential real estate                                   | 10,704                 | 12,272                         | 1,796                          | 9,185                             | 428                              |
| Consumer  | 75                     | 84                             |                                | 90                                | 6                                |
| <b>Total impaired loans</b>                               | <b>\$ 25,958</b>       | <b>\$ 28,716</b>               | <b>\$ 3,937</b>                | <b>\$ 25,905</b>                  | <b>\$ 1,230</b>                  |

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|   | Outstanding<br>Balance | Unpaid<br>Principal<br>Balance | 2011<br>Valuation<br>Allowance | Average<br>Outstanding<br>Balance | Interest<br>Income<br>Recognized |
|---|------------------------|--------------------------------|--------------------------------|-----------------------------------|----------------------------------|
| <b>Impaired loans with a valuation allowance</b>          |                        |                                |                                |                                   |                                  |
| Commercial real estate                                    | \$ 5,014               | \$ 5,142                       | \$ 1,881                       | \$ 4,012                          | \$ 247                           |
| Commercial other  | 734                    | 734                            | 271                            | 376                               | 25                               |
| Agricultural real estate                                  |                        |                                |                                | 9                                 |                                  |
| Agricultural other  | 2,689                  | 2,689                          | 822                            | 2,443                             | 138                              |
| Residential mortgage senior liens                         | 7,269                  | 8,825                          | 1,111                          | 5,781                             | 331                              |
| Residential mortgage junior liens                         | 195                    | 260                            | 35                             | 184                               | 11                               |
| <b>Total impaired loans with a valuation allowance</b>    | <b>15,901</b>          | <b>17,650</b>                  | <b>4,120</b>                   | <b>12,805</b>                     | <b>752</b>                       |
| <b>Impaired loans without a valuation allowance</b>       |                        |                                |                                |                                   |                                  |
| Commercial real estate                                    | 7,984                  | 10,570                         |                                | 4,863                             | 375                              |
| Commercial other  | 365                    | 460                            |                                | 267                               | 10                               |
| Agricultural real estate                                  | 190                    | 190                            |                                | 180                               |                                  |
| Agricultural other  | 505                    | 625                            |                                | 253                               | 18                               |
| Residential mortgage senior liens                         | 2                      | 2                              |                                | 202                               |                                  |
| Home equity lines of credit                               | 198                    | 498                            |                                | 99                                | 12                               |
| Consumer secured  | 105                    | 114                            |                                | 77                                | 4                                |
| <b>Total impaired loans without a valuation allowance</b> | <b>9,349</b>           | <b>12,459</b>                  |                                | <b>5,941</b>                      | <b>419</b>                       |
| <b>Impaired loans</b>                                     |                        |                                |                                |                                   |                                  |
| Commercial  | 14,097                 | 16,906                         | 2,152                          | 9,518                             | 657                              |
| Agricultural  | 3,384                  | 3,504                          | 822                            | 2,885                             | 156                              |
| Residential mortgage                                      | 7,664                  | 9,585                          | 1,146                          | 6,266                             | 354                              |
| Consumer  | 105                    | 114                            |                                | 77                                | 4                                |
| <b>Total impaired loans</b>                               | <b>\$ 25,250</b>       | <b>\$ 30,109</b>               | <b>\$ 4,120</b>                | <b>\$ 18,746</b>                  | <b>\$ 1,171</b>                  |

As of December 31, 2012 and 2011, we had committed to advance \$9 and \$243, respectively, in connection with impaired loans, which include TDR s.

**Troubled Debt Restructurings**

Loan modifications are considered to be TDR s when the modification includes 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.



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

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

The following is a summary of information pertaining to TDR's granted in the years ended December 31:

|                                      | Number<br>of<br>Loans | 2012   |   | Number<br>of<br>Loans | 2011   |   |
|--------------------------------------|-----------------------|--|---|-----------------------|--|---|
|                                      |                       | Pre-<br>Modification<br>Recorded<br>Investment | Post-<br>Modification<br>Recorded<br>Investment |                       | Pre-<br>Modification<br>Recorded<br>Investment | Post-<br>Modification<br>Recorded<br>Investment |
| <b>Commercial</b>                    |                       |  |   |                       |  |   |
| Commercial real estate               | 1                     | \$ 912   | \$ 792  | 1                     | \$ 408   | \$ 408  |
| Commercial other                     | 28                    | 6,437  | 6,437   | 42                    | 12,575   | 12,132  |
| Total commercial                     | 29                    | 7,349  | 7,229   | 43                    | 12,983   | 12,540  |
| <b>Agricultural other</b>            |                       |  |   |                       |  |   |
| Agricultural other                   | 7                     | 652  | 652   | 8                     | 1,321  | 1,321   |
| Residential real estate Senior liens | 29                    | 3,463  | 3,463   | 36                    | 3,915  | 3,865   |
| Junior liens                         | 1                     | 22   | 22  |                       |  |   |
| Total residential real estate        | 30                    | 3,485  | 3,485   | 36                    | 3,915  | 3,865   |
| <b>Consumer</b>                      |                       |  |   |                       |  |   |
| Secured                              | 1                     |  |   | 7                     | 69   | 69  |
| Unsecured                            |                       |  |   | 2                     | 20   | 20  |
| Total consumer                       | 1                     |  |   | 9                     | 89   | 89  |
| <b>Total</b>                         | <b>67</b>             | <b>\$ 11,486</b>                               | <b>\$ 11,366</b>                                | <b>96</b>             | <b>\$ 18,308</b>                               | <b>\$ 17,815</b>                                |

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The following tables summarize concessions we granted to borrowers in financial difficulty during 2012:

|                                      | Below Market Interest Rate |                                      | Extension of Amortization Period |                                      | Below Market Interest Rate and Extension of Amortization Period |                                      |
|--------------------------------------|----------------------------|--------------------------------------|----------------------------------|--------------------------------------|---|--------------------------------------|
|                                      | Number of Loans            | Pre-Modification Recorded Investment | Number of Loans                  | Pre-Modification Recorded Investment | Number of Loans   | Pre-Modification Recorded Investment |
| Commercial                           |                            |                                      |                                  |                                      |   |                                      |
| Commercial real estate               |                            | \$                                   |                                  | \$                                   | 1   | \$ 912                               |
| Commercial other                     | 25                         | 4,924                                | 1                                | 1,368                                | 2   | 145                                  |
| Total commercial                     | 25                         | 4,924                                | 1                                | 1,368                                | 3   | 1,057                                |
| Agricultural other                   | 6                          | 561                                  | 1                                | 91                                   |   |                                      |
| Residential real estate Senior liens | 17                         | 1,779                                | 3                                | 521                                  | 9   | 1,163                                |
| Junior liens                         |                            |                                      |                                  |                                      | 1   | 22                                   |
| Total residential real estate        | 17                         | 1,779                                | 3                                | 521                                  | 10  | 1,185                                |
| Consumer secured                     | 1                          |                                      |                                  |                                      |   |                                      |
| <b>Total</b>                         | <b>49</b>                  | <b>\$ 7,264</b>                      | <b>5</b>                         | <b>\$ 1,980</b>                      | <b>13</b>   | <b>\$ 2,242</b>                      |

The following tables summarize concessions we granted to borrowers in financial difficulty during 2011:

|                                      | Below Market Interest Rate |                                      | Extension of Amortization Period |                                      | Below Market Interest Rate and Extension of Amortization Period |                                      |
|--------------------------------------|----------------------------|--------------------------------------|----------------------------------|--------------------------------------|---|--------------------------------------|
|                                      | Number of Loans            | Pre-Modification Recorded Investment | 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 real estate Senior liens | 19                         | 2,161                                |                                  |                                      | 17  | 1,754                                |
| Consumer                             |                            |                                      |                                  |                                      |   |                                      |
| Secured                              | 6                          | 65                                   |                                  |                                      | 1   | 4                                    |
| Unsecured                            |                            |                                      |                                  |                                      | 2   | 20                                   |
| Total consumer                       | 6                          | 65                                   |                                  |                                      | 3   | 24                                   |

|              |           |                  |           |           |                 |
|--------------|-----------|------------------|-----------|-----------|-----------------|
| <b>Total</b> | <b>72</b> | <b>\$ 13,887</b> | <b>\$</b> | <b>24</b> | <b>\$ 4,421</b> |
|--------------|-----------|------------------|-----------|-----------|-----------------|

We did not restructure any loans through the forbearance of principal or accrued interest during 2012 and 2011.

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

Following is a summary of loans that defaulted during 2012, which were modified within 12 months prior to the default date:

|                                      | Number<br>of<br>Loans | Pre-<br>Default<br>Recorded<br>Investment | Charge-Off<br>Recorded<br>Upon<br>Default | Post-<br>Default<br>Recorded<br>Investment |
|--------------------------------------|-----------------------|---|---|--|
| Commercial other                     | 5                     | \$ 342                                    | \$ 143                                    | \$ 199                                     |
| Residential real estate senior liens | 1                     | 47  | 43  | 4  |
| Consumer secured                     | 1                     | 8   | 8   |  |
| <b>Total</b>                         | <b>7</b>              | <b>\$ 397</b>                             | <b>\$ 194</b>                             | <b>\$ 203</b>                              |

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

The following is a summary of TDR loan balances as of December 31:

|                              | 2012      | 2011      |
|------------------------------|-----------|-----------|
| Troubled debt restructurings | \$ 19,355 | \$ 18,756 |

**NOTE 7 PREMISES AND EQUIPMENT**

A summary of premises and equipment at December 31 follows:

|                                    | 2012             | 2011             |
|------------------------------------|------------------|------------------|
| Land                               | \$ 5,435         | \$ 5,174         |
| Buildings and improvements         | 22,705           | 22,397           |
| Furniture and equipment            | 29,755           | 26,926           |
| Total                              | 57,895           | 54,497           |
| Less: accumulated depreciation     | 32,108           | 29,871           |
| <b>Premises and equipment, net</b> | <b>\$ 25,787</b> | <b>\$ 24,626</b> |

Depreciation expense amounted to \$2,417, \$2,521 and \$2,522 in 2012, 2011, and 2010, respectively.

**NOTE 8 GOODWILL AND OTHER INTANGIBLE ASSETS**

The carrying amount of goodwill was \$45,618 at December 31, 2012 and 2011.

Identifiable intangible assets at year end were as follows:

2012

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|  | <b>Gross<br/>Intangible<br/>Assets</b> | <b>Accumulated<br/>Amortization</b> | <b>Net<br/>Intangible<br/>Assets</b> |
|--|--|-------------------------------------|--------------------------------------|
| Core deposit premium resulting from acquisitions | \$ 5,373                               | \$ 4,459                            | \$ 914                               |

|  | <b>Gross<br/>Intangible<br/>Assets</b> | <b>2011<br/>Accumulated<br/>Amortization</b> | <b>Net<br/>Intangible<br/>Assets</b> |
|--|--|--|--------------------------------------|
| Core deposit premium resulting from acquisitions | \$ 5,373                               | \$ 4,199                                     | \$ 1,174                             |

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Amortization expense associated with identifiable intangible assets was \$260, \$299, and \$338 in 2012, 2011, and 2010, respectively.

Estimated amortization expense associated with identifiable intangibles for each of the next five years succeeding December 31, 2012, and thereafter is as follows:

| Year       | Amount |
|------------|--------|
| 2013       | \$ 221 |
| 2014       | 183    |
| 2015       | 145    |
| 2016       | 106    |
| 2017       | 74     |
| Thereafter | 185    |
|            | \$ 914 |

**NOTE 9 DEPOSITS**

Scheduled maturities of time deposits for the next five years, and thereafter, are as follows:

| Year       | Amount     |
|------------|------------|
| 2013       | \$ 205,754 |
| 2014       | 76,742     |
| 2015       | 71,685     |
| 2016       | 51,232     |
| 2017       | 40,523     |
| Thereafter | 18,399     |
|            | \$ 464,335 |

Interest expense on time deposits greater than \$100 was \$3,854 in 2012, \$4,302 in 2011, and \$4,427 in 2010.

**NOTE 10 BORROWED FUNDS**

Borrowed funds consist of the following obligations at December 31:

|  | 2012              |              | 2011              |              |
|--|-------------------|--------------|-------------------|--------------|
|  | Amount            | Rate         | Amount            | Rate         |
| FHLB advances  | \$ 152,000        | 2.05%        | \$ 142,242        | 3.16%        |
| Securities sold under agreements to repurchase without stated maturity dates | 66,147            | 0.15%        | 57,198            | 0.25%        |
| Securities sold under agreements to repurchase with stated maturity dates    | 16,284            | 3.57%        | 16,696            | 3.51%        |
| Federal funds purchased  | 6,570             | 0.50%        |                   |              |
| <b>Total</b>   | <b>\$ 241,001</b> | <b>1.59%</b> | <b>\$ 216,136</b> | <b>2.42%</b> |

The FHLB borrowings are collateralized by U.S. government and federal agency securities and a blanket lien on all qualified 1-to-4 family mortgage loans. Advances are also secured by FHLB stock that we own. As of December 31, 2012, we had total unused lines of credit of \$108,646.



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

|   | 2012              |              | 2011              |              |
|---|-------------------|--------------|-------------------|--------------|
|   | Amount            | Rate         | Amount            | Rate         |
| Fixed rate advances due 2012                  | \$                |              | \$ 17,000         | 2.97%        |
| One year putable fixed rate advances due 2012 |                   |              | 15,000            | 4.10%        |
| Fixed rate advances due 2013                  |                   |              | 5,242             | 4.14%        |
| One year putable fixed rate advances due 2013 |                   |              | 5,000             | 3.15%        |
| Fixed rate advances due 2014                  | 10,000            | 0.48%        | 25,000            | 3.16%        |
| Fixed rate advances due 2015                  | 42,000            | 1.12%        | 45,000            | 3.30%        |
| Fixed rate advances due 2016                  | 10,000            | 2.15%        | 10,000            | 2.15%        |
| Fixed rate advances due 2017                  | 40,000            | 2.15%        | 20,000            | 2.56%        |
| Fixed rate advances due 2018                  | 20,000            | 2.86%        |                   |              |
| Fixed rate advances due 2019                  | 20,000            | 3.73%        |                   |              |
| Fixed rate advances due 2020                  | 10,000            | 1.98%        |                   |              |
| <b>Total</b>                                  | <b>\$ 152,000</b> | <b>2.05%</b> | <b>\$ 142,242</b> | <b>3.16%</b> |

Securities sold under agreements to repurchase are classified as secured borrowings. Securities sold under agreements to repurchase without stated maturity dates generally mature within one to four days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction. The securities underlying the agreements had a fair value of \$143,322 and \$99,869 at December 31, 2012 and 2011, respectively. Such securities remain under our control. We may be required to provide additional collateral based on the fair value of underlying securities.

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

|                                | 2012             |              | 2011             |              |
|--------------------------------|------------------|--------------|------------------|--------------|
|                                | Amount           | Rate         | Amount           | Rate         |
| Repurchase agreements due 2012 | \$               |              | \$ 428           | 2.08%        |
| Repurchase agreements due 2013 | 5,000            | 4.51%        | 5,000            | 4.51%        |
| Repurchase agreements due 2014 | 10,872           | 3.15%        | 10,869           | 3.12%        |
| Repurchase agreements due 2015 | 412              | 3.25%        | 399              | 3.25%        |
| <b>Total</b>                   | <b>\$ 16,284</b> | <b>3.57%</b> | <b>\$ 16,696</b> | <b>3.51%</b> |

Securities sold under repurchase agreements without stated maturity dates, federal funds purchased, and FRB discount window advances generally mature within one to four days from the transaction date. The following table provides a summary of short term borrowings for the years ended December 31:

|  | 2012                      |                     |  | 2011                      |                     |  |
|--|---------------------------|---------------------|--|---------------------------|---------------------|--|
|  | Maximum Month End Balance | YTD Average Balance | Weighted Average Interest Rate During the Period | Maximum Month End Balance | YTD Average Balance | Weighted Average Interest Rate During the Period |
| Securities sold under agreements to repurchase without stated maturity dates | \$ 66,147                 | \$ 57,466           | 0.20%  | \$ 57,198                 | \$ 45,397           | 0.25%  |
| Federal funds purchased  | 17,900                    | 3,386               | 0.47%  | 18,300                    | 3,467               | 0.51%  |





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We had pledged certificates of deposit held in other financial institutions, trading securities, AFS securities, and 1-4 family mortgage loans in the following amounts at December 31:

|   | 2012              | 2011              |
|---|-------------------|-------------------|
| Pledged to secure borrowed funds  | \$ 308,628        | \$ 292,092        |
| Pledged to secure repurchase agreements   | 143,322           | 99,869            |
| Pledged for public deposits and for other purposes necessary or required by law | 22,955            | 26,761            |
| <b>Total</b>  | <b>\$ 474,905</b> | <b>\$ 418,722</b> |

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

**NOTE 11 OTHER NONINTEREST EXPENSES**

A summary of expenses included in other noninterest expenses is as follows for the years ended December 31:

|                                   | 2012            | 2011            | 2010            |
|-----------------------------------|-----------------|-----------------|-----------------|
| Marketing and community relations | \$ 1,965        | \$ 1,174        | \$ 1,093        |
| Directors fees                    | 885             | 842             | 887             |
| FDIC insurance premiums           | 864             | 1,086           | 1,254           |
| Audit fees                        | 711             | 714             | 710             |
| Education and travel              | 588             | 526             | 499             |
| Consulting fees                   | 482             | 386             | 167             |
| Printing and supplies             | 424             | 405             | 420             |
| Postage and freight               | 389             | 388             | 395             |
| Other losses                      | 300             | 54              | 72              |
| Legal fees                        | 268             | 302             | 382             |
| Amortization of deposit premium   | 260             | 299             | 338             |
| Foreclosed asset and collection   | 202             | 576             | 916             |
| State taxes                       | 187             | 57              | 51              |
| All other                         | 1,526           | 1,462           | 1,376           |
| <b>Total other</b>                | <b>\$ 9,051</b> | <b>\$ 8,271</b> | <b>\$ 8,560</b> |

**NOTE 12 FEDERAL INCOME TAXES**

Components of the consolidated provision for federal income taxes are as follows for the year ended December 31:

|                           | 2012            | 2011            | 2010            |
|---------------------------|-----------------|-----------------|-----------------|
| Currently payable         | \$ 1,747        | \$ 965          | \$ 1,425        |
| Deferred expense          | 616             | 389             | 179             |
| <b>Income tax expense</b> | <b>\$ 2,363</b> | <b>\$ 1,354</b> | <b>\$ 1,604</b> |

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The reconciliation of the provision for federal income taxes and the amount computed at the federal statutory tax rate of 34% of income before federal income taxes is as follows for the years ended December 31:

|   | 2012            | 2011            | 2010            |
|---|-----------------|-----------------|-----------------|
| Income taxes at 34% statutory rate            | \$ 4,953        | \$ 3,932        | \$ 3,621        |
| Effect of nontaxable income                   |                 |                 |                 |
| Interest income on tax exempt municipal bonds | (1,675)         | (1,687)         | (1,565)         |
| Earnings on corporate owned life insurance    | (238)           | (207)           | (225)           |
| Other   | (147)           | (65)            | (132)           |
| Total effect of nontaxable income             | (2,060)         | (1,959)         | (1,922)         |
| Effect of tax credits                         | (667)           | (793)           | (263)           |
| Effect of nondeductible expenses              | 137             | 174             | 168             |
| <b>Income tax expense</b>                     | <b>\$ 2,363</b> | <b>\$ 1,354</b> | <b>\$ 1,604</b> |

Included in OCI are unrealized gains (losses) on auction rate money market preferred and preferred stocks. For federal income tax purposes, these securities are considered equity investments. As such, no deferred federal income taxes related to unrealized holding gains or losses are expected or recorded.

A summary of the components of unrealized holding gains on AFS securities included in OCI follows for the years ended December 31:

|   | 2012  |                                   |                 | 2011  |                                   |                 | 2010  |                                   |               |
|---|---|-----------------------------------|-----------------|---|-----------------------------------|-----------------|---|-----------------------------------|---------------|
|   | Auction<br>Rate<br>Money<br>Market<br>Preferred<br>and<br>Preferred<br>Stocks | All<br>Other<br>AFS<br>Securities | Total           | Auction<br>Rate<br>Money<br>Market<br>Preferred<br>and<br>Preferred<br>Stocks | All<br>Other<br>AFS<br>Securities | Total           | Auction<br>Rate<br>Money<br>Market<br>Preferred<br>and<br>Preferred<br>Stocks | All<br>Other<br>AFS<br>Securities | Total         |
| Unrealized gains arising during the year                                  | \$ 2,059  | \$ 1,862                          | \$ 3,921        | \$ (1,719)  | \$ 10,939                         | \$ 9,220        | \$ (226)  | \$ 1,382                          | \$ 1,156      |
| Reclassification adjustment for net realized gains included in net income |   | (1,119)                           | (1,119)         |   | (3)                               | (3)             |   | (348)                             | (348)         |
| Reclassification adjustment for impairment loss included in net income    |   | 282                               | 282             |   |                                   |                 |   |                                   |               |
| Net unrealized gains  | 2,059   | 1,025                             | 3,084           | (1,719)   | 10,936                            | 9,217           | (226)   | 1,034                             | 808           |
| Tax effect  |   | (348)                             | (348)           |   | (3,719)                           | (3,719)         |   | (351)                             | (351)         |
| <b>Unrealized gains, net of tax</b>                                       | <b>\$ 2,059</b>   | <b>\$ 677</b>                     | <b>\$ 2,736</b> | <b>\$ (1,719)</b>   | <b>\$ 7,217</b>                   | <b>\$ 5,498</b> | <b>\$ (226)</b>   | <b>\$ 683</b>                     | <b>\$ 457</b> |

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for federal income tax purposes.

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Significant components of our deferred tax assets and liabilities, included in other assets in the accompanying consolidated balance sheets, are as follows as of December 31:

|   | 2012            | 2011            |
|---|-----------------|-----------------|
| <b>Deferred tax assets</b>                            |                 |                 |
| Allowance for loan losses                             | \$ 3,133        | \$ 3,278        |
| Deferred directors fees                               | 2,100           | 2,384           |
| Employee benefit plans                                | 189             | 158             |
| Core deposit premium and acquisition expenses         | 892             | 800             |
| Net unrealized losses on trading securities           | 351             | 364             |
| Net unrecognized actuarial loss on pension plan       | 1,891           | 1,780           |
| Life insurance death benefit payable                  | 804             | 804             |
| Alternative minimum tax                               | 729             | 729             |
| Other   | 195             | 260             |
| <b>Total deferred tax assets</b>                      | <b>10,284</b>   | <b>10,557</b>   |
| <b>Deferred tax liabilities</b>                       |                 |                 |
| Prepaid pension cost                                  | 1,021           | 851             |
| Premises and equipment                                | 724             | 992             |
| Accretion on securities                               | 37              | 34              |
| Core deposit premium and acquisition expenses         | 1,203           | 1,102           |
| Net unrealized gains on available-for-sale securities | 4,912           | 4,564           |
| Other   | 1,163           | 937             |
| <b>Total deferred tax liabilities</b>                 | <b>9,060</b>    | <b>8,480</b>    |
| <b>Net deferred tax assets</b>                        | <b>\$ 1,224</b> | <b>\$ 2,077</b> |

We are subject to U.S. federal income tax; however, we are no longer subject to examination by taxing authorities for years before 2009. There are no material uncertain tax positions requiring recognition in our consolidated financial statements. We do not expect the total amount of unrecognized tax benefits to significantly increase in the next twelve months.

We recognize interest and/or penalties related to income tax matters in income tax expense. We do not have any amounts accrued for interest and penalties at December 31, 2012 and 2011 and we not aware of any claims for such amounts by federal income tax authorities.

**NOTE 13 OFF-BALANCE-SHEET ACTIVITIES*****Credit-Related Financial Instruments***

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

|  | December 31 |            |
|--|-------------|------------|
|  | 2012        | 2011       |
| Unfunded commitments under lines of credit | \$ 115,233  | \$ 102,822 |
| Commercial and standby letters of credit   | 3,935       | 4,461      |
| Commitments to grant loans                 | 40,507      | 21,806     |



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

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

Commitments to grant loans are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The amount of collateral obtained, if we deem necessary, is based on our credit evaluation of the customer. Commitments to grant loans include loans committed to be sold to the secondary market.

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

**NOTE 14 ON-BALANCE SHEET ACTIVITIES*****Derivative Loan Commitments***

Mortgage loan commitments are referred to as derivative loan commitments if the loan that will result from exercise of the commitment will be held for sale upon funding. We enter into commitments to fund residential mortgage loans at specific times in the future, with the intention that these loans will subsequently be sold in the secondary market. A mortgage loan commitment binds us to lend funds to a potential borrower at a specified interest rate within a specified period of time, generally up to 60 days after inception of the rate lock.

Outstanding derivative loan commitments expose us to the risk that the price of the loans arising from the exercise of the loan commitment might decline from the inception of the rate lock to funding of the loan due to increases in mortgage interest rates. If interest rates increase, the value of these loan commitments decreases. Conversely, if interest rates decrease, the value of these loan commitments increase. The notional amount of undesignated interest rate lock commitments was \$1,912 and \$875 at December 31, 2012 and 2011, respectively.

***Forward Loan Sale Commitments***

To protect against the price risk inherent in derivative loan commitments, we utilize both mandatory delivery and best efforts forward loan sale commitments to mitigate the risk of potential decreases in the values of loan that would result from the exercise of the derivative loan commitments.

With a mandatory delivery contract, we commit to deliver a certain principal amount of mortgage loans to an investor at a specified price on or before a specified date. If we fail to deliver the amount of mortgages necessary to fulfill the commitment by the specified date, we are obligated to pay a pair-off fee, based on then current market prices, to the investor to compensate the investor for the shortfall.

With a best efforts contract, we commit to deliver an individual mortgage loan of a specified principal amount and quality to an investor if the loan to the underlying borrower closes. Generally, the price the investor

will pay the seller for an individual loan is specified prior to the loan being funded (e.g. on the same day the lender commits to lend funds to a potential borrower).

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We expect that these forward loan sale commitments will experience changes in fair value opposite to the change in fair value of derivative loan commitments. The notional amount of undesignated forward loan sale commitments was \$5,545 and \$4,080 at December 31, 2012 and 2011, respectively.

The fair values of the rate lock loan commitments related to the origination of mortgage loans that will be held for sale and the forward loan sale commitments are deemed insignificant by management and, accordingly, are not recorded in our consolidated financial statements.

**NOTE 15 COMMITMENTS AND OTHER MATTERS**

Banking regulations require us to maintain cash reserve balances in currency or as deposits with the FRB. At December 31, 2012 and 2011, the reserve balances amounted to \$885 and \$821, respectively.

Banking regulations limit the transfer of assets in the form of dividends, loans, or advances from the Bank to the Corporation. At December 31, 2012, substantially all of the Bank's assets were restricted from transfer to the Corporation in the form of loans or advances. Consequently, Bank dividends are the principal source of funds for the Corporation. Payment of dividends without regulatory approval is limited to the current year's retained net income plus retained net income for the preceding two years, less any required transfers to common stock. At January 1, 2013, the amount available to the Corporation for dividends from the Bank, without regulatory approval, was approximately \$17,000.

**NOTE 16 MINIMUM REGULATORY CAPITAL REQUIREMENTS**

The Corporation (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the FRB and the FDIC. Failure to meet minimum capital requirements can initiate mandatory and possibly additional discretionary actions by the FRB and the FDIC that if undertaken, could have a material effect on our financial statements. Under regulatory capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that include quantitative measures of assets, liabilities, capital, and certain off-balance-sheet items, as calculated under regulatory accounting standards. Our capital amounts and classifications are also subject to qualitative judgments by the FRB and the FDIC about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require us to maintain minimum amounts and ratios (set forth in the following table) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined) and Tier 1 capital to average assets (as defined). We believe, as of December 31, 2012 and 2011, that we met all capital adequacy requirements.

As of December 31, 2012, the most recent notifications from the FRB and the FDIC categorized us as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the

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following tables. There are no conditions or events since the notifications that we believe has changed our categories. Our actual capital amounts and ratios are also presented in the table.

|  | Actual     |        | Minimum Capital Requirement |       | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|--|------------|--------|-----------------------------|-------|--|--------|
|  | Amount     | Ratio  | Amount                      | Ratio | Amount   | Ratio  |
| <b>December 31, 2012</b>               |            |        |                             |       |  |        |
| Total capital to risk weighted assets  |            |        |                             |       |  |        |
| Isabella Bank                          | \$ 112,498 | 13.40% | \$ 67,150                   | 8.00% | \$ 83,937  | 10.00% |
| Consolidated                           | 123,388    | 14.48  | 68,161                      | 8.00  | N/A  | N/A    |
| Tier 1 capital to risk weighted assets |            |        |                             |       |  |        |
| Isabella Bank                          | 101,988    | 12.15  | 33,575                      | 4.00  | 50,362   | 6.00   |
| Consolidated                           | 112,722    | 13.23  | 34,080                      | 4.00  | N/A  | N/A    |
| Tier 1 capital to average assets       |            |        |                             |       |  |        |
| Isabella Bank                          | 101,988    | 7.57   | 53,916                      | 4.00  | 67,395   | 5.00   |
| Consolidated                           | 112,722    | 8.29   | 54,411                      | 4.00  | N/A  | N/A    |
|  | Actual     |        | Minimum Capital Requirement |       | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|  | Amount     | Ratio  | Amount                      | Ratio | Amount   | Ratio  |
| <b>December 31, 2011</b>               |            |        |                             |       |  |        |
| Total capital to risk weighted assets  |            |        |                             |       |  |        |
| Isabella Bank                          | \$ 104,542 | 13.06% | \$ 64,028                   | 8.00% | \$ 80,035  | 10.00% |
| Consolidated                           | 115,172    | 14.17  | 65,009                      | 8.00  | N/A  | N/A    |
| Tier 1 capital to risk weighted assets |            |        |                             |       |  |        |
| Isabella Bank                          | 94,508     | 11.81  | 32,014                      | 4.00  | 48,021   | 6.00   |
| Consolidated                           | 104,987    | 12.92  | 32,505                      | 4.00  | N/A  | N/A    |
| Tier 1 capital to average assets       |            |        |                             |       |  |        |
| Isabella Bank                          | 94,508     | 7.44   | 50,808                      | 4.00  | 63,510   | 5.00   |
| Consolidated                           | 104,987    | 8.18   | 51,317                      | 4.00  | N/A  | N/A    |

**NOTE 17 BENEFIT PLANS****401(k) Plan**

We have a 401(k) plan in which substantially all employees are eligible to participate. Employees may contribute up to 50% of their compensation subject to certain limits based on federal tax laws. We made a 3.0% safe harbor contribution for all eligible employees and matching contributions equal to 50% of the first 4.0% of an employee's compensation contributed to the Plan during the year. Employees are 100% vested in the safe harbor contributions and are 0% vested through their first two years of employment and are 100% vested after 6 years of service for matching contributions. For 2012, 2011 and 2010, expenses attributable to the Plan were \$662, \$652, and \$625, respectively.

**Defined Benefit Pension Plan**

We have a non-contributory defined benefit pension plan which was curtailed in 2007. Due to the curtailment, future salary increases will not be considered and the benefits are based on years of service and the employees' five highest consecutive years of compensation out of the last ten years of service rendered through March 1, 2007.



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Changes in the projected benefit obligation and plan assets during each year, the funded status of the plan, and the net amount recognized on our consolidated balance sheets using an actuarial measurement date of December 31, are summarized as follows during the years ended December 31:

|  | 2012              | 2011              |
|--|-------------------|-------------------|
| <b>Change in benefit obligation</b>  |                   |                   |
| Benefit obligation, January 1  | \$ 11,334         | \$ 9,660          |
| Interest cost  | 470               | 507               |
| Actuarial loss   | 888               | 1,750             |
| Benefits paid, including plan expenses   | (483)             | (583)             |
| <b>Benefit obligation, December 31</b>   | <b>12,209</b>     | <b>11,334</b>     |
| <b>Change in plan assets</b>   |                   |                   |
| Fair value of plan assets, January 1   | 8,603             | 8,900             |
| Investment return  | 778               | 148               |
| Contributions  | 752               | 138               |
| Benefits paid, including plan expenses   | (483)             | (583)             |
| <b>Fair value of plan assets, December 31</b>  | <b>9,650</b>      | <b>8,603</b>      |
| <b>Deficiency in funded status at December 31, included on the consolidated balance sheets in accrued interest payable and other liabilities</b> | <b>\$ (2,559)</b> | <b>\$ (2,731)</b> |

|  | 2012              | 2011              |
|--|-------------------|-------------------|
| <b>Change in accrued pension benefit costs</b>                   |                   |                   |
| Accrued benefit cost at January 1                                | \$ (2,731)        | \$ (760)          |
| Contributions  | 752               | 138               |
| Net periodic cost for the year                                   | (251)             | (138)             |
| Net change in unrecognized actuarial loss and prior service cost | (329)             | (1,971)           |
| <b>Accrued pension benefit cost at December 31</b>               | <b>\$ (2,559)</b> | <b>\$ (2,731)</b> |

Amounts recognized as a component of other comprehensive income consist of the following amounts during the years ended December 31:

|                                     | 2012            | 2011              | 2010           |
|-------------------------------------|-----------------|-------------------|----------------|
| Change in unrecognized pension cost | \$ (329)        | \$ (1,971)        | \$ (72)        |
| Tax effect                          | 111             | 671               | 25             |
| <b>Net</b>                          | <b>\$ (218)</b> | <b>\$ (1,300)</b> | <b>\$ (47)</b> |

The accumulated benefit obligation was \$12,209 and \$11,334 at December 31, 2012 and 2011, respectively.

We have recorded the funded status of the Plan in our consolidated balance sheets. We adjust the underfunded status in a liability account to reflect the current funded status of the plan. Any gains or losses that arise during the period but are not recognized as components of net periodic benefit cost will be recognized as a component of other comprehensive income (loss). The components of net periodic benefit cost are as follows for the years ended December 31:

|   | 2012          | 2011          | 2010          |
|---|---------------|---------------|---------------|
| Interest cost on projected benefit obligation   | \$ 470        | \$ 507        | \$ 531        |
| Expected return on plan assets                  | (511)         | (522)         | (491)         |
| Amortization of unrecognized actuarial net loss | 292           | 153           | 153           |
| <b>Total</b>                                    | <b>\$ 251</b> | <b>\$ 138</b> | <b>\$ 193</b> |

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Accumulated other comprehensive income at December 31, 2012 includes net unrecognized pension costs before income taxes of \$5,562, of which \$208 is expected to be amortized into benefit cost during 2013.

The actuarial assumptions used in determining the projected benefit obligation are as follows for the year ended December 31:

|                                   | 2012  | 2011  | 2010  |
|-----------------------------------|-------|-------|-------|
| Discount rate                     | 3.75% | 4.22% | 5.36% |
| Expected long-term rate of return | 6.00% | 6.00% | 6.00% |

The actuarial weighted average assumptions used in determining the net periodic pension costs are as follows for the year ended December 31:

|  | 2012  | 2011  | 2010  |
|--|-------|-------|-------|
| Discount rate                            | 4.22% | 5.36% | 6.10% |
| Expected long-term return on plan assets | 6.00% | 6.00% | 6.00% |

As a result of the curtailment of the Plan, there is no rate of compensation increase considered in the above assumptions.

The expected long term rate of return is an estimate of anticipated future long term rates of return on plan assets as measured on a market value basis. Factors considered in arriving at this assumption include:

Historical long term rates of return for broad asset classes.

Actual past rates of return achieved by the plan.

The general mix of assets held by the plan.

The stated investment policy for the plan.

The selected rate of return is net of anticipated investment related expenses.

**Plan Assets**

Our overall investment strategy is to moderately grow the portfolio by investing 50% of the portfolio in equity securities and 50% in fixed income securities. This strategy is designed to generate a long term rate of return of 6.0%. Equity securities primarily consist of the S&P 500 Index with a smaller allocation to the Small Cap and International Index. Fixed income securities are invested in the Bond Market Index. The Plan has appropriate assets invested in short term investments to meet near-term benefit payments.

The asset mix and the sector weighting of the investments are determined by our pension committee, which is comprised of members of our management. To manage the Plan, we retain a third party investment advisor to conduct consultations. We review the performance of the advisor no less than annually.

The fair values of our pension plan assets by asset category were as follows as of December 31:

| Description | 2012  |           | 2011  |           |
|-------------|-------|-----------|-------|-----------|
|             | Total | (Level 2) | Total | (Level 2) |

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| <b>Asset Category</b>    |          |          |          |          |
|--------------------------|----------|----------|----------|----------|
| Short-term investments   | \$ 80    | \$ 80    | \$ 16    | \$ 16    |
| Common collective trusts |          |          |          |          |
| Fixed income             | 4,832    | 4,832    | 4,357    | 4,357    |
| Equity investments       | 4,738    | 4,738    | 4,230    | 4,230    |
|                          | \$ 9,650 | \$ 9,650 | \$ 8,603 | \$ 8,603 |

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The following is a description of the valuation methodologies used for assets measured at fair value. There have been no changes in the methodologies used at December 31, 2012 and 2011:

*Short-term investments:* Shares of a money market portfolio, which is valued using amortized cost, which approximates fair value.

*Common collective trusts:* These investments are public investment securities valued using the NAV provided by a third party investment advisor. The NAV is quoted on a private market that is not active; however, the unit price is based on underlying investments which are traded on an active market.

We anticipate contributions of \$215 to the plan in 2013.

Estimated future benefit payments are as follows for the next ten years:

| Year              | Amount |
|-------------------|--------|
| 2013              | \$ 432 |
| 2014              | 526    |
| 2015              | 567    |
| 2016              | 567    |
| 2017              | 593    |
| Years 2018 - 2022 | 3,281  |

The components of projected net periodic benefit cost are as follows for the year ending December 31:

|   |               |
|---|---------------|
|   | <b>2013</b>   |
| Interest cost on projected benefit obligation   | \$ 450        |
| Expected return on plan assets                  | (572)         |
| Amortization of unrecognized actuarial net loss | 330           |
| <b>Net periodic benefit cost</b>                | <b>\$ 208</b> |

**Equity Compensation Plan**

Pursuant to the terms of the Directors Plan, our directors are required to defer at least 25% of their earned board fees into the Directors Plan. The fees are converted on a quarterly basis into shares of our common stock based on the fair value of a share of common stock as of the relevant valuation date. Stock credited to a participant's account is eligible for stock and cash dividends as declared. Upon retirement from the board or the occurrence of certain other events, the participant is eligible to receive a lump-sum, in-kind, distribution of all of the stock that is then in his or her account, and any unconverted cash will be converted to and rounded up to whole shares of stock and distributed, as well. The Directors Plan does not allow for cash settlement, and therefore, such share-based payment awards qualify for classification as equity. All authorized but unissued shares of common stock are eligible for issuance under the Directors Plan. We may also purchase shares of common stock on the open market to meet our obligations under the Directors Plan.

We maintain the Rabbi Trust to fund the Directors Plan. The Rabbi Trust is an irrevocable grantor trust to which we may contribute assets for the limited purpose of funding a nonqualified deferred compensation plan. Although we may not reach the assets of the Rabbi Trust for any purpose other than meeting our obligations under the Directors Plan, the assets of the Rabbi Trust remain subject to the claims of our creditors and are included in the consolidated financial statements. We may contribute cash or common stock to the Rabbi Trust from time to time for the sole purpose of funding the Directors Plan. The Rabbi Trust will use any cash that we contributed to purchase shares of our common stock on the open market through our brokerage services department.



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The components of shares eligible to be issued under the Directors Plan were as follows as of December 31:

|                            | 2012            |                 | 2011            |                 |
|----------------------------|-----------------|-----------------|-----------------|-----------------|
|                            | Eligible Shares | Market Value    | Eligible Shares | Market Value    |
| Unissued                   | 165,436         | \$ 3,598        | 201,438         | \$ 4,774        |
| Shares held in Rabbi Trust | 5,130           | 112             | 16,585          | 393             |
| <b>Total</b>               | <b>170,566</b>  | <b>\$ 3,710</b> | <b>218,023</b>  | <b>\$ 5,167</b> |

**Other Employee Benefit Plans**

We maintain two nonqualified supplementary employee retirement plans to provide supplemental retirement benefits to specified participants. Expenses related to these programs for 2012, 2011, and 2010 were \$382, \$444, and \$363, respectively, and are being recognized over the participants' expected years of service.

We maintain a non-leveraged ESOP which was frozen to new participants on December 31, 2006. Contributions to the plan are discretionary and are approved by the Board of Directors and recorded as compensation expense. During 2012, the Board of Directors approved a contribution of \$75 to the ESOP. Prior to 2012, the most recent contribution was \$50 in 2009. We made no contributions in 2011 or 2010. Compensation cost related to the plan for 2012, 2011, and 2010 was \$102, \$20, and \$0, respectively. Total allocated shares outstanding related to the ESOP at December 31, 2012, 2011, and 2010 were 246,404, 246,404, and 246,419, respectively. Such shares are included in the computation of dividends and earnings per share in each of the respective years.

We maintain a self-funded medical plan under which we are responsible for the first \$75 per year of claims made by a covered family. Expenses are accrued based on estimates of the aggregate liability for claims incurred and our experience. Expenses were \$2,534 in 2012, \$2,045 in 2011 and \$2,101 in 2010.

**NOTE 18 ACCUMULATED OTHER COMPREHENSIVE INCOME**

Accumulated other comprehensive income includes net income as well as unrealized gains and losses, net of tax, on AFS investment securities owned and changes in the funded status of our defined benefit pension plan, which are excluded from net income. Unrealized AFS securities gains and losses and changes in the funded status of the pension plan, net of tax, are excluded from net income, and are reflected as a direct charge or credit to shareholders' equity. Comprehensive income (loss) and the related components are disclosed in the consolidated statements of comprehensive income.

The following is a summary of the components comprising the balance of accumulated other comprehensive income (loss) reported on the consolidated balance sheets as of December 31 (presented net of tax):

|  | 2012            | 2011            |
|--|-----------------|-----------------|
| Unrealized gains on available-for-sale investment securities | \$ 8,678        | \$ 5,942        |
| Unrecognized pension costs                                   | (3,671)         | (3,453)         |
| <b>Accumulated other comprehensive income</b>                | <b>\$ 5,007</b> | <b>\$ 2,489</b> |

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In the ordinary course of business, we grant loans to principal officers and directors and their affiliates (including their families and companies in which they have 10% or more ownership). Annual activity during the years ended December 31 consisted of the following:

|                             | 2012            | 2011            |
|-----------------------------|-----------------|-----------------|
| Balance, January 1          | \$ 3,728        | \$ 4,347        |
| New loans                   | 8,435           | 1,800           |
| Repayments                  | (5,565)         | (2,419)         |
| <b>Balance, December 31</b> | <b>\$ 6,598</b> | <b>\$ 3,728</b> |

Total deposits of these principal officers and directors and their affiliates amounted to \$6,871 and \$7,664 at December 31, 2012 and 2011, respectively. In addition, the ESOP held deposits with the Bank aggregating \$517 and \$275, respectively, at December 31, 2012 and 2011.

From time to time, we make charitable donations to the Isabella Bank Foundation (the Foundation), which is an affiliated nonprofit entity formed for the purpose of distributing charitable donations to recipient organizations generally located in the communities we service. Donations are expensed when committed to the Foundation as they are non-refundable. The assets and transactions of the Foundation are not included in our consolidated financial statements.

The following table displays ending balances of, and our contributions to, the Foundation as of, and for the years ended, December 31:

|               | 2012     | 2011     | 2010     |
|---------------|----------|----------|----------|
| Ending assets | \$ 1,766 | \$ 1,150 | \$ 1,108 |
| Contributions | \$ 850   | \$ 250   | \$ 250   |

**NOTE 20 FAIR VALUE**

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

***Cash and demand deposits due from banks:***

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

***Certificates of deposit held in other financial institutions:***

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

***Investment securities:***

Investment securities are recorded at fair value on a recurring basis. Level 1 fair value measurement is based upon quoted prices for identical instruments. Level 2 fair value measurement is based upon quoted prices for similar instruments. If quoted prices are not available, fair values are measured using independent pricing models or other model based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss and liquidity assumptions. The values for Level 1 and Level 2 investment securities are generally obtained from an independent third party. On a quarterly basis, we compare the values



provided to alternative pricing sources.

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Due to the limited trading activity of certain auction rate money market preferred securities and preferred stocks, we measured these securities using Level 3 inputs as of December 31, 2010. As the markets for these securities normalized and established regular trading patterns, we measured preferred stocks utilizing Level 1 inputs and the auction rate money market preferred security utilizing Level 2 inputs as of December 31, 2011 and continued to measure at these levels as of December 31, 2012.

The table below represents the activity in auction rate money market preferred and preferred stock AFS securities measured with Level 3 inputs on a recurring basis for the year ended December 31, 2011:

|   | <b>Auction Rate<br/>Money Market<br/>Preferred</b> | <b>Preferred<br/>Stocks</b> |
|---|--|-----------------------------|
| Level 3 inputs January 1, 2011          | \$ 2,865   | \$ 6,936                    |
| Calls                                   |  | (1,000)                     |
| Transfer to Level 1 inputs              |  | (5,033)                     |
| Transfer to Level 2 inputs              | (2,049)  |                             |
| Net unrealized losses on AFS securities | (816)  | (903)                       |
| Level 3 inputs December 31, 2011        | \$   | \$                          |

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

***Mortgage loans available-for-sale:***

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

***Loans:***

For variable rate loans with no significant change in credit risk, fair values are based on carrying values. Fair values for fixed rate loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The resulting amounts are adjusted to estimate the effect of changes in the credit quality of borrowers since the loans were originated. Upon reviewing our assumptions related to the estimation of the fair value of loans, we transferred loans with an estimated fair value of \$751,009 as of December 31, 2012 from nonrecurring Level 2 assets to nonrecurring Level 3 assets. As such, we classify loans as level 3 assets.

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

We review the net realizable values of the underlying collateral for collateral dependent impaired loans on at least a quarterly basis for all loan types. To determine the collateral value, management utilizes independent appraisals, broker price opinions, or internal evaluations. These valuations are reviewed to determine whether an additional discount should be applied given the age of market information that may have been considered as well as other factors such as costs to carry and sell an asset if it is determined that the collateral will be liquidated in connection with the ultimate settlement of the loan. We use these valuations to determine if any charge offs or specific reserves are necessary. We may obtain new valuations in certain circumstances, including when there has been significant deterioration in the condition of the collateral, if the foreclosure process has begun, or if the existing valuation is deemed to be outdated.

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Impaired loans where an allowance is established based on the net realizable value of collateral require classification in the fair value hierarchy. Due to the inherent level of estimation in the valuation process, we record impaired loans as nonrecurring Level 3.

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

| Valuation Techniques              | Fair Value | Unobservable Input                                  | Range         |
|-----------------------------------|------------|---|---------------|
| <b>Discounted cash flow</b>       | \$10,522   | Duration of cash flows                              | 14 120 Months |
|                                   |            | Reduction in interest rate from original loan terms | 5.00% 6.25%   |
|                                   |            | Discount applied to collateral appraisal:           |               |
| <b>Discounted appraisal value</b> | \$11,499   | Real Estate   | 20% 30%       |
|                                   |            | Equipment   | 50%           |
|                                   |            | Livestock   | 50%           |
|                                   |            | Cash crop inventory                                 | 50%           |
|                                   |            | Other inventory                                     | 75%           |
|                                   |            | Accounts receivable                                 | 75%           |

**Accrued interest:**

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

**Goodwill and other intangible assets:**

Acquisition intangibles and goodwill are evaluated for potential impairment on at least an annual basis. Acquisition intangibles and goodwill are 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 acquisition intangibles or goodwill is more likely than not to be impaired, we perform a cash flow valuation to determine the extent of the potential impairment. If the testing resulted in impairment, we would classify goodwill and other acquisition intangibles subjected to nonrecurring fair value adjustments as Level 3. During 2012 and 2011 there were no impairments recorded on goodwill and other acquisition intangibles.

**Equity securities without readily determinable fair values:**

Included in equity securities without readily determinable fair values are FHLB Stock and FRB Stock as well as our ownership interests in Corporate Settlement Solutions and Valley Financial Corporation. The investment in Corporate Settlement Solutions, a title insurance company, was made in the 1st quarter 2007. The Corporation is not the managing entity of Corporate Settlement Solutions, LLC, and accounts for its investment in that entity under the equity method of accounting. Valley Financial Corporation is the parent company of 1st State Bank in Saginaw, Michigan, which is a de novo bank that opened in 2005. The Corporation made investments in Valley Financial Corporation in 2004 and in 2007.

The lack of an active market, or other independent sources to validate fair value estimates coupled with the impact of future capital calls and transfer restrictions, is an inherent limitation in the valuation process. As the fair values of these investments are not readily determinable, they are not disclosed under a specific fair value hierarchy; however, they are reviewed quarterly for impairment. If we were to record an impairment adjustment related to these securities, it would be classified as a nonrecurring Level 3 fair value adjustment. During 2012 and 2011, there were no impairments recorded on equity securities without readily determinable fair values.

**Table of Contents*****Foreclosed assets:***

Upon transfer from the loan portfolio, foreclosed assets are adjusted to and subsequently carried at the lower of carrying value or fair value less costs to sell. Net realizable value is based upon independent market prices, appraised values of the collateral, or management's estimation of the value of the collateral. Upon reviewing our assumptions related to the estimation of the fair value of loans, we transferred foreclosed assets with an estimated fair value of \$2,018 as of December 31, 2012 from nonrecurring Level 2 assets to nonrecurring Level 3 assets. Due to the inherent level of estimation in the valuation process, we record foreclosed assets as nonrecurring Level 3.

The table below lists the quantitative information related to foreclosed assets measured utilizing Level 3 fair value measurements as of December 31, 2012:

| <b>Valuation Technique</b>        | <b>Fair Value</b> | <b>Unobservable Input</b>                 | <b>Range</b> |
|-----------------------------------|-------------------|---|--------------|
| <b>Discounted appraisal value</b> |                   | Discount applied to collateral appraisal: | 20%          |
|                                   | \$2,018           | Real Estate                               | 30%          |
|                                   |                   | Equipment                                 | 50%          |

***Originated mortgage servicing rights:***

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

***Deposits:***

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

***Borrowed funds:***

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

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

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The activity in borrowings which we have elected to carry at fair value was as follows for the years ended December 31:

|   | 2012      | 2011            |
|---|-----------|-----------------|
| Borrowings carried at fair value beginning of year  | \$ 5,242  | \$ 10,423       |
| Paydowns and maturities                             | (5,209)   | (5,000)         |
| Net unrealized change in fair value                 | (33)      | (181)           |
| <b>Borrowings carried at fair value December 31</b> | <b>\$</b> | <b>\$ 5,242</b> |
| <b>Unpaid principal balance December 31</b>         | <b>\$</b> | <b>\$ 5,000</b> |

***Commitments to extend credit, standby letters of credit and undisbursed loans:***

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

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

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

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

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The carrying amount and estimated fair value of financial instruments not recorded at fair value in their entirety on a recurring basis on our consolidated balance sheets are as follows as of December 31:

|   | Carrying Value | Estimated Fair Value | 2012      |           |           |
|---|----------------|----------------------|-----------|-----------|-----------|
|   |                |                      | (Level 1) | (Level 2) | (Level 3) |
| <b>ASSETS</b>   |                |                      |           |           |           |
| Cash and demand deposits due from banks                       | \$ 24,920      | \$ 24,920            | \$ 24,920 | \$        | \$        |
| Certificates of deposit held in other financial institutions  | 4,465          | 4,475                |           | 4,475     |           |
| Mortgage loans available-for-sale                             | 3,633          | 3,680                |           | 3,680     |           |
| Total loans   | 772,753        | 784,964              |           |           | 784,964   |
| Less allowance for loan losses                                | (11,936)       | (11,936)             |           |           | (311,936) |
| Net loans   | 760,817        | 773,028              |           |           | 773,028   |
| Accrued interest receivable                                   | 5,227          | 5,227                | 5,227     |           |           |
| Equity securities without readily determinable fair values(1) | 18,118         | 18,118               |           |           |           |
| Originated mortgage servicing rights                          | 2,285          | 2,285                |           | 2,285     |           |
| <b>LIABILITIES</b>  |                |                      |           |           |           |
| Deposits without stated maturities                            | 553,332        | 553,332              | 553,332   |           |           |
| Deposits with stated maturities                               | 464,335        | 472,630              |           | 472,630   |           |
| Borrowed funds  | 241,001        | 248,822              |           | 248,822   |           |
| Accrued interest payable                                      | 751            | 751                  | 751       |           |           |
| <b>2011</b>   |                |                      |           |           |           |
|   | Carrying Value | Estimated Fair Value | (Level 1) | (Level 2) | (Level 3) |
| <b>ASSETS</b>   |                |                      |           |           |           |
| Cash and demand deposits due from banks                       | \$ 28,590      | \$ 28,590            | \$ 28,590 | \$        | \$        |
| Certificates of deposit held in other financial institutions  | 8,924          | 8,977                |           | 8,977     |           |
| Mortgage loans available-for-sale                             | 3,205          | 3,252                |           | 3,252     |           |
| Total loans   | 750,291        | 769,177              |           | 743,927   | 25,250    |
| Less allowance for loan losses                                | (12,375)       | (12,375)             |           | (8,255)   | (4,120)   |
| Net loans   | 737,916        | 756,802              |           | 735,672   | 21,130    |
| Accrued interest receivable                                   | 5,848          | 5,848                | 5,848     |           |           |
| Equity securities without readily determinable fair values(1) | 17,189         | 17,189               |           |           |           |
| Originated mortgage servicing rights                          | 2,374          | 2,374                |           | 2,374     |           |
| <b>LIABILITIES</b>  |                |                      |           |           |           |
| Deposits without stated maturities                            | 476,627        | 476,627              | 476,627   |           |           |
| Deposits with stated maturities                               | 481,537        | 499,644              |           | 499,644   |           |
| Borrowed funds  | 210,894        | 222,538              |           | 222,538   |           |
| Accrued interest payable                                      | 967            | 967                  | 967       |           |           |

- (1) Due to the characteristics of equity securities without readily determinable fair values, they are not disclosed under a specific fair value hierarchy. If we were to record an impairment adjustment related to these securities, such amount would be classified as a nonrecurring Level 3 fair value adjustment.



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

The table below presents the recorded amount of assets and liabilities measured at fair value on December 31:

| Description  | Total      | 2012      |            |           | Total      | 2011      |            |           |
|--|------------|-----------|------------|-----------|------------|-----------|------------|-----------|
|  |            | (Level 1) | (Level 2)  | (Level 3) |            | (Level 1) | (Level 2)  | (Level 3) |
| <b>Recurring items</b>                                   |            |           |            |           |            |           |            |           |
| Trading securities                                       |            |           |            |           |            |           |            |           |
| States and political subdivisions                        | \$ 1,573   | \$        | \$ 1,573   | \$        | \$ 4,710   |           | \$ 4,710   | \$        |
| Available-for-sale investment securities                 |            |           |            |           |            |           |            |           |
| Government-sponsored enterprises                         | 25,776     |           | 25,776     |           | 397        |           | 397        |           |
| States and political subdivisions                        | 182,743    |           | 182,743    |           | 174,938    |           | 174,938    |           |
| Auction rate money market preferred                      | 2,778      |           | 2,778      |           | 2,049      |           | 2,049      |           |
| Preferred stock  | 6,363      | 6,363     |            |           | 5,033      | 5,033     |            |           |
| Mortgage-backed  | 155,345    |           | 155,345    |           | 143,602    |           | 143,602    |           |
| Collateralized mortgage obligations                      | 131,005    |           | 131,005    |           | 99,101     |           | 99,101     |           |
| Total available-for-sale investment securities           |            |           |            |           |            |           |            |           |
|  | 504,010    | 6,363     | 497,647    |           | 425,120    | 5,033     | 420,087    |           |
| Borrowed funds   |            |           |            |           |            |           |            |           |
|  |            |           |            |           | 5,242      |           | 5,242      |           |
| <b>Nonrecurring items</b>                                |            |           |            |           |            |           |            |           |
| Impaired loans   | 22,021     |           |            | 22,021    | 21,130     |           |            | 21,130    |
| Originated mortgage servicing rights                     | 2,285      |           | 2,285      |           | 2,374      |           | 2,374      |           |
| Foreclosed assets  | 2,018      |           |            | 2,018     | 1,876      |           | 1,876      |           |
|  | \$ 531,907 | \$ 6,363  | \$ 501,505 | \$ 24,039 | \$ 460,452 | \$ 5,033  | \$ 434,289 | \$ 21,130 |
| Percent of assets and liabilities measured at fair value |            |           |            |           |            |           |            |           |
|  |            | 1.20%     | 94.28%     | 4.52%     |            | 1.09%     | 94.32%     | 4.59%     |

The changes in fair value of assets and liabilities recorded at fair value through earnings on a recurring basis and changes in assets and liabilities recorded at fair value on a nonrecurring basis, for which an impairment, or reduction of an impairment, was recognized in the years ended December 31:

| Description                          | 2012           |                          |                 | 2011           |                          |                 |
|--------------------------------------|----------------|--------------------------|-----------------|----------------|--------------------------|-----------------|
|                                      | Trading Losses | Other Gains and (Losses) | Total           | Trading Losses | Other Gains and (Losses) | Total           |
| <b>Recurring items</b>               |                |                          |                 |                |                          |                 |
| Trading securities                   | \$ (52)        | \$                       | \$ (52)         | \$ (78)        | \$                       | \$ (78)         |
| Borrowed funds                       |                | 33                       | 33              |                | 181                      | 181             |
| <b>Nonrecurring items</b>            |                |                          |                 |                |                          |                 |
| Foreclosed assets                    |                | (166)                    | (166)           |                | (82)                     | (82)            |
| Originated mortgage servicing rights |                | (58)                     | (58)            |                | (243)                    | (243)           |
| <b>Total</b>                         | <b>\$ (52)</b> | <b>\$ (191)</b>          | <b>\$ (243)</b> | <b>\$ (78)</b> | <b>\$ (144)</b>          | <b>\$ (222)</b> |





**Table of Contents****NOTE 21 PARENT COMPANY ONLY FINANCIAL INFORMATION****Condensed Balance Sheets**

|  | December 31       |                   |
|--|-------------------|-------------------|
|  | 2012              | 2011              |
| <b>ASSETS</b>                                    |                   |                   |
| Cash on deposit at subsidiary Bank               | \$ 332            | \$ 1,474          |
| Securities available for sale                    | 3,939             | 3,567             |
| Investments in subsidiaries                      | 115,781           | 106,463           |
| Premises and equipment                           | 2,041             | 1,916             |
| Other assets                                     | 52,398            | 52,060            |
| <b>TOTAL ASSETS</b>                              | <b>\$ 174,491</b> | <b>\$ 165,480</b> |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>       |                   |                   |
| Other liabilities                                | \$ 10,002         | \$ 10,697         |
| Shareholders equity                              | 164,489           | 154,783           |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b> | <b>\$ 174,491</b> | <b>\$ 165,480</b> |

**Condensed Statements of Income**

|   | Year Ended December 31 |                  |                 |
|---|------------------------|------------------|-----------------|
|   | 2012                   | 2011             | 2010            |
| <b>Income</b>   |                        |                  |                 |
| Dividends from subsidiaries   | \$ 6,125               | \$ 6,500         | \$ 6,250        |
| Interest income   | 174                    | 128              | 72              |
| Management fee and other  | 2,037                  | 1,201            | 1,340           |
| <b>Total income</b>   | <b>8,336</b>           | <b>7,829</b>     | <b>7,662</b>    |
| <b>Expenses</b>   |                        |                  |                 |
| Compensation and benefits   | 2,424                  | 2,267            | 2,286           |
| Occupancy and equipment   | 370                    | 370              | 356             |
| Audit fees  | 351                    | 378              | 476             |
| Other   | 945                    | 1,089            | 932             |
| <b>Total expenses</b>   | <b>4,090</b>           | <b>4,104</b>     | <b>4,050</b>    |
| Income before income tax benefit and equity in undistributed earnings of subsidiaries | 4,246                  | 3,725            | 3,612           |
| Federal income tax benefit  | 673                    | 958              | 896             |
|   | 4,919                  | 4,683            | 4,508           |
| Undistributed earnings of subsidiaries  | 7,287                  | 5,527            | 4,537           |
| <b>Net income</b>   | <b>\$ 12,206</b>       | <b>\$ 10,210</b> | <b>\$ 9,045</b> |

**Table of Contents****Condensed Statements of Cash Flows**

|  | Year Ended December 31 |                 |                |
|--|------------------------|-----------------|----------------|
|  | 2012                   | 2011            | 2010           |
| <b>OPERATING ACTIVITIES</b>  |                        |                 |                |
| Net income   | \$ 12,206              | \$ 10,210       | \$ 9,045       |
| Adjustments to reconcile net income to cash provided by operations                   |                        |                 |                |
| Undistributed earnings of subsidiaries   | (7,287)                | (5,527)         | (4,537)        |
| Undistributed earnings of equity securities without readily determinable fair values | (459)                  | 160             | (7)            |
| Share-based payment awards   | 643                    | 615             | 650            |
| Depreciation   | 114                    | 123             | 147            |
| Net amortization of investment securities  | 4                      | 7               | 5              |
| Deferred income tax expense (benefit)  | 425                    | (48)            | (172)          |
| Changes in operating assets and liabilities which (used) provided cash               |                        |                 |                |
| Other assets   | (513)                  | 7               | 305            |
| Accrued interest and other liabilities   | (98)                   | 757             | 1,883          |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>                                     | <b>5,035</b>           | <b>6,304</b>    | <b>7,319</b>   |
| <b>INVESTING ACTIVITIES</b>  |                        |                 |                |
| Activity in available-for-sale securities  |                        |                 |                |
| Maturities, calls, and sales   | 370                    | 585             | 110            |
| Purchases  |                        | (3,000)         |                |
| (Purchases) sales of equipment and premises  | (239)                  | (87)            | 247            |
| Advances to subsidiaries   | (50)                   |                 | (250)          |
| <b>NET CASH (USED IN) PROVIDED BY INVESTING ACTIVITIES</b>                           | <b>81</b>              | <b>(2,502)</b>  | <b>107</b>     |
| <b>FINANCING ACTIVITIES</b>  |                        |                 |                |
| Net (decrease) increase in other borrowed funds                                      | (597)                  | 2,772           | (1,550)        |
| Cash dividends paid on common stock  | (6,074)                | (5,770)         | (5,421)        |
| Proceeds from the issuance of common stock   | 2,279                  | 2,302           | 2,208          |
| Common stock repurchased   | (1,361)                | (1,507)         | (2,020)        |
| Common stock purchased for deferred compensation obligations                         | (505)                  | (426)           | (514)          |
| <b>NET CASH USED IN FINANCING ACTIVITIES</b>   | <b>(6,258)</b>         | <b>(2,629)</b>  | <b>(7,297)</b> |
| <b>(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>                              | <b>(1,142)</b>         | <b>1,173</b>    | <b>129</b>     |
| Cash and cash equivalents at beginning of year                                       | 1,474                  | 301             | 172            |
| <b>CASH AND CASH EQUIVALENTS AT END OF YEAR</b>                                      | <b>\$ 332</b>          | <b>\$ 1,474</b> | <b>\$ 301</b>  |

**NOTE 22 OPERATING SEGMENTS**

Our reportable segments are based on legal entities that account for at least 10 percent of net operating results. Retail banking operations for 2012, 2011, and 2010 represent approximately 90% or greater of our total assets and operating results. As such, no additional segment information is presented.

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

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

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

The following is management's discussion and analysis of the financial condition and results of our operations. 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***

Despite the challenges and uncertainty of the current economic environment, we are pleased to report our strongest earnings ever. There continues to be slight improvements in the local, regional, and national economies, but a large degree of economic uncertainty remains. Our continued success throughout these challenging times is a direct result of our unwavering focus on community banking principles, prudent underwriting standards, and long term sustainable growth. This focus has enabled us to continue to meet the needs of the communities we serve. Carefully managed growth is an important part of our strategy to maintain shareholder value. We are excited about the prospects of our new Freeland, Michigan office which was opened in October 2012. The new location complements our existing office locations, increases our brand awareness in the Freeland area, and is expected to provide additional shareholder value for years to come.

#### ***Recent Legislation***

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

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

#### ***Other***

We have not received any notices of regulatory actions as of March 1, 2013.

#### ***CRITICAL ACCOUNTING POLICIES:***

Our significant accounting policies are set forth in Note 1 Nature of Operations and Summary of Significant Accounting Policies of the Consolidated Financial Statements. Of these significant accounting policies, we consider our policies regarding the ALLL, acquisition intangibles and goodwill, and the determination of the fair value and assessment of OTTI of investment securities to be our most critical accounting policies.

The ALLL requires our most subjective and complex judgment. Changes in economic conditions can have a significant impact on the ALLL and, therefore, the provision for loan losses and results of operations. We have developed policies and procedures for assessing the appropriateness of the ALLL, recognizing that this process requires a number of assumptions and estimates with respect to our loan portfolio. Our 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 us at the time of the issuance of the consolidated financial statements. For

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additional discussion concerning our ALLL and related matters, see the detailed discussion to follow under the heading Allowance for Loan Losses and Note 6 Loans and Allowance for Loan Losses of the Notes to Consolidated Financial Statements.

United States generally accepted accounting principles require that we determine the fair value of the assets and liabilities of an acquired entity, and record their fair value on the date of acquisition. We employ 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 we believe we have the appropriate expertise to determine the fair value, we may choose to use our own calculations of the value. In other cases, where the value is not easily determined, we consult 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 net value of assets acquired on our balance sheet, including identifiable intangibles, is recorded as goodwill. Acquisition intangibles and goodwill are qualitatively evaluated to determine if it is more likely than not that the carrying balance is impaired on a quarterly basis.

We currently have both AFS and trading investment securities that are carried at fair value. Changes in the fair value of AFS 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. We evaluate AFS securities for indications of losses that are considered other-than-temporary, if any, on a regular basis. The market values for AFS and trading investment securities are typically obtained from outside sources and applied to individual securities within the portfolio.

**Table of Contents****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 present an analysis of interest income and interest expense for the years indicated. All interest income is reported on an 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. FRB and FHLB stock holdings, which are restricted, are included in accrued income and other assets.

|   | Year Ended December 31 |                              |                    |                     |                              |                    |                     |                              |                    |
|---|------------------------|------------------------------|--------------------|---------------------|------------------------------|--------------------|---------------------|------------------------------|--------------------|
|   | Average Balance        | 2012 Tax Equivalent Interest | Average Yield/Rate | Average Balance     | 2011 Tax Equivalent Interest | Average Yield/Rate | Average Balance     | 2010 Tax Equivalent Interest | Average Yield/Rate |
| <b>INTEREST EARNING ASSETS</b>                    |                        |                              |                    |                     |                              |                    |                     |                              |                    |
| Loans   | \$ 754,304             | \$ 43,396                    | 5.75%              | \$ 743,441          | \$ 45,463                    | 6.12%              | \$ 725,534          | \$ 46,794                    | 6.45%              |
| Taxable investment securities                     | 309,681                | 7,555                        | 2.44%              | 235,437             | 6,941                        | 2.95%              | 160,514             | 5,271                        | 3.28%              |
| Nontaxable investment securities                  | 145,502                | 7,941                        | 5.46%              | 136,356             | 7,847                        | 5.75%              | 120,999             | 7,095                        | 5.86%              |
| Trading securities                                | 2,624                  | 142                          | 5.41%              | 5,087               | 286                          | 5.62%              | 8,097               | 436                          | 5.38%              |
| Other   | 33,359                 | 486                          | 1.46%              | 37,539              | 506                          | 1.35%              | 45,509              | 479                          | 1.05%              |
| <b>Total earning assets</b>                       | <b>1,245,470</b>       | <b>59,520</b>                | <b>4.78%</b>       | <b>1,157,860</b>    | <b>61,043</b>                | <b>5.27%</b>       | <b>1,060,653</b>    | <b>60,075</b>                | <b>5.66%</b>       |
| <b>NONEARNING ASSETS</b>                          |                        |                              |                    |                     |                              |                    |                     |                              |                    |
| Allowance for loan losses                         | (12,408)               |                              |                    | (12,522)            |                              |                    | (13,262)            |                              |                    |
| Cash and demand deposits due from banks           | 19,409                 |                              |                    | 20,195              |                              |                    | 18,070              |                              |                    |
| Premises and equipment                            | 25,244                 |                              |                    | 24,397              |                              |                    | 24,624              |                              |                    |
| Accrued income and other assets                   | 103,368                |                              |                    | 97,265              |                              |                    | 92,845              |                              |                    |
| <b>Total assets</b>                               | <b>\$ 1,381,083</b>    |                              |                    | <b>\$ 1,287,195</b> |                              |                    | <b>\$ 1,182,930</b> |                              |                    |
| <b>INTEREST BEARING LIABILITIES</b>               |                        |                              |                    |                     |                              |                    |                     |                              |                    |
| Interest bearing demand deposits                  | \$ 170,851             | 204                          | 0.12%              | \$ 152,530          | 189                          | 0.12%              | \$ 137,109          | 151                          | 0.11%              |
| Savings deposits                                  | 214,958                | 451                          | 0.21%              | 192,999             | 488                          | 0.25%              | 169,579             | 391                          | 0.23%              |
| Time deposits                                     | 473,675                | 8,476                        | 1.79%              | 467,931             | 10,258                       | 2.19%              | 430,892             | 10,988                       | 2.55%              |
| Borrowed funds                                    | 225,689                | 4,292                        | 1.90%              | 198,828             | 5,268                        | 2.65%              | 188,512             | 5,674                        | 3.01%              |
| <b>Total interest bearing liabilities</b>         | <b>1,085,173</b>       | <b>13,423</b>                | <b>1.24%</b>       | <b>1,012,288</b>    | <b>16,203</b>                | <b>1.60%</b>       | <b>926,092</b>      | <b>17,204</b>                | <b>1.86%</b>       |
| <b>NONINTEREST BEARING LIABILITIES</b>            |                        |                              |                    |                     |                              |                    |                     |                              |                    |
| Demand deposits                                   | 125,443                |                              |                    | 113,726             |                              |                    | 102,812             |                              |                    |
| Other   | 9,785                  |                              |                    | 9,802               |                              |                    | 8,722               |                              |                    |
| Shareholders equity                               | 160,682                |                              |                    | 151,379             |                              |                    | 145,304             |                              |                    |
| <b>Total liabilities and shareholders equity</b>  | <b>\$ 1,381,083</b>    |                              |                    | <b>\$ 1,287,195</b> |                              |                    | <b>\$ 1,182,930</b> |                              |                    |
| <b>Net interest income (FTE)</b>                  |                        | <b>\$ 46,097</b>             |                    |                     | <b>\$ 44,840</b>             |                    |                     | <b>\$ 42,871</b>             |                    |
| <b>Net yield on interest earning assets (FTE)</b> |                        |                              | <b>3.70%</b>       |                     |                              | <b>3.87%</b>       |                     |                              | <b>4.04%</b>       |

**Net Interest Income**

Our primary sources of revenues are interest earned on loans and investments, while our most significant expense is interest expense on deposits and borrowings. Net interest income is the amount by which interest income on earning assets exceeds the interest expenses on interest bearing

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liabilities. Net interest income is influenced by changes in the balance and mix of assets and liabilities and market interest rates. We exert some control over these factors; however, FRB monetary policy and competition have a significant impact. Interest income includes loan fees of \$3,178 in 2012, \$2,385 in 2011, and \$2,196 in 2010. For analytical purposes, net

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interest income is adjusted to an FTE basis by adding the income tax savings from interest on tax exempt 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.

|  | 2012 Compared to 2011      |                 |                 | 2011 Compared to 2010      |                 |                 |
|--|----------------------------|-----------------|-----------------|----------------------------|-----------------|-----------------|
|  | Increase (Decrease) Due to |                 |                 | Increase (Decrease) Due to |                 |                 |
|  | Volume                     | Rate            | Net             | Volume                     | Rate            | Net             |
| <b>CHANGES IN INTEREST INCOME:</b>         |                            |                 |                 |                            |                 |                 |
| Loans                                      | \$ 656                     | \$ (2,723)      | \$ (2,067)      | \$ 1,136                   | \$ (2,467)      | \$ (1,331)      |
| Taxable AFS securities                     | 1,945                      | (1,331)         | 614             | 2,254                      | (584)           | 1,670           |
| Nontaxable AFS securities                  | 511                        | (417)           | 94              | 886                        | (134)           | 752             |
| Trading securities                         | (134)                      | (10)            | (144)           | (168)                      | 18              | (150)           |
| Other                                      | (59)                       | 39              | (20)            | (93)                       | 120             | 27              |
| <b>Total changes in interest income</b>    | <b>2,919</b>               | <b>(4,442)</b>  | <b>(1,523)</b>  | <b>4,015</b>               | <b>(3,047)</b>  | <b>968</b>      |
| <b>CHANGES IN INTEREST EXPENSE:</b>        |                            |                 |                 |                            |                 |                 |
| Interest bearing demand deposits           | 22                         | (7)             | 15              | 18                         | 20              | 38              |
| Savings deposits                           | 52                         | (89)            | (37)            | 57                         | 40              | 97              |
| Time deposits                              | 124                        | (1,906)         | (1,782)         | 894                        | (1,624)         | (730)           |
| Borrowed funds                             | 647                        | (1,623)         | (976)           | 299                        | (705)           | (406)           |
| <b>Total changes in interest expense</b>   | <b>845</b>                 | <b>(3,625)</b>  | <b>(2,780)</b>  | <b>1,268</b>               | <b>(2,269)</b>  | <b>(1,001)</b>  |
| <b>Net change in interest margin (FTE)</b> | <b>\$ 2,074</b>            | <b>\$ (817)</b> | <b>\$ 1,257</b> | <b>\$ 2,747</b>            | <b>\$ (778)</b> | <b>\$ 1,969</b> |

We, like all financial institutions, are experiencing downward pressure on our net yield on interest earning assets. This pressure is a direct result of FRB monetary policy which has reduced yields on interest earning assets more than rates on interest bearing liabilities. A key benchmark for lending is the 10 year US Treasury, which is currently trading below 2.0%. As a result of the persistent low interest rate environment, our net yield on interest earning assets is at historically low levels. However, as shown in the following table, our net yield on interest earning assets remained relatively flat throughout 2012. This is a direct result of our restructuring of \$60,000 of FHLB advances in the first quarter of 2012, which reduced 2012 interest expense by approximately \$450.

|   | Average Yield/Rate For The Three Month Periods Ended: |                      |                 |                  |                     |
|---|---|----------------------|-----------------|------------------|---------------------|
|   | December 31<br>2012                                   | September 30<br>2012 | June 30<br>2012 | March 31<br>2012 | December 31<br>2011 |
| Total earning assets                              | 4.61%   | 4.76%                | 4.84%           | 4.91%            | 5.12%               |
| Total interest bearing liabilities                | 1.12%   | 1.18%                | 1.27%           | 1.38%            | 1.53%               |
| <b>Net yield on interest earning assets (FTE)</b> | <b>3.65%</b>  | <b>3.73%</b>         | <b>3.73%</b>    | <b>3.70%</b>     | <b>3.78%</b>        |

Given that the historically low interest rate environment is expected to continue for the foreseeable future, the net yield on interest earning assets is not likely to increase in future periods. We anticipate continued reduction in rates earned on loans without a proportionate decline in funding rates. Any additional interest income will most likely be contingent upon increases in volume and probably at interest margins lower than those earned in the fourth quarter of 2012.





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

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

The following table summarizes our charge-off and recovery activity for the years ended December 31:

|   | 2012              | 2011              | 2010              | 2009              | 2008              |
|---|-------------------|-------------------|-------------------|-------------------|-------------------|
| ALLL January 1  | \$ 12,375         | \$ 12,373         | \$ 12,979         | \$ 11,982         | \$ 7,301          |
| ALLL of acquired bank                                     |                   |                   |                   |                   | 822               |
| Loans charged-off   |                   |                   |                   |                   |                   |
| Commercial and agricultural                               | 1,672             | 1,984             | 3,731             | 3,081             | 2,137             |
| Residential real estate                                   | 1,142             | 2,240             | 2,524             | 2,627             | 3,334             |
| Consumer  | 542               | 552               | 596               | 934               | 854               |
| <b>Total loans charged-off</b>                            | <b>3,356</b>      | <b>4,776</b>      | <b>6,851</b>      | <b>6,642</b>      | <b>6,325</b>      |
| Recoveries  |                   |                   |                   |                   |                   |
| Commercial and agricultural                               | 240               | 461               | 453               | 623               | 160               |
| Residential real estate                                   | 122               | 177               | 638               | 546               | 240               |
| Consumer  | 255               | 314               | 297               | 377               | 284               |
| <b>Total recoveries</b>                                   | <b>617</b>        | <b>952</b>        | <b>1,388</b>      | <b>1,546</b>      | <b>684</b>        |
| Provision for loan losses                                 | 2,300             | 3,826             | 4,857             | 6,093             | 9,500             |
| <b>ALLL December 31</b>                                   | <b>\$ 11,936</b>  | <b>\$ 12,375</b>  | <b>\$ 12,373</b>  | <b>\$ 12,979</b>  | <b>\$ 11,982</b>  |
| Net loans charged-off                                     | \$ 2,739          | \$ 3,824          | \$ 5,463          | \$ 5,096          | \$ 5,641          |
| Year to date average loans                                | 754,304           | 743,441           | 725,534           | 725,299           | 717,040           |
| <b>Net loans charged off to average loans outstanding</b> | <b>0.36%</b>      | <b>0.51%</b>      | <b>0.75%</b>      | <b>0.70%</b>      | <b>0.79%</b>      |
| <b>Total loans</b>  | <b>\$ 772,753</b> | <b>\$ 750,291</b> | <b>\$ 735,304</b> | <b>\$ 723,316</b> | <b>\$ 735,385</b> |
| <b>ALLL as a % of loans</b>                               | <b>1.54%</b>      | <b>1.65%</b>      | <b>1.68%</b>      | <b>1.79%</b>      | <b>1.63%</b>      |

The following table summarizes our charge-off and recovery activity for the three months ended:

|                              | December 31<br>2012 | September 30<br>2012 | Three Months Ended<br>June 30<br>2012 | March 31<br>2012 | December 31<br>2011 |
|------------------------------|---------------------|----------------------|---------------------------------------|------------------|---------------------|
| Total loans charged-off      | \$ 1,469            | \$ 611               | \$ 621                                | \$ 655           | \$ 1,170            |
| Total recoveries             | 143                 | 155                  | 125                                   | 194              | 202                 |
| <b>Net loans charged-off</b> | <b>1,326</b>        | <b>456</b>           | <b>496</b>                            | <b>461</b>       | <b>968</b>          |
| Average loans outstanding    | 764,004             | 761,069              | 748,223                               | 743,921          | 749,840             |

|   |              |              |              |              |              |
|---|--------------|--------------|--------------|--------------|--------------|
| <b>Net loans charged-off to average loans outstanding</b> | <b>0.17%</b> | <b>0.06%</b> | <b>0.07%</b> | <b>0.06%</b> | <b>0.13%</b> |
|---|--------------|--------------|--------------|--------------|--------------|

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In the fourth quarter of 2012, we experienced a significant increase in charge-offs. Of the \$1,469 of total loans charged-off during the quarter, \$356 had previously been identified through specific impairment valuation allowances. The remaining charge-offs were identified in the fourth quarter as part of our credit risk management process. Of those not previously identified as impaired, two charge-offs totaling \$357 individually exceeded \$100.

Despite the increase in loans charged-off in the fourth quarter of 2012, the level of net loans charged-off has continued to trend downward since 2008. This trend, coupled with declines in loans past due and in nonaccrual status, has allowed us to reduce our provision, and has led to a decline in the ALLL in both amount and as a percentage of loans. For further discussion of the allocation of the ALLL, see Note 6 Loans and Allowance for Loan Losses to the consolidated financial statements.

**Loans Past Due in Nonaccrual Status**

Increases in past due and nonaccrual loans can have a significant impact on the ALLL. To determine the potential impact, and corresponding estimated losses, we analyze our historical loss trends on loans past due 30-89 days, 90 days or more, and nonaccrual loans. We monitor all loans that are past due and in nonaccrual status for indicators of additional deterioration.

The following tables summarize our past due and nonaccrual loans as of December 31:

|                             | <b>Total Past Due and Nonaccrual</b> |                  |                  |                  |                  |
|-----------------------------|--------------------------------------|------------------|------------------|------------------|------------------|
|                             | <b>2012</b>                          | <b>2011</b>      | <b>2010</b>      | <b>2009</b>      | <b>2008</b>      |
| Commercial and agricultural | \$ 7,271                             | \$ 7,420         | \$ 9,606         | \$ 8,839         | \$ 13,958        |
| Residential real estate     | 5,431                                | 5,297            | 8,119            | 10,296           | 12,418           |
| Consumer                    | 199                                  | 186              | 309              | 460              | 956              |
| <b>Total</b>                | <b>\$ 12,901</b>                     | <b>\$ 12,903</b> | <b>\$ 18,034</b> | <b>\$ 19,595</b> | <b>\$ 27,332</b> |

A summary of loans past due and in nonaccrual status, including the composition of the ending balance of nonaccrual loans by type, is included in Note 6 Loans and Allowance for Loan Losses of the Notes to Consolidated Financial Statements.

**Troubled Debt Restructurings**

We have taken a proactive approach to avoid foreclosures on borrowers who are willing to work with us in modifying their loans, thus making them more affordable. While this approach has allowed certain borrowers to develop a payment structure that will allow them to continue making payments in lieu of foreclosure, it has contributed to a significant increase in the level of loans classified as TDR. The implementation of ASU No. 2011-02 *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring* has also contributed to the increased level of TDRs. The modifications have been extremely successful for us and our customers as very few of the modified loans have resulted in foreclosures. At the time of the TDR, the loan is reviewed to determine whether or not to classify the loan as accrual or nonaccrual. The majority of new modifications result in terms that satisfy our criteria for continued interest accrual. TDRs that have been placed in nonaccrual status may be placed back on accrual status after six months of continued performance.

We restructure debt with borrowers who due to temporary financial difficulties are unable to service their debt under the original terms. We may extend the amortization period, reduce interest rates, forgive principal, or a combination of these modifications. Typically, the modifications are for a period of five years or less. There are no TDRs that were Government sponsored as of December 31, 2012.

Losses associated with TDRs, if any, are included in the estimation of the ALLL in the quarter in which a loan is identified as a TDR, and we review the ALLL estimation each reporting period to ensure its continued appropriateness.

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The following tables provide a roll-forward of TDRs for the years ended December 31, 2011 and 2012:

|                                 | Accruing Interest |                  | Nonaccrual      |                 | Total           |                  |
|---------------------------------|-------------------|------------------|-----------------|-----------------|-----------------|------------------|
|                                 | Number of Loans   | Balance          | Number of Loans | Balance         | Number of Loans | Balance          |
| <b>January 1, 2011</b>          | <b>35</b>         | <b>\$ 5,075</b>  | <b>10</b>       | <b>\$ 688</b>   | <b>45</b>       | <b>\$ 5,763</b>  |
| New modifications               | 93                | 17,334           | 3               | 481             | 96              | 17,815           |
| Principal payments and pay-offs | (12)              | (4,381)          | (2)             | (254)           | (14)            | (4,635)          |
| Balances charged-off (1)        |                   | (15)             |                 | (51)            |                 | (66)             |
| Transfers to OREO               | (2)               | (35)             | (1)             | (86)            | (3)             | (121)            |
| Transfers to accrual status     | 2                 | 54               | (2)             | (54)            |                 |                  |
| Transfers to nonaccrual status  | (4)               | (293)            | 4               | 293             |                 |                  |
| <b>December 31, 2011</b>        | <b>112</b>        | <b>17,739</b>    | <b>12</b>       | <b>1,017</b>    | <b>124</b>      | <b>18,756</b>    |
| New modifications               | 51                | 8,658            | 16              | 2,708           | 67              | 11,366           |
| Principal payments and pay-offs | (41)              | (9,312)          | (3)             | (595)           | (44)            | (9,907)          |
| Balances charged-off            | (2)               | (246)            | (4)             | (196)           | (6)             | (442)            |
| Transfers to OREO               | (4)               | (173)            | (3)             | (245)           | (7)             | (418)            |
| Transfers to accrual status     | 2                 | 130              | (2)             | (130)           |                 |                  |
| Transfers to nonaccrual status  | (3)               | (265)            | 3               | 265             |                 |                  |
| <b>December 31, 2012</b>        | <b>115</b>        | <b>\$ 16,531</b> | <b>19</b>       | <b>\$ 2,824</b> | <b>134</b>      | <b>\$ 19,355</b> |

(1) Balances charged-off represent a partial charge off. As such, the number of loans was unaffected. The following table summarizes our TDRs as of December 31:

|                          | 2012              |                 |                  | 2011              |                 |                  | 2010              |               |                 |
|--------------------------|-------------------|-----------------|------------------|-------------------|-----------------|------------------|-------------------|---------------|-----------------|
|                          | Accruing Interest | Non-accrual     | Total            | Accruing Interest | Non-accrual     | Total            | Accruing Interest | Non-accrual   | Total           |
| Current                  | \$ 16,301         | \$ 941          | \$ 17,242        | \$ 16,125         | \$ 514          | \$ 16,639        | \$ 4,798          | \$ 499        | \$ 5,297        |
| Past due 30-59 days      | 158               | 561             | 719              | 1,564             | 344             | 1,908            | 175               | 26            | 201             |
| Past due 60-89 days      | 72                | 41              | 113              | 50                | 85              | 135              | 102               |               | 102             |
| Past due 90 days or more |                   | 1,281           | 1,281            |                   | 74              | 74               |                   | 163           | 163             |
| <b>Total</b>             | <b>\$ 16,531</b>  | <b>\$ 2,824</b> | <b>\$ 19,355</b> | <b>\$ 17,739</b>  | <b>\$ 1,017</b> | <b>\$ 18,756</b> | <b>\$ 5,075</b>   | <b>\$ 688</b> | <b>\$ 5,763</b> |

|                          | 2009              |                 |                 | 2008              |                 |                 |
|--------------------------|-------------------|-----------------|-----------------|-------------------|-----------------|-----------------|
|                          | Accruing Interest | Non-accrual     | Total           | Accruing Interest | Non-accrual     | Total           |
| Current                  | \$ 2,754          | \$ 786          | \$ 3,540        | \$ 2,297          | \$ 1,355        | \$ 3,652        |
| Past due 30-59 days      | 107               | 80              | 187             | 268               |                 | 268             |
| Past due 60-89 days      |                   | 824             | 824             |                   |                 |                 |
| Past due 90 days or more |                   | 426             | 426             |                   | 630             | 630             |
| <b>Total</b>             | <b>\$ 2,861</b>   | <b>\$ 2,116</b> | <b>\$ 4,977</b> | <b>\$ 2,565</b>   | <b>\$ 1,985</b> | <b>\$ 4,550</b> |

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Additional disclosures about TDR s are included in Note 6 Loans and Allowance for Loan Losses of the Notes to Consolidated Financial Statements.

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

The following is a summary of information pertaining to impaired loans as of and for the year ended December 31:

|                                      | Outstanding<br>Balance | 2012<br>Unpaid<br>Principal<br>Balance | Valuation<br>Allowance | Outstanding<br>Balance | 2011<br>Unpaid<br>Principal<br>Balance | Valuation<br>Allowance |
|--------------------------------------|------------------------|--|------------------------|------------------------|--|------------------------|
| <b>TDR s</b>                         |                        |  |                        |                        |  |                        |
| Commercial real estate               | \$ 9,227               | \$ 9,640                               | \$ 1,333               | \$ 8,862               | \$ 9,055                               | \$ 1,853               |
| Commercial other                     | 1,167                  | 1,197                                  | 38                     | 1,047                  | 1,078                                  | 271                    |
| Agricultural real estate             | 91                     | 91                                     | 32                     |                        |  |                        |
| Agricultural other                   | 569                    | 689                                    | 59                     | 2,779                  | 2,779                                  | 822                    |
| Residential real estate senior liens | 8,224                  | 8,670                                  | 1,429                  | 5,882                  | 6,377                                  | 922                    |
| Residential real estate junior liens | 21                     | 57                                     | 4                      | 101                    | 137                                    | 18                     |
| Consumer secured                     | 56                     | 56                                     |                        | 85                     | 85                                     |                        |
| <b>Total TDR s</b>                   | <b>19,355</b>          | <b>20,400</b>                          | <b>2,895</b>           | <b>18,756</b>          | <b>19,511</b>                          | <b>3,886</b>           |
| <b>Other impaired loans</b>          |                        |  |                        |                        |  |                        |
| Commercial real estate               | 1,817                  | 2,304                                  | 320                    | 4,136                  | 6,657                                  | 28                     |
| Commercial other                     | 2,245                  | 2,376                                  | 359                    | 52                     | 116                                    |                        |
| Agricultural real estate             |                        |  |                        | 190                    | 190                                    |                        |
| Agricultural other                   | 63                     | 63                                     |                        | 415                    | 535                                    |                        |
| Residential real estate senior liens | 2,226                  | 3,002                                  | 354                    | 1,389                  | 2,450                                  | 189                    |
| Residential real estate junior liens | 51                     | 61                                     | 9                      | 94                     | 123                                    | 17                     |
| Home equity lines of credit          | 182                    | 482                                    |                        | 198                    | 498                                    |                        |
| Consumer secured                     | 19                     | 28                                     |                        | 20                     | 29                                     |                        |
| <b>Total other impaired loans</b>    | <b>6,603</b>           | <b>8,316</b>                           | <b>1,042</b>           | <b>6,494</b>           | <b>10,598</b>                          | <b>234</b>             |
| <b>Total impaired loans</b>          | <b>\$ 25,958</b>       | <b>\$ 28,716</b>                       | <b>\$ 3,937</b>        | <b>\$ 25,250</b>       | <b>\$ 30,109</b>                       | <b>\$ 4,120</b>        |

Additional disclosure related to impaired loans is included in Note 6 Loans and Allowance for Loan Losses of the Notes to Consolidated Financial Statements.

**Nonperforming Assets**

The following table summarizes our nonperforming assets as of December 31:

|  | 2012            | 2011            | 2010            | 2009             | 2008             |
|--|-----------------|-----------------|-----------------|------------------|------------------|
| Nonaccrual loans                               | \$ 7,303        | \$ 6,389        | \$ 5,610        | \$ 8,522         | \$ 11,175        |
| Accruing loans past due 90 days or more        | 428             | 760             | 486             | 768              | 1,251            |
| <b>Total nonperforming loans</b>               | <b>7,731</b>    | <b>7,149</b>    | <b>6,096</b>    | <b>9,290</b>     | <b>12,426</b>    |
| OREO   | 2,008           | 1,867           | 2,039           | 1,141            | 2,770            |
| Repossessed assets                             | 10              | 9               | 28              | 16               | 153              |
| <b>Total nonperforming assets</b>              | <b>\$ 9,749</b> | <b>\$ 9,025</b> | <b>\$ 8,163</b> | <b>\$ 10,447</b> | <b>\$ 15,349</b> |
| <b>Nonperforming loans as % of total loans</b> | <b>1.00%</b>    | <b>0.95%</b>    | <b>0.83%</b>    | <b>1.28%</b>     | <b>1.69%</b>     |

|   |              |              |              |              |              |
|---|--------------|--------------|--------------|--------------|--------------|
| <b>Nonperforming assets as a % of total loans</b> | <b>0.68%</b> | <b>0.67%</b> | <b>0.67%</b> | <b>0.91%</b> | <b>1.35%</b> |
|---|--------------|--------------|--------------|--------------|--------------|



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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. Upon transferring the loans to nonaccrual status, we perform an evaluation to determine the net realizable value of the underlying collateral. This evaluation is used to help determine if any charge offs are necessary. Loans may be placed back on accrual status after six months of continued performance.

Included in the nonaccrual loan balances above were credits classified as TDR s as of December 31:

|                             | 2012            | 2011            | 2010          | 2009            | 2008            |
|-----------------------------|-----------------|-----------------|---------------|-----------------|-----------------|
| Commercial and agricultural | \$ 2,325        | \$ 520          | \$ 115        | \$ 1,692        | \$ 1,985        |
| Residential mortgage        | 499             | 497             | 573           | 424             |                 |
|                             | <b>\$ 2,824</b> | <b>\$ 1,017</b> | <b>\$ 688</b> | <b>\$ 2,116</b> | <b>\$ 1,985</b> |

Nonaccrual TDR s increased in 2012 as a result of two large TDR s that were granted during 2012. These relationships had a balance of \$1,710 as of December 31, 2012.

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

|                                       | 2012                   |                        | 2011                   |                        | 2010                   |                        | 2009                   |                        |
|---------------------------------------|------------------------|------------------------|------------------------|------------------------|------------------------|------------------------|------------------------|------------------------|
|                                       | Outstanding<br>Balance | Specific<br>Allocation | Outstanding<br>Balance | Specific<br>Allocation | Outstanding<br>Balance | Specific<br>Allocation | Outstanding<br>Balance | Specific<br>Allocation |
| Borrower 1                            | \$ (A)                 | \$                     | \$ 1,014               | \$ (C)                 | \$                     | \$                     | \$                     | \$                     |
| Borrower 2                            | (B)                    |                        | 1,900                  | (D)                    | 2,679                  | 345                    |                        |                        |
| Borrower 3                            | 2,077                  | 359                    |                        |                        |                        |                        |                        |                        |
| Borrower 4                            |                        |                        |                        |                        | (B)                    |                        | 1,800                  | (D)                    |
| Other not individually<br>significant | 5,226                  |                        | 3,475                  |                        | 2,931                  |                        | 6,722                  |                        |
| <b>Total</b>                          | <b>\$ 7,303</b>        |                        | <b>\$ 6,389</b>        |                        | <b>\$ 5,610</b>        |                        | <b>\$ 8,522</b>        |                        |

A Transferred to accrual status.

B Loan was partially charged-off with the remaining outstanding balance paid off by the customer.

C No specific allocation as the net realizable value of the loan s underlying collateral value exceeded the loan s carrying balance.

D No specific allocation established for this loan as it was charged down to reflect the current fair value of the underlying real estate. There were no other individually significant credits included in nonaccrual loans as of December 31, 2012, 2011, 2010, 2009, or 2008.

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

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We believe that the level of the ALLL is appropriate as of December 31, 2012 and we will continue to closely monitor overall credit quality and our policies and procedures related to the analysis of the ALLL to ensure that the ALLL remains appropriate.

**Table of Contents****NONINTEREST INCOME AND EXPENSES****Noninterest Income**

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

|   | 2012             | 2011            | Change          |              | 2010            | Change            |              |
|---|------------------|-----------------|-----------------|--------------|-----------------|-------------------|--------------|
|   |                  |                 | \$              | %            |                 | \$                | %            |
| <b>Service charges and fees</b>                     |                  |                 |                 |              |                 |                   |              |
| NSF and overdraft fees                              | \$ 2,367         | \$ 2,500        | \$ (133)        | 5.3%         | \$ 2,809        | \$ (309)          | 11.0%        |
| ATM and debit card fees                             | 1,874            | 1,736           | 138             | 7.9%         | 1,492           | 244               | 16.4%        |
| Trust fees  | 1,061            | 979             | 82              | 8.4%         | 896             | 83                | 9.3%         |
| Mortgage servicing fees                             | 757              | 732             | 25              | 3.4%         | 760             | (28)              | 3.7%         |
| Service charges on deposit accounts                 | 337              | 324             | 13              | 4.0%         | 333             | (9)               | 2.7%         |
| Net originated mortgage servicing rights loss       | (89)             | (293)           | 204             | 69.6%        | 47              | (340)             | N/M          |
| All other   | 125              | 140             | (15)            | 10.7%        | 143             | (3)               | 2.1%         |
| <b>Total service charges and fees</b>               | <b>6,432</b>     | <b>6,118</b>    | <b>314</b>      | <b>5.1%</b>  | <b>6,480</b>    | <b>(362)</b>      | <b>5.6%</b>  |
| Gain on sale of mortgage loans                      | 1,576            | 538             | 1,038           | N/M          | 610             | (72)              | 11.8%        |
| Gain on sale of AFS securities                      | 1,119            | 3               | 1,116           | N/M          | 348             | (345)             | N/M          |
| Earnings on corporate owned life insurance policies | 698              | 609             | 89              | 14.6%        | 663             | (54)              | 8.1%         |
| <b>Other</b>  |                  |                 |                 |              |                 |                   |              |
| Brokerage and advisory fees                         | 574              | 545             | 29              | 5.3%         | 573             | (28)              | 4.9%         |
| Corporate Settlement Solutions joint venture        | 504              | (182)           | 686             | N/M          | 11              | (193)             | N/M          |
| Gain on sale of OREO                                | 220              | 62              | 158             | N/M          | 12              | 50                | N/M          |
| Net loss on trading securities                      | (52)             | (78)            | 26              | 33.3%        | (94)            | 16                | 17.0%        |
| Net gain on borrowings measured at fair value       | 33               | 181             | (148)           | 81.8%        | 227             | (46)              | 20.3%        |
| All other   | 426              | 422             | 4               | 0.9%         | 470             | (48)              | 10.2%        |
| <b>Total other</b>                                  | <b>1,705</b>     | <b>950</b>      | <b>755</b>      | <b>79.5%</b> | <b>1,199</b>    | <b>(249)</b>      | <b>20.8%</b> |
| <b>Total noninterest income</b>                     | <b>\$ 11,530</b> | <b>\$ 8,218</b> | <b>\$ 3,312</b> | <b>40.3%</b> | <b>\$ 9,300</b> | <b>\$ (1,082)</b> | <b>11.6%</b> |

Significant changes in noninterest income are detailed below:

We continuously analyze various fees related to deposit accounts including service charges and NSF and overdraft fees. Based on these analyses, we make any necessary adjustments to ensure that our fee structure is within the range of our competitors, while at the same time making sure that the fees remain fair to deposit customers. NSF and overdraft fees represent the largest single component of service charges and fees. While we have experienced significant increases in deposit accounts, NSF and overdraft fees have declined. This decline has been the result of reduced overdraft activity by our customers as well as changes in banking regulations. Despite increasing our per item NSF and overdraft fees in December 2012, we expect this downward trend to continue into the foreseeable future.

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



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

Historically low offering rates on residential real estate loans have led to a significant increase in the level of refinancing activity. This increase in activity has resulted in substantial increases in the gain on sale of mortgage loans, while contributing to fluctuations in the value of our OMSR portfolio. We anticipate that mortgage refinancing activity will decline in 2013.

We are continually analyzing our AFS security portfolio for potential sale opportunities. During the first quarter of 2012, we identified several pools of mortgage-backed securities with significant unrealized gains. As the interest rates of the underlying mortgages were significantly higher than the current offering rates for similar mortgages, we elected to realize these gains through the sales of such securities as the investments would have likely been paid off in the near term through refinancing activity. In the third quarter of 2012, we elected to sell some additional mortgage-backed securities as their current prepayment characteristics had resulted in less than acceptable yields. We do not anticipate any significant investment sales during 2013.

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

In 2011, Corporate Settlement Solutions invested significant resources to expand and enhance their services offered. While these efforts reduced earnings in 2011, they have led to the significant increase in earnings in 2012. We expect future earnings to approximate current levels.

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

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

The fluctuation in all other income is spread throughout various categories, none of which are individually significant. We do not anticipate any significant fluctuations from current levels in 2013.

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

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

|  | 2012             | 2011             | Change          |              | 2010             | Change        |             |
|--|------------------|------------------|-----------------|--------------|------------------|---------------|-------------|
|  |                  |                  | \$              | %            |                  | \$            | %           |
| <b>Compensation and benefits</b>       |                  |                  |                 |              |                  |               |             |
| Employee salaries                      | \$ 15,374        | \$ 14,377        | \$ 997          | 6.9%         | \$ 13,697        | \$ 680        | 5.0%        |
| Employee benefits                      | 5,842            | 4,902            | 940             | 19.2%        | 4,837            | 65            | 1.3%        |
| All other                              | 11               | 13               | (2)             | 15.4%        | 18               | (5)           | 27.8%       |
| <b>Total compensation and benefits</b> | <b>21,227</b>    | <b>19,292</b>    | <b>1,935</b>    | <b>10.0%</b> | <b>18,552</b>    | <b>740</b>    | <b>4.0%</b> |
| <b>Occupancy</b>                       |                  |                  |                 |              |                  |               |             |
| Property taxes                         | 501              | 470              | 31              | 6.6%         | 505              | (35)          | 6.9%        |
| Utilities                              | 463              | 462              | 1               | 0.2%         | 423              | 39            | 9.2%        |
| Outside services                       | 605              | 587              | 18              | 3.1%         | 524              | 63            | 12.0%       |
| Depreciation                           | 621              | 605              | 16              | 2.6%         | 584              | 21            | 3.6%        |
| Building repairs                       | 244              | 262              | (18)            | 6.9%         | 243              | 19            | 7.8%        |
| All other                              | 85               | 84               | 1               | 1.2%         | 72               | 12            | 16.7%       |
| <b>Total occupancy</b>                 | <b>2,519</b>     | <b>2,470</b>     | <b>49</b>       | <b>2.0%</b>  | <b>2,351</b>     | <b>119</b>    | <b>5.1%</b> |
| <b>Furniture and equipment</b>         |                  |                  |                 |              |                  |               |             |
| Depreciation                           | 1,796            | 1,916            | (120)           | 6.3%         | 1,938            | (22)          | 1.1%        |
| Computer/service contracts             | 1,995            | 1,898            | 97              | 5.1%         | 1,779            | 119           | 6.7%        |
| ATM and debit card fees                | 690              | 629              | 61              | 9.7%         | 595              | 34            | 5.7%        |
| All other                              | 79               | 54               | 25              | 46.3%        | 32               | 22            | 68.8%       |
| <b>Total furniture and equipment</b>   | <b>4,560</b>     | <b>4,497</b>     | <b>63</b>       | <b>1.4%</b>  | <b>4,344</b>     | <b>153</b>    | <b>3.5%</b> |
| <b>Net AFS impairment loss</b>         | <b>282</b>       |                  | <b>282</b>      | <b>N/M</b>   |                  |               | <b>N/M</b>  |
| <b>Other</b>                           |                  |                  |                 |              |                  |               |             |
| Marketing and community relations      | 1,965            | 1,174            | 791             | 67.4%        | 1,093            | 81            | 7.4%        |
| Directors fees                         | 885              | 842              | 43              | 5.1%         | 887              | (45)          | 5.1%        |
| FDIC insurance premiums                | 864              | 1,086            | (222)           | 20.4%        | 1,254            | (168)         | 13.4%       |
| Audit fees                             | 711              | 714              | (3)             | 0.4%         | 710              | 4             | 0.6%        |
| Education and travel                   | 588              | 526              | 62              | 11.8%        | 499              | 27            | 5.4%        |
| Consulting fees                        | 482              | 386              | 96              | 24.9%        | 167              | 219           | 131.1%      |
| Printing and supplies                  | 424              | 405              | 19              | 4.7%         | 420              | (15)          | 3.6%        |
| Postage and freight                    | 389              | 388              | 1               | 0.3%         | 395              | (7)           | 1.8%        |
| Other losses                           | 300              | 54               | 246             | N/M          | 72               | (18)          | 25.0%       |
| Legal fees                             | 268              | 302              | (34)            | 11.3%        | 382              | (80)          | 20.9%       |
| Amortization of deposit premium        | 260              | 299              | (39)            | 13.0%        | 338              | (39)          | 11.5%       |
| Foreclosed asset and collection        | 202              | 576              | (374)           | 64.9%        | 916              | (340)         | 37.1%       |
| State taxes                            | 187              | 57               | 130             | N/M          | 51               | 6             | 11.8%       |
| All other                              | 1,526            | 1,462            | 64              | 4.4%         | 1,376            | 86            | 6.3%        |
| <b>Total other</b>                     | <b>9,051</b>     | <b>8,271</b>     | <b>780</b>      | <b>9.4%</b>  | <b>8,560</b>     | <b>(289)</b>  | <b>3.4%</b> |
| <b>Total noninterest expenses</b>      | <b>\$ 37,639</b> | <b>\$ 34,530</b> | <b>\$ 3,109</b> | <b>9.0%</b>  | <b>\$ 33,807</b> | <b>\$ 723</b> | <b>2.1%</b> |



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Significant changes in noninterest expenses are detailed below:

The increase in employee salaries is due to annual merit increases and our continued growth as well as additional staff additions to help comply with the Dodd Frank Act and other recently passed regulations. Employee benefits increased in 2012 primarily as a result of increases in health care and retirement benefit related expenses. We expect employee salaries and benefits to increase with the growth of the Corporation.

During the first quarter of 2012, we recorded a credit impairment on an AFS investment security through earnings due to a bond being downgraded by an independent rating agency below investment grade. We will continue to monitor the investment portfolio throughout 2013 for other potential other-than-temporary impairments. For further discussion, see Note 5 Available-For-Sale Securities of the Notes to Consolidated Financial Statements.

We have been a consistently strong supporter of the various communities, schools, and charities in the markets we serve. In the 1996, we established a foundation that is generally funded from non-recurring revenue sources. The foundation provides centralized oversight for donations to organizations that benefit our communities. Donation expenses related to the foundation were \$850, \$250, and \$250 for the years ended December 31, 2012, 2011, and 2010, respectively and is included in marketing and community relations.

FDIC insurance premiums have declined due to changes in the premium calculation. Premiums will increase in future periods as we continue to grow our balance sheet. There are no significant changes to the premium calculation expected in 2013.

The increase in consulting fees is primarily related to consulting services employed to review the FHLB advance restructure (see Volume and Rate Variance Analysis , above). Such expenses also increased due to the engagement of consultants to review our loan prepayment and deposit decay assumptions as well as to review various information technology projects. Consulting fees are expected to decline in 2013.

Other losses increased significantly in 2012 primarily as a result of losses incurred related to fraudulent activities as well as losses related to the repurchase of a loan that was previously sold to a third party. We do not anticipate any significant other losses in 2013.

As a result of decreases in foreclosure and repossession activity, we have seen significant declines in foreclosed asset and collection and legal expenses. These expenses have also declined as we have been able to recover expenses through our collection efforts. Foreclosed asset and collection expenses are expected to continue their decline in 2013.

State taxes increased in 2012 as a result of changes to Michigan s Corporate Income Tax structure. These expenses are expected to increase marginally in future periods.

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



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

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

|  | 2012                | 2011                | Change           |              |
|--|---------------------|---------------------|------------------|--------------|
|  |                     |                     | \$               | %            |
| <b>ASSETS</b>  |                     |                     |                  |              |
| Cash and cash equivalents                                    | \$ 24,920           | \$ 28,590           | \$ (3,670)       | 12.84%       |
| Certificates of deposit held in other financial institutions | 4,465               | 8,924               | (4,459)          | 49.97%       |
| Trading securities   | 1,573               | 4,710               | (3,137)          | 66.60%       |
| Available-for-sale securities                                | 504,010             | 425,120             | 78,890           | 18.56%       |
| Mortgage loans available-for-sale                            | 3,633               | 3,205               | 428              | 13.35%       |
| Loans  | 772,753             | 750,291             | 22,462           | 2.99%        |
| Allowance for loan losses                                    | (11,936)            | (12,375)            | 439              | 3.55%        |
| Premises and equipment                                       | 25,787              | 24,626              | 1,161            | 4.71%        |
| Corporate owned life insurance                               | 22,773              | 22,075              | 698              | 3.16%        |
| Accrued interest receivable                                  | 5,227               | 5,848               | (621)            | 10.62%       |
| Equity securities without readily determinable fair values   | 18,118              | 17,189              | 929              | 5.40%        |
| Goodwill and other intangible assets                         | 46,532              | 46,792              | (260)            | 0.56%        |
| Other assets   | 12,784              | 12,930              | (146)            | 1.13%        |
| <b>TOTAL ASSETS</b>  | <b>\$ 1,430,639</b> | <b>\$ 1,337,925</b> | <b>\$ 92,714</b> | <b>6.93%</b> |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>                   |                     |                     |                  |              |
| <b>Liabilities</b>   |                     |                     |                  |              |
| Deposits   | \$ 1,017,667        | \$ 958,164          | \$ 59,503        | 6.21%        |
| Borrowed funds   | 241,001             | 216,136             | 24,865           | 11.50%       |
| Accrued interest payable and other liabilities               | 7,482               | 8,842               | (1,360)          | 15.38%       |
| <b>Total liabilities</b>                                     | <b>1,266,150</b>    | <b>1,183,142</b>    | <b>83,008</b>    | <b>7.02%</b> |
| <b>Shareholders equity</b>                                   | <b>164,489</b>      | <b>154,783</b>      | <b>9,706</b>     | <b>6.27%</b> |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>             | <b>\$ 1,430,639</b> | <b>\$ 1,337,925</b> | <b>\$ 92,714</b> | <b>6.93%</b> |

As shown above, we were able to continue to grow our balance sheet in 2012. The growth in deposits was supplemented by an increase in borrowed funds. As loan growth continues to be relatively soft, the additional funding provided by the growth in borrowings and deposits were deployed into available-for-sale investment securities. For 2013, we anticipate that deposit growth will continue to be strong and that loan demand will improve.

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

**Certificates of deposit held in other financial institutions**

During 2012, we reinvested maturities of certificates of deposit held in other financial institutions into AFS investment securities to increase net interest margins (as the yields on AFS 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 2013.

**Table of Contents****Trading securities**

Trading securities are carried at fair value. Our overall intent is to maintain a trading portfolio to enhance the ongoing restructuring of assets and liabilities as part of our IRR management objectives (see Note 4 Trading Securities of the Notes to Consolidated Financial Statements). Due to the current interest rate environment, we have allowed this balance to decline.

**AFS investment securities**

The primary objective of our investing activities is to provide for safety of the principal invested. Secondary considerations include the need for earnings, liquidity, and our overall exposure to changes in interest rates.

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

|                                     | 2012              | 2011              | 2010              |
|-------------------------------------|-------------------|-------------------|-------------------|
| Government sponsored enterprises    | \$ 25,776         | \$ 397            | \$ 5,404          |
| States and political subdivisions   | 182,743           | 174,938           | 169,717           |
| Auction rate money market preferred | 2,778             | 2,049             | 2,865             |
| Preferred stocks                    | 6,363             | 5,033             | 6,936             |
| Mortgage-backed securities          | 155,345           | 143,602           | 102,215           |
| Collateralized mortgage obligations | 131,005           | 99,101            | 43,587            |
| <b>Total</b>                        | <b>\$ 504,010</b> | <b>\$ 425,120</b> | <b>\$ 330,724</b> |

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. We have a policy prohibiting investments in securities that we deem 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. Our holdings in mortgage-backed securities and collateralized mortgage obligations include only government agencies and government sponsored agencies as we hold no investments in private label mortgage-backed securities or collateralized mortgage obligations.

The following is a schedule of maturities of AFS investment securities and their weighted average yield as of December 31, 2012. Weighted average yields have been computed on an FTE basis using a tax rate of 34%. Our auction rate money market preferred is a long term floating rate instrument for which the interest rate is set at periodic auctions. At each successful auction, we have 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 lack of contractual maturities, auction rate money market preferred and preferred stocks are not reported by a specific maturity group. Mortgage-backed securities and collateralized mortgage obligations are not reported by a specific maturity group due to their variable monthly payments. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

|                                     | Maturing |           |           |           |            |           |           |           | Securities with  |                 |
|-------------------------------------|----------|-----------|-----------|-----------|------------|-----------|-----------|-----------|------------------|-----------------|
|                                     | Within   |           | After One |           | After Five |           | After     |           | Variable Monthly |                 |
|                                     | One Year | Yield (%) | Year But  | Yield (%) | Years But  | Yield (%) | Ten Years | Yield (%) | Payments or      | Non contractual |
|                                     | Amount   |           | Amount    |           | Amount     |           | Amount    |           | Amount           | Maturities      |
|                                     |          |           |           |           |            |           |           |           |                  | Yield (%)       |
| Government sponsored enterprises    | \$       |           | \$ 73     | 7.91      | \$ 25,703  | 1.47      | \$        |           | \$               |                 |
| States and political subdivisions   | 11,746   | 3.65      | 37,686    | 5.15      | 92,181     | 5.15      | 41,130    | 3.85      |                  |                 |
| Mortgage-backed securities          |          |           |           |           | 36,626     | 2.05      | 118,719   | 2.15      |                  |                 |
| Collateralized mortgage obligations |          |           |           |           |            |           |           |           | 131,005          | 2.32            |
| Auction rate money market preferred |          |           |           |           |            |           |           |           | 2,778            | 6.29            |
| Preferred stocks                    |          |           |           |           |            |           |           |           | 6,363            | 5.76            |

|              |                  |             |                  |             |                   |             |                   |             |                   |             |
|--------------|------------------|-------------|------------------|-------------|-------------------|-------------|-------------------|-------------|-------------------|-------------|
| <b>Total</b> | <b>\$ 11,746</b> | <b>3.65</b> | <b>\$ 37,759</b> | <b>5.15</b> | <b>\$ 154,510</b> | <b>3.81</b> | <b>\$ 159,849</b> | <b>2.59</b> | <b>\$ 140,146</b> | <b>2.56</b> |
|--------------|------------------|-------------|------------------|-------------|-------------------|-------------|-------------------|-------------|-------------------|-------------|

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

Loans are the largest component of earning assets. The proper management of credit and market risk inherent in the loan portfolio is critical to our financial well-being. To control these risks, we have adopted strict underwriting standards. These standards include specific criteria against lending outside our defined market areas, lending limits to a single borrower, and strict loan to collateral value limits. We also monitor and limit loan concentrations to specific industries. We have 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:

|                         | 2012              | 2011              | 2010              | 2009              | 2008              |
|-------------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| Commercial              | \$ 371,505        | \$ 365,714        | \$ 348,852        | \$ 340,274        | \$ 324,806        |
| Agricultural            | 83,606            | 74,645            | 71,446            | 64,845            | 58,003            |
| Residential real estate | 284,148           | 278,360           | 284,029           | 285,838           | 319,397           |
| Consumer                | 33,494            | 31,572            | 30,977            | 32,359            | 33,179            |
|                         | <b>\$ 772,753</b> | <b>\$ 750,291</b> | <b>\$ 735,304</b> | <b>\$ 723,316</b> | <b>\$ 735,385</b> |

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

|                         | 2012             |             | 2011             |             | 2010             |             |
|-------------------------|------------------|-------------|------------------|-------------|------------------|-------------|
|                         | \$ Change        | % Change    | \$ Change        | % Change    | \$ Change        | % Change    |
| Commercial              | \$ 5,791         | 1.6%        | \$ 16,862        | 4.8%        | \$ 8,578         | 2.5%        |
| Agricultural            | 8,961            | 12.0%       | 3,199            | 4.5%        | 6,601            | 10.2%       |
| Residential real estate | 5,788            | 2.1%        | (5,669)          | 2.0%        | (1,809)          | 0.6%        |
| Consumer                | 1,922            | 6.1%        | 595              | 1.9%        | (1,382)          | 4.3%        |
|                         | <b>\$ 22,462</b> | <b>3.0%</b> | <b>\$ 14,987</b> | <b>2.0%</b> | <b>\$ 11,988</b> | <b>1.7%</b> |

We expect loans to increase moderately in 2013, with most of this growth coming in commercial loans.

**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 and Note 20 Fair Value of the Notes to Consolidated Financial Statements).

**Deposits**

Deposits are our primary source of funding. The following table presents the composition of the deposit portfolio as of December 31:

|                                  | 2012       | 2011       | 2010       | 2009      | 2008      |
|----------------------------------|------------|------------|------------|-----------|-----------|
| Noninterest bearing deposits     | \$ 143,735 | \$ 119,072 | \$ 104,902 | \$ 96,875 | \$ 97,546 |
| NOW accounts                     | 181,259    | 163,653    | 142,259    | 128,111   | 113,973   |
| Savings deposits                 | 228,338    | 193,902    | 177,817    | 157,020   | 182,523   |
| Certificates of deposit          | 376,790    | 395,777    | 386,435    | 356,594   | 340,976   |
| Brokered certificates of deposit | 55,348     | 54,326     | 53,748     | 50,933    | 28,185    |
| Internet certificates of deposit | 32,197     | 31,434     | 12,178     | 13,119    | 12,427    |

|              |                     |                   |                   |                   |                   |
|--------------|---------------------|-------------------|-------------------|-------------------|-------------------|
| <b>Total</b> | <b>\$ 1,017,667</b> | <b>\$ 958,164</b> | <b>\$ 877,339</b> | <b>\$ 802,652</b> | <b>\$ 775,630</b> |
|--------------|---------------------|-------------------|-------------------|-------------------|-------------------|

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

|                                  | 2012             |             | 2011             |             | 2010             |             |
|----------------------------------|------------------|-------------|------------------|-------------|------------------|-------------|
|                                  | \$ Change        | % Change    | \$ Change        | % Change    | \$ Change        | % Change    |
| Noninterest bearing deposits     | \$ 24,663        | 20.7%       | \$ 14,170        | 13.5%       | \$ 8,027         | 8.3%        |
| NOW accounts                     | 17,606           | 10.8%       | 21,394           | 15.0%       | 14,148           | 11.0%       |
| Savings deposits                 | 34,436           | 17.8%       | 16,085           | 9.0%        | 20,797           | 13.2%       |
| Certificates of deposit          | (18,987)         | 4.8%        | 9,342            | 2.4%        | 29,841           | 8.4%        |
| Brokered certificates of deposit | 1,022            | 1.9%        | 578              | 1.1%        | 2,815            | 5.5%        |
| Internet certificates of deposit | 763              | 2.4%        | 19,256           | 158.1%      | (941)            | 7.2%        |
| <b>Total</b>                     | <b>\$ 59,503</b> | <b>6.2%</b> | <b>\$ 80,825</b> | <b>9.2%</b> | <b>\$ 74,687</b> | <b>9.3%</b> |

While we anticipate that deposits will continue to increase in 2013, it is expected to be at a lower rate than 2012. Growth in 2013 is anticipated to continue to come in the form on non-contractual deposits. Certificates of deposits are expected to approximate current levels.

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

|                                     | 2012              |       | 2011              |       | 2010              |       |
|-------------------------------------|-------------------|-------|-------------------|-------|-------------------|-------|
|                                     | Amount            | Rate  | Amount            | Rate  | Amount            | Rate  |
| Noninterest bearing demand deposits | \$ 125,443        | N/A   | \$ 113,726        | N/A   | \$ 102,812        | N/A   |
| Interest bearing demand deposits    | 170,851           | 0.12% | 152,530           | 0.12% | 137,109           | 0.11% |
| Savings deposits                    | 214,958           | 0.21% | 192,999           | 0.25% | 169,579           | 0.23% |
| Time deposits                       | 473,675           | 1.79% | 467,931           | 2.19% | 430,892           | 2.55% |
| <b>Total</b>                        | <b>\$ 984,927</b> |       | <b>\$ 927,186</b> |       | <b>\$ 840,392</b> |       |

The remaining maturity of time certificates and other time deposits of \$100 or more as of December 31, 2012 was as follows:

|                       |                   |
|-----------------------|-------------------|
| Maturity              |                   |
| Within 3 months       | \$ 31,319         |
| Within 3 to 6 months  | 24,323            |
| Within 6 to 12 months | 52,684            |
| Over 12 months        | 128,801           |
| <b>Total</b>          | <b>\$ 237,127</b> |

**Borrowed Funds**

Borrowed funds include FHLB advances and securities sold under agreements to repurchase. The balance of borrowed funds fluctuates from period to period based on our funding needs including changes in loans, investments, and deposits. For additional disclosure related to borrowed funds see Note 10 Borrowed Funds of Notes to Consolidated Financial Statements.

**Table of Contents****Contractual Obligations and Loan Commitments**

We have various financial obligations, including contractual obligations and commitments, which may require future cash payments. The following schedule summarizes our non-cancelable obligations and future minimum payments as of December 31, 2012:

|  | Minimum Payments Due by Period |  |  |                     | Total               |
|--|--------------------------------|--|--|---------------------|---------------------|
|  | Due in<br>One Year<br>or Less  | After One<br>Year But<br>Within<br>Three Years | After Three<br>Years But<br>Within<br>Five Years | After<br>Five Years |                     |
| <b>Deposits</b>                                |                                |  |  |                     |                     |
| Deposits with no stated maturity               | \$ 553,332                     | \$   | \$   | \$                  | \$ 553,332          |
| Certificates of deposit with stated maturities | 205,754                        | 148,427  | 91,755   | 18,399              | 464,335             |
| <b>Total deposits</b>                          | <b>759,086</b>                 | <b>148,427</b>                                 | <b>91,755</b>                                    | <b>18,399</b>       | <b>1,017,667</b>    |
| <b>Borrowed funds</b>                          |                                |  |  |                     |                     |
| Short term borrowings                          | 72,717                         |  |  |                     | 72,717              |
| Long term borrowings                           | 5,000                          | 63,284   | 50,000   | 50,000              | 168,284             |
| <b>Total borrowed funds</b>                    | <b>77,717</b>                  | <b>63,284</b>                                  | <b>50,000</b>                                    | <b>50,000</b>       | <b>241,001</b>      |
| <b>Total contractual obligations</b>           | <b>\$ 836,803</b>              | <b>\$ 211,711</b>                              | <b>\$ 141,755</b>                                | <b>\$ 68,399</b>    | <b>\$ 1,258,668</b> |

We also have loan commitments that may impact liquidity. The following schedule summarizes our loan commitments and expiration dates by period as of December 31, 2012. Commitments to grant loans include loans to be sold to the secondary market. Since many of these commitments historically have expired without being drawn upon, the total amount of these commitments does not necessarily represent our future cash requirements.

|  | Expiration Dates by Period    |  |  |                     | Total             |
|--|-------------------------------|--|--|---------------------|-------------------|
|  | Due in<br>One Year<br>or Less | After One<br>Year But<br>Within<br>Three Years | After Three<br>Years But<br>Within<br>Five Years | After<br>Five Years |                   |
| Unused commitments under lines of credit | \$ 69,385                     | \$ 34,744                                      | \$ 7,934   | \$ 3,170            | \$ 115,233        |
| Commitments to grant loans               | 40,507                        |  |  |                     | 40,507            |
| Commercial and standby letters of credit | 3,935                         |  |  |                     | 3,935             |
| <b>Total loan commitments</b>            | <b>\$ 113,827</b>             | <b>\$ 34,744</b>                               | <b>\$ 7,934</b>                                  | <b>\$ 3,170</b>     | <b>\$ 159,675</b> |

For additional disclosure related to Contractual Obligations and Loan Commitments, see Note 13 Off-Balance Sheet Activities of the Notes to Consolidated Financial Statements.

**Capital**

Capital consists solely of common stock, retained earnings, and accumulated other comprehensive income. We are currently authorized to raise capital through dividend reinvestment, employee and director stock purchases, and shareholder stock purchases. Pursuant to these authorizations, we issued 124,530 shares of common stock generating \$2,898 of capital during 2012, and 115,359 shares of common stock generating \$2,192 of capital in 2011. We also offer the Directors Plan which allows participants to purchase stock units, in lieu of cash payments (see Note 17 Benefit Plans of the Notes to Consolidated Financial Statements). Pursuant to this plan, we raised \$643 and \$615 of capital in 2012 and 2011, respectively.

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We have approved a publicly announced common stock repurchase plan. During 2012 and 2011, pursuant to this plan, we repurchased 83,586 shares of common stock at an average price of \$23.69 and 120,441 shares of common stock at an average price of \$18.30, respectively. As of December 31, 2012, we were authorized to repurchase up to an additional 85,410 shares of common stock.



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There are no significant regulatory constraints placed on our capital. The FRB's current recommended minimum primary capital to assets requirement is 6.0%. Our primary capital to average assets ratio, which consists of shareholders' equity plus the ALL less goodwill and acquisition intangibles, was 8.29% at December 31, 2012.

The FRB has established a minimum risk based capital standard. Under this standard, a framework has been established that assigns risk weights to each category of on and off balance sheet items to arrive at risk adjusted total assets. Regulatory capital is divided by the risk adjusted assets with the resulting ratio compared to the minimum standard to determine whether a corporation has adequate capital. The minimum standard is 8%, of which at least 4% must consist of equity capital net of goodwill. The following table sets forth the percentages required under the Risk Based Capital guidelines and our values as of December 31:

|                      | 2012          | 2011          | Required     |
|----------------------|---------------|---------------|--------------|
| Equity Capital       | 13.23%        | 12.92%        | 4.00%        |
| Secondary Capital    | 1.25%         | 1.25%         | 4.00%        |
| <b>Total Capital</b> | <b>14.48%</b> | <b>14.17%</b> | <b>8.00%</b> |

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

The FRB and FDIC also prescribe minimum capital requirements for the Bank. At December 31, 2012, the Bank exceeded these minimum capital requirements. Proposed new capital standards, if enacted, will require us to meet higher capital standards. This increase in capital levels may have an adverse impact on our ability to grow and pay dividends. For further information regarding the Bank's capital requirements, see Note 16 Minimum Regulatory Capital Requirements of the Notes to Consolidated Financial Statements.

**Fair Value**

We utilize fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. AFS securities, trading securities, and certain liabilities are recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record at fair value other assets on a nonrecurring basis, such as loans held-for-sale, foreclosed assets, OMSR, 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.

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 Notes to 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. We strive to achieve reasonable stability in the net interest margin through periods of changing interest rates. One tool we use to measure interest rate sensitivity is gap analysis. As shown in the following table, the gap analysis depicts our 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 AFS 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 \$162,635 as of December 31, 2012, 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 \$1,151 that are included in the 0 to 3 month time frame.

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Savings and NOW accounts have no contractual maturity date and are believed by us to be predominantly noninterest rate sensitive. These accounts have been classified in the gap table according to their estimated withdrawal rates based upon our analysis of deposit decay over the past five years. We believe this decay experience is consistent with our expectation for the future. As of December 31, 2012, we had a positive cumulative gap within one year. A positive gap position results when more assets, within a specified time frame, have the potential to mature or reprice than liabilities.

The following table shows the time periods and the amount of assets and liabilities available for interest rate repricing as of December 31, 2012. 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<br>Months  | 4 to 12<br>Months | 1 to 5<br>Years   | Over 5<br>Years   |
|---------------------------------------|-------------------|-------------------|-------------------|-------------------|
| <b>Interest sensitive assets</b>      |                   |                   |                   |                   |
| Trading securities                    | \$ 1,573          | \$                | \$                | \$                |
| AFS securities                        | 37,663            | 86,789            | 211,184           | 168,374           |
| Loans                                 | 194,062           | 101,725           | 380,469           | 89,194            |
| <b>Total</b>                          | <b>\$ 233,298</b> | <b>\$ 188,514</b> | <b>\$ 591,653</b> | <b>\$ 257,568</b> |
| <b>Interest sensitive liabilities</b> |                   |                   |                   |                   |
| Borrowed funds                        | \$ 72,754         | \$ 5,111          | \$ 113,136        | \$ 50,000         |
| Time deposits                         | 62,287            | 143,836           | 239,813           | 18,399            |
| Savings                               | 6,242             | 20,903            | 82,438            | 118,755           |
| NOW                                   | 2,163             | 6,488             | 30,237            | 142,371           |
| <b>Total</b>                          | <b>\$ 143,446</b> | <b>\$ 176,338</b> | <b>\$ 465,624</b> | <b>\$ 329,525</b> |
| Cumulative gap                        | \$ 89,852         | \$ 102,028        | \$ 228,057        | \$ 156,100        |
| Cumulative gap as a % of assets       | 6.28%             | 7.13%             | 15.94%            | 10.91%            |

The following table shows the maturity of commercial and agricultural loans outstanding at December 31, 2012. Also provided are the amounts due after one year, classified according to the sensitivity to changes in interest rates.

|   | 1 Year<br>or Less | 1 to 5<br>Years   | Over 5<br>Years  | Total      |
|---|-------------------|-------------------|------------------|------------|
| Commercial and agricultural                     | \$ 99,889         | \$ 288,297        | \$ 66,925        | \$ 455,111 |
| <b>Interest sensitivity</b>                     |                   |                   |                  |            |
| <b>Loans maturing after one year that have:</b> |                   |                   |                  |            |
| Fixed interest rates                            |                   | \$ 231,656        | \$ 59,368        |            |
| Variable interest rates                         |                   | 56,641            | 7,557            |            |
| <b>Total</b>                                    |                   | <b>\$ 288,297</b> | <b>\$ 66,925</b> |            |

**Liquidity**

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

The primary sources of our liquidity are cash and cash equivalents, certificates of deposit held in other financial institutions, trading securities, and AFS securities. These categories totaled \$534,968 or 37.4% of assets



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as of December 31, 2012 as compared to \$467,344 or 34.9% in 2011. 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.

Our primary source of funds is deposit accounts. We also have the ability to borrow from the FHLB, the FRB, and through various correspondent banks as federal funds purchased. These funding methods typically carry a higher interest rate than traditional market deposit accounts. Some borrowed funds, including FHLB Advances, FRB Discount Window Advances, and repurchase agreements, require us to pledge assets, typically in the form of certificates of deposits held in other financial institutions, investment securities, or loans as collateral. As of December 31, 2012, we had available lines of credit of \$108,646.

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

|  | 2012      | 2011      | \$ Variance |
|--|-----------|-----------|-------------|
| Net cash provided by operating activities        | \$ 19,464 | \$ 18,860 | \$ 604      |
| Net cash used in investing activities            | (101,874) | (105,203) | 3,329       |
| Net cash provided by financing activities        | 78,740    | 96,824    | (18,084)    |
| (Decrease) increase in cash and cash equivalents | (3,670)   | 10,481    | (14,151)    |
| Cash and cash equivalents January 1              | 28,590    | 18,109    | 10,481      |
| Cash and cash equivalents December 31            | \$ 24,920 | \$ 28,590 | \$ (3,670)  |

**Market Risk**

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

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

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

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

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Our interest rate sensitivity is estimated by first forecasting the next twelve months of net interest income under an assumed environment of a constant balance sheet and constant market interest rates (base case). We then compare the results of various simulation analyses to the base case. At December 31, 2012, we projected the change in net interest income during the next twelve months assuming market interest rates were to immediately decrease by 100 basis points and increase by 100, 200, 300, and 400 basis points in a parallel fashion over the entire yield curve during the same time period. We did not project scenarios showing decreases in interest rates beyond 100 basis points as this is considered extremely unlikely given prevailing interest rate levels. These projections were based on our assets and liabilities remaining static over the next twelve months, while factoring in probable calls and prepayments of certain investment securities and real estate residential and consumer loans. While it is extremely unlikely that interest rates would immediately increase to these levels, we feel that these extreme scenarios help us identify potential gaps and mismatches in the repricing characteristics of assets and liabilities. We regularly monitor our forecasted net interest income sensitivity to ensure that it remains within established limits.

The following table summarizes our interest rate sensitivity as of:

|  | <b>December 31, 2012</b> |   |       |       |       |       |
|--|--------------------------|---|-------|-------|-------|-------|
| Immediate basis point change assumption (short-term rates) | 100                      | 0 | 100   | 200   | 300   | 400   |
| Percent change in net income vs. constant rates            | 1.61%                    |   | 0.49% | 1.58% | 1.74% | 2.16% |
|  | <b>December 31, 2011</b> |   |       |       |       |       |
| Immediate basis point change assumption (short-term rates) | 100                      | 0 | 100   | 200   | 300   | 400   |
| Percent change in net income vs. constant rates            | 1.50%                    |   | 1.34% | 0.84% | 0.78% | N/A   |

A 400 basis point increase was not applicable as of December 31, 2011 as we were not utilizing this scenario as part of our interest rate sensitivity analysis at that time. We believe our risk associated with changes in interest rates are acceptable.

The secondary method to measure interest rate risk is gap analysis. Gap analysis measures the cash flows and/or the earliest repricing of our interest bearing assets and liabilities. This analysis is useful for measuring trends in the repricing characteristics of the balance sheet. Significant assumptions are required in this process because of the imbedded repricing options contained in assets and liabilities. Residential real estate and consumer loans 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 offering rates, the level of sales of used homes, and the overall availability of credit in the market place. Generally, a decrease in interest rates will result in an increase in cash flows from these assets. A significant portion of our securities are callable or have prepayment options. The call and prepayment options are more likely to be exercised in a period of decreasing interest rates. Savings and demand accounts may generally be withdrawn on request without prior notice. The timing of cash flows from these deposits is estimated based on historical experience. Time deposits have penalties that discourage early withdrawals.

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

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reviewed the results of the analyses in detail and feel that it reasonably reflects the prepayment speeds and decay rates of our loan and deposit portfolios.

|                                      | December 31, 2012 |           |           |           |            |            | Total      | Fair Value |
|--------------------------------------|-------------------|-----------|-----------|-----------|------------|------------|------------|------------|
|                                      | 2013              | 2014      | 2015      | 2016      | 2017       | Thereafter |            |            |
| Rate sensitive assets                |                   |           |           |           |            |            |            |            |
| Other interest bearing assets        | \$ 6,411          | \$ 100    | \$ 240    | \$        | \$         | \$         | \$ 6,751   | \$ 6,761   |
| Average interest rates               | 0.86%             | 0.35%     | 1.25%     |           |            |            | 0.86%      |            |
| Trading securities                   | \$ 1,051          | \$ 522    | \$        | \$        | \$         | \$         | \$ 1,573   | \$ 1,573   |
| Average interest rates               | 2.68%             | 2.54%     |           |           |            |            | 2.63%      |            |
| AFS securities                       | \$ 124,452        | \$ 83,606 | \$ 49,419 | \$ 42,655 | \$ 35,504  | \$ 168,374 | \$ 504,010 | \$ 504,010 |
| Average interest rates               | 2.42%             | 2.30%     | 2.53%     | 2.82%     | 2.89%      | 2.48%      | 2.50%      |            |
| Fixed interest rate loans (1)        | \$ 138,840        | \$ 96,013 | \$ 91,353 | \$ 85,095 | \$ 109,057 | \$ 89,760  | \$ 610,118 | \$ 622,329 |
| Average interest rates               | 5.74%             | 5.62%     | 5.57%     | 5.21%     | 4.60%      | 4.63%      | 5.26%      |            |
| Variable interest rate loans (1)     | \$ 64,482         | \$ 28,076 | \$ 24,669 | \$ 12,650 | \$ 22,061  | \$ 10,697  | \$ 162,635 | \$ 162,635 |
| Average interest rates               | 4.90%             | 3.77%     | 3.96%     | 3.89%     | 3.36%      | 3.90%      | 4.21%      |            |
| Rate sensitive liabilities           |                   |           |           |           |            |            |            |            |
| Borrowed funds                       | \$ 77,865         | \$ 10,814 | \$ 42,322 | \$ 20,000 | \$ 40,000  | \$ 50,000  | \$ 241,001 | \$ 248,822 |
| Average interest rates               | 0.46%             | 0.65%     | 1.14%     | 2.67%     | 2.15%      | 3.03%      | 1.59%      |            |
| Savings and NOW accounts             | \$ 35,796         | \$ 32,794 | \$ 29,476 | \$ 26,520 | \$ 23,885  | \$ 261,126 | \$ 409,597 | \$ 409,597 |
| Average interest rates               | 0.13%             | 0.13%     | 0.12%     | 0.12%     | 0.12%      | 0.11%      | 0.12%      |            |
| Fixed interest rate time deposits    | \$ 204,972        | \$ 76,373 | \$ 71,685 | \$ 51,232 | \$ 40,523  | \$ 18,399  | \$ 463,184 | \$ 471,479 |
| Average interest rates               | 1.13%             | 1.69%     | 2.10%     | 2.14%     | 1.72%      | 1.67%      | 1.55%      |            |
| Variable interest rate time deposits | \$ 782            | \$ 369    | \$        | \$        | \$         | \$         | \$ 1,151   | \$ 1,151   |
| Average interest rates               | 0.46%             | 0.45%     |           |           |            |            | 0.46%      |            |

|                                      | December 31, 2011 |            |           |           |           | Total      | Fair Value |
|--------------------------------------|-------------------|------------|-----------|-----------|-----------|------------|------------|
|                                      | 2012              | 2013       | 2014      | 2015      | 2016      |            |            |
| 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%      |            |
| AFS securities                       | \$ 104,559        | \$ 61,421  | \$ 48,659 | \$ 37,777 | \$ 35,108 | \$ 137,596 | \$ 425,120 |
| Average interest rates               | 2.98%             | 2.84%      | 2.91%     | 2.93%     | 3.21%     | 3.01%      | 2.98%      |
| Fixed interest rate loans (1)        | \$ 141,867        | \$ 140,390 | \$ 90,852 | \$ 75,690 | \$ 76,985 | \$ 61,854  | \$ 587,638 |
| Average interest rates               | 6.24%             | 6.08%      | 5.94%     | 5.99%     | 5.40%     | 5.15%      | 5.90%      |
| Variable interest rate loans (1)     | \$ 70,783         | \$ 25,267  | \$ 20,803 | \$ 18,853 | \$ 11,631 | \$ 15,316  | \$ 162,653 |
| 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 |
| 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 |
| 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 |
| 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   |
| Average interest rates               | 0.67%             | 0.69%      |           |           |           |            | 0.68%      |

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

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We do not believe that there has been a material change in the nature or categories of our primary market risk exposure, or the particular markets that present the primary risk of loss. As of the date of this report, we do not know of or expect there to be any material change in the general nature of our primary market risk exposure in the near term. As of the date of this report, we do not expect to make material changes in those methods in the near term. We may change those methods in the future to adapt to changes in circumstances or to implement new techniques.

**Common Stock and Dividend Information**

Our common stock is traded in the over the counter market. The common stock is quoted on the OTCQB market 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 we may have little or no information.

Our authorized common stock consists of 15,000,000 shares, of which 7,671,846 shares are issued and outstanding as of December 31, 2012. As of that date, there were 3,049 shareholders of record.

We have 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 our 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 us, which we have 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 our common stock.

|                | Number of<br>Shares | Sale Price |          |
|----------------|---------------------|------------|----------|
|                |                     | Low        | High     |
| <b>2012</b>    |                     |            |          |
| First Quarter  | 64,873              | \$ 22.15   | \$ 24.25 |
| Second Quarter | 63,656              | 23.45      | 24.98    |
| Third Quarter  | 97,706              | 22.50      | 24.90    |
| Fourth Quarter | 87,966              | 21.60      | 23.45    |
|                | <b>314,201</b>      |            |          |
| <b>2011</b>    |                     |            |          |
| 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    |
|                | <b>313,162</b>      |            |          |

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

|                | Per Share      |                |
|----------------|----------------|----------------|
|                | 2012           | 2011           |
| First Quarter  | \$ 0.20        | \$ 0.19        |
| Second Quarter | 0.20           | 0.19           |
| Third Quarter  | 0.20           | 0.19           |
| Fourth Quarter | 0.20           | 0.19           |
| <b>Total</b>   | <b>\$ 0.80</b> | <b>\$ 0.76</b> |





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Our Board has authorized a common stock repurchase plan, which was last amended in April 2012. 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, 2012, with respect to this plan:

|                                   | Shares Repurchased |                         | Total Number of  | Maximum Number of  |
|-----------------------------------|--------------------|-------------------------|--|--|
|                                   | Number             | Average Price Per Share | Shares Purchased as Part of Publicly Announced Plan or Program | Shares That May Yet Be Purchased Under the Plans or Programs |
| Balance, September 30, 2012       |                    |                         |  | 105,893  |
| October 1 - 31, 2012              | 9,014              | \$ 22.52                | 9,014  | 96,879   |
| November 1 - 30, 2012             | 5,457              | 22.91                   | 5,457  | 91,422   |
| December 1 - 31, 2012             | 6,012              | 22.79                   | 6,012  | 85,410   |
| <b>Balance, December 31, 2012</b> | <b>20,483</b>      | <b>\$ 22.70</b>         | <b>20,483</b>  | <b>85,410</b>  |

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 in our annual report on Form 10-K.

**Table of Contents****Stock Performance**

The following graph compares the cumulative total shareholder return on our common stock for the last five years with the cumulative total return on (1) NASDAQ, which is comprised of all United States common shares traded on the NASDAQ and (2) the 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 ISBA and each index was \$100 at December 31, 2007 and all dividends are reinvested.

**Stock Performance****Five-Year Total Return**

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

**Comparison of Five Year Cumulative**

**Among ISBA, NASDAQ Stock Market,**

**and NASDAQ Bank Stock**

| <b>Year</b> | <b>ISBA</b> | <b>NASDAQ</b> | <b>NASDAQ<br/>Banks</b> |
|-------------|-------------|---------------|-------------------------|
| 12/31/2007  | 100.00      | 100.00        | 100.00                  |
| 12/31/2008  | 65.10       | 60.20         | 78.80                   |
| 12/31/2009  | 50.20       | 87.33         | 65.86                   |
| 12/31/2010  | 47.80       | 103.05        | 75.08                   |
| 12/31/2011  | 68.10       | 102.26        | 67.22                   |
| 12/31/2012  | 64.70       | 120.36        | 79.73                   |

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**SHAREHOLDERS INFORMATION**

**Annual Meeting**

The Annual Meeting of Shareholders will be held at 5:00 p.m., Tuesday, May 7, 2013, Comfort Inn, 2424 S. Mission Street, Mt. Pleasant, Michigan.

**Financial Information and Form 10-K**

Copies of the 2012 Annual Report, Isabella Bank Corporation Form 10-K, and other financial information not contained herein are available on the Bank's website ([www.isbellabank.com](http://www.isbellabank.com)) under the Investors tab, or may be obtained, without charge, by writing to:

Debra Campbell

Secretary

Isabella Bank Corporation

401 N. Main St.

Mt. Pleasant, Michigan 48858

**Mission Statement**

To create an operating environment that will provide shareholders with sustained growth in their investment while maintaining our independence and subsidiaries' autonomy.

**Equal Employment Opportunity**

The equal employment opportunity clauses in Section 202 of the Executive Order 11246, as amended; 38 USC 2012, Vietnam Era Veterans Readjustment Act of 1974; Section 503 of the Rehabilitation Act of 1973, as amended; relative to equal employment opportunity and implementing rules and regulations of the Secretary of Labor are adhered to and supported by Isabella Bank Corporation, and its subsidiaries.

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**PROXY CARD**

**THIS PROXY IS SOLICITED ON BEHALF OF THE BOARD OF DIRECTORS**

The undersigned hereby appoints Jeffrey J. Barnes, Sandra L. Caul, and W. Michael McGuire as proxies, each with the power to appoint his/her substitute, and hereby authorizes them to represent and to vote as designated below, all the shares of Common Stock of Isabella Bank Corporation that the undersigned is eligible to vote as of March 26, 2013 at the annual meeting of shareholders to be held on May 7, 2013 or any adjournments thereof.

**PROPOSAL 1 ELECTION OF DIRECTORS:** Proposal to elect the following four (4) persons as directors. Please mark the appropriate box for each director-nominee.

|                      | FOR | AGAINST | WITHHOLD AUTHORITY |
|----------------------|-----|---------|--------------------|
| Thomas L. Kleinhardt | ..  | ..      | ..                 |
| Joseph LaFramboise   | ..  | ..      | ..                 |
| Wilson Lauer         | ..  | ..      | ..                 |
| Sarah Opperman       | ..  | ..      | ..                 |

This proxy, when properly executed, will be voted in the manner directed herein by the undersigned shareholder. **IF NO DIRECTION IS MADE, THIS PROXY WILL BE VOTED FOR THE NOMINEES LISTED UNDER PROPOSAL 1** . The shares represented by this proxy will be voted in the discretion of the proxies on any other matters which may come before the meeting.

Please sign as your name appears below. When shares are held by joint tenants, both should sign. When signing as attorney, executor, administrator, trustee or guardian, please give full title as such. If a corporation or other business entity, please sign full entity name, by an authorized officer.

Dated: \_\_\_\_\_, 2013

Please mark, sign, date, and return

Signature

Proxy card promptly using the enclosed

envelope.

Signature (if held jointly)