ISABELLA BANK CORP
Form 10-Q
August 08, 2011

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**
For the quarterly period ended June 30, 2011

or

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

Commission File Number: 0-18415
Isabella Bank Corporation
(Exact name of registrant as specified in its charter)

Michigan	38-2830092
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer identification No.)
401 N. Main St, Mt. Pleasant, MI	48858
(Address of principal executive offices)	(Zip code)

(989) 772-9471
(Registrant s telephone number, including area code)
N/A
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

þ Yes o No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

þ Yes o No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of accelerated filer , large accelerated filer , and smaller reporting company , in Rule 12b-2 of the Exchange Act (Check One).

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Common Stock no par value, 7,580,042 as of July 22, 2011

ISABELLA BANK CORPORATION
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PART I FINANCIAL INFORMATION

Item 1 Interim Condensed Consolidated Financial Statements (Unaudited)

INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(Dollars in thousands)

	June 30 2011	December 31 2010
ASSETS		
Cash and cash equivalents		
Cash and demand deposits due from banks	$ 20,707	$ 16,978
Interest bearing balances due from banks	1,085	1,131
Total cash and cash equivalents	**21,792**	**18,109**
Certificates of deposit held in other financial institutions	10,874	15,808
Trading securities	4,910	5,837
Available-for-sale securities (amortized cost of $373,607 in 2011 and $329,435 in 2010)	380,225	330,724
Mortgage loans available-for-sale	764	1,182
Loans		
Agricultural	72,126	71,446
Commercial	358,943	348,852
Installment	31,035	30,977
Residential real estate mortgage	284,190	284,029
Total loans	**746,294**	**735,304**
Less allowance for loan losses	12,378	12,373
Net loans	**733,916**	**722,931**
Premises and equipment	24,229	24,627
Corporate owned life insurance	17,753	17,466
Accrued interest receivable	5,579	5,456
Equity securities without readily determinable fair values	17,061	17,564
Goodwill and other intangible assets	46,939	47,091
Other assets	17,228	19,015
TOTAL ASSETS	**$ 1,281,270**	**$ 1,225,810**
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits		
Noninterest bearing	$ 113,635	$ 104,902
NOW accounts	148,176	142,259
Certificates of deposit under $100 and other savings	443,909	425,981
Certificates of deposit over $100	218,479	204,197
Total deposits	**924,199**	**877,339**
Borrowed funds ($10,306 in 2011 and $10,423 in 2010 at fair value)	196,480	194,917
Accrued interest payable and other liabilities	9,077	8,393

Total liabilities	**1,129,756**	**1,080,649**
Shareholders equity		
Common stock no par value 15,000,000 shares authorized; issued and outstanding 7,576,676 (including 30,312 shares to be issued) in 2011 and 7,550,074 (including 32,686 shares to be issued) in 2010	134,063	133,592
Shares to be issued for deferred compensation obligations	4,735	4,682
Retained earnings	10,703	8,596
Accumulated other comprehensive income (loss)	2,013	(1,709)
Total shareholders equity	**151,514**	**145,161**
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	**$ 1,281,270**	**$ 1,225,810**

See notes to interim condensed consolidated financial statements.

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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY (UNAUDITED)

(Dollars in thousands except per share data)

	Common Stock Shares Outstanding	Common Stock	Shares to be Issued for Deferred Compensation Obligations	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Totals
Balance, January 1, 2010	**7,535,193**	**$ 133,443**	**$ 4,507**	**$ 4,972**	**$ (2,119)**	**$ 140,803**
Comprehensive income				4,174	3,744	7,918
Issuance of common stock	59,197	1,529				1,529
Common stock issued for deferred compensation obligations	26,898	537	(448)			89
Share based payment awards under equity compensation plan			332			332
Common stock purchased for deferred compensation obligations		(254)				(254)
Common stock repurchased pursuant to publicly announced repurchase plan	(76,097)	(1,426)				(1,426)
Cash dividends ($0.36 per share)				(2,712)		(2,712)
Balance, June 30, 2010	**7,545,191**	**$ 133,829**	**$ 4,391**	**$ 6,434**	**$ 1,625**	**$ 146,279**
Balance, January 1, 2011	**7,550,074**	**$ 133,592**	**$ 4,682**	**$ 8,596**	**$ (1,709)**	**$ 145,161**
Comprehensive income				4,988	3,722	8,710
Issuance of common stock	61,218	1,346				1,346
Common stock issued for deferred compensation obligations	14,842	266	(254)			12
Share based payment awards under equity compensation plan			307			307
Common stock purchased for deferred compensation obligations		(227)				(227)
Common stock repurchased pursuant to publicly announced repurchase plan	(50,458)	(914)				(914)

Cash dividends ($0.38 per share)				(2,881)		(2,881)
Balance, June 30, 2011	**7,575,676**	**$ 134,063**	**$ 4,735**	**$ 10,703**	**$ 2,013**	**$ 151,514**

See notes to interim condensed consolidated financial statements.

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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(Dollars in thousands except per share data)

	Three Months Ended June 30		Six Months Ended June 30	
	2011	2010	2011	2010
Interest income				
Loans, including fees	$ 11,464	$ 11,651	$ 22,825	$ 23,168
Investment securities				
Taxable	1,836	1,346	3,349	2,625
Nontaxable	1,189	1,079	2,368	2,173
Trading account securities	47	86	98	191
Federal funds sold and other	133	110	267	214
Total interest income	**14,669**	**14,272**	**28,907**	**28,371**
Interest expense				
Deposits	2,776	2,874	5,561	5,757
Borrowings	1,325	1,417	2,593	2,934
Total interest expense	**4,101**	**4,291**	**8,154**	**8,691**
Net interest income	**10,568**	**9,981**	**20,753**	**19,680**
Provision for loan losses	603	1,056	1,420	2,263
Net interest income after provision for loan losses	**9,965**	**8,925**	**19,333**	**17,417**
Noninterest income				
Service charges and fees	1,617	1,494	3,093	3,122
Gain on sale of mortgage loans	53	74	182	167
Net loss on trading securities	(8)	(37)	(27)	(38)
Net gain (loss) on borrowings measured at fair value	37	(3)	117	53
Gain on sale of available-for-sale investment securities				56
Other	279	342	561	677
Total noninterest income	**1,978**	**1,870**	**3,926**	**4,037**
Noninterest expenses				
Compensation and benefits	4,746	4,565	9,751	9,160
Occupancy	613	557	1,259	1,119
Furniture and equipment	1,127	1,082	2,233	2,113
FDIC insurance premiums	331	313	665	619
Other	1,962	1,758	3,458	3,618
Total noninterest expenses	**8,779**	**8,275**	**17,366**	**16,629**

Income before federal income tax expense	**3,164**	**2,520**	**5,893**	**4,825**
Federal income tax expense	492	369	905	651
NET INCOME	**$ 2,672**	**$ 2,151**	**$ 4,988**	**$ 4,174**
Earnings per share				
Basic	**$ 0.35**	**$ 0.29**	**$ 0.66**	**$ 0.55**
Diluted	**$ 0.34**	**$ 0.28**	**$ 0.64**	**$ 0.54**
Cash dividends per basic share	**$ 0.19**	**$ 0.18**	**$ 0.38**	**$ 0.36**

See notes to interim condensed consolidated financial statements.

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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)
(Dollars in thousands)

	Three Months Ended June 30		Six Months Ended June 30	
	2011	2010	2011	2010
Net income	**$ 2,672**	**$ 2,151**	**$ 4,988**	**$ 4,174**
Unrealized holding gains on available-for-sale securities:				
Unrealized holding gains arising during the period	3,576	4,633	5,329	5,993
Reclassification adjustment for net realized gains included in net income				(56)
Net unrealized gains	3,576	4,633	5,329	5,937
Tax effect	(1,212)	(1,704)	(1,607)	(2,193)
Other comprehensive income, net of tax	2,364	2,929	3,722	3,744
COMPREHENSIVE INCOME	**$ 5,036**	**$ 5,080**	**$ 8,710**	**$ 7,918**

See notes to interim condensed consolidated financial statements.

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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(UNAUDITED)
(Dollars in thousands)

	Six Months Ended June 30	
	2011	2010
OPERATING ACTIVITIES		
Net income	$ 4,988	$ 4,174
Reconciliation of net income to net cash provided by operations:		
Provision for loan losses	1,420	2,263
Impairment of foreclosed assets	35	90
Depreciation	1,282	1,235
Amortization and impairment of originated mortgage servicing rights	193	283
Amortization of acquisition intangibles	152	172
Net amortization of available-for-sale securities	693	442
Gain on sale of available-for-sale securities		(56)
Net unrealized losses on trading securities	27	38
Net gain on sale of mortgage loans	(182)	(167)
Net unrealized gains on borrowings measured at fair value	(117)	(53)
Increase in cash value of corporate owned life insurance	(287)	(292)
Realized gain on redemption of corporate owned life insurance		(21)
Share-based payment awards under equity compensation plan	307	332
Origination of loans held for sale	(17,247)	(22,311)
Proceeds from loan sales	17,847	24,295
Net changes in operating assets and liabilities which provided (used) cash:		
Trading securities	900	6,302
Accrued interest receivable	(123)	520
Other assets	653	(593)
Accrued interest payable and other liabilities	684	(29)
Net cash provided by operating activities	**11,225**	**16,624**
INVESTING ACTIVITIES		
Net change in certificates of deposit held in other financial institutions	4,934	(7,043)
Activity in available-for-sale securities		
Maturities, calls, and sales	33,799	36,924
Purchases	(78,664)	(40,249)
Loan principal originations and collections, net	(13,462)	(7,627)
Proceeds from sales of foreclosed assets	859	1,662
Purchases of premises and equipment	(884)	(2,093)
Purchases of corporate owned life insurance		(175)
Proceeds from the redemption of corporate owned life insurance		154
Net cash used in investing activities	**(53,418)**	**(18,447)**

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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED) (continued) (UNAUDITED)

(Dollars in thousands)

	Six Months Ended June 30	
	2011	2010
FINANCING ACTIVITIES		
Acceptances and withdrawals of deposits, net	46,860	22,161
Net increase (decrease) in other borrowed funds	1,680	(9,158)
Cash dividends paid on common stock	(2,881)	(2,712)
Proceeds from issuance of common stock	1,092	1,081
Common stock repurchased	(648)	(889)
Common stock purchased for deferred compensation obligations	(227)	(254)
Net cash provided by financing activities	**45,876**	**10,229**
INCREASE IN CASH AND CASH EQUIVALENTS	**3,683**	**8,406**
Cash and cash equivalents at beginning of period	18,109	22,706
CASH AND CASH EQUIVALENTS AT END OF PERIOD	**$ 21,792**	**$ 31,112**
SUPPLEMENTAL CASH FLOWS INFORMATION:		
Interest paid	$ 8,156	$ 8,744
Federal income taxes paid	365	136
SUPPLEMENTAL NONCASH INFORMATION:		
Transfers of loans to foreclosed assets	$ 1,057	$ 1,668
Common stock issued for deferred compenstion obligations	254	448
Common stock repurchased from an associated grantor trust (Rabbi Trust)	(266)	(537)

See notes to interim condensed consolidated financial statements.

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NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollars in thousands except per share amounts)

NOTE 1 BASIS OF PRESENTATION

The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In management s opinion, all adjustments considered necessary for a fair presentation have been included. Operating results for the three and six month periods ended June 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. For further information, refer to the consolidated financial statements and footnotes thereto included in the Corporation s annual report for the year ended December 31, 2010.

The accounting policies are the same as those discussed in Note 1 to the Consolidated Financial Statements included in the Corporation s annual report for the year ended December 31, 2010.

NOTE 2 ACCOUNTING STANDARDS UPDATES

Recently Adopted Accounting Standards Updates

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

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

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

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

Pending Accounting Standards Updates

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

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

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

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

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

In addition, ASU No. 2011-02 clarifies that a creditor is precluded from using the effective interest rate test in the debtor s guidance on modification of payables (ASC Topic 470, Debt) when evaluating whether a modification constitutes a troubled debt restructuring. The new authoritative guidance is effective for interim and annual periods beginning on or after June 15, 2011 and is likely to increase the volume of loans that the Corporation classifies as troubled debt restructurings. The Corporation is currently in the process of evaluating the extent of the impact that this standard will have on the Corporation s financial statements.

ASU No. 2011-03: Reconsideration of Effective Control for Repurchase Agreements

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

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

In May 2011, ASU No. 2011-04 amended ASC Topic 820, Fair Value Measurement to align fair value measurements and disclosures in U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). The ASU changes the wording used to describe the requirements in GAAP for measuring fair value and disclosures about fair value.

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

- The application of highest and best use and valuation premise concepts.
- Measuring the fair value of an instrument classified in a reporting entity s stockholders equity.
- Disclosure about fair value measurements within Level 3 of the fair value hierarchy.

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

- Measuring the fair value of financial instruments that are managed within a portfolio.
- Application of premiums and discounts in a fair value measurement.

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

ASU No. 2011-05: Presentation of Comprehensive Income

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

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

NOTE 3 COMPUTATION OF EARNINGS PER SHARE

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

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

	Three Months Ended June 30		Six Months Ended June 30	
	2011	2010	2011	2010
Average number of common shares outstanding for basic calculation	7,570,752	7,544,629	7,564,060	7,542,693
Average potential effect of shares in the Directors Plan (1)	194,964	185,950	194,051	184,178
Average number of common shares outstanding used to calculate diluted earnings per common share	7,765,716	7,730,579	7,758,111	7,726,871
Net income	$ 2,672	$ 2,151	$ 4,988	$ 4,174
Earnings per share				
Basic	**$ 0.35**	**$ 0.29**	**$ 0.66**	**$ 0.55**
Diluted	**$ 0.34**	**$ 0.28**	**$ 0.64**	**$ 0.54**

(1) Exclusive of shares held in the Rabbi Trust

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NOTE 4 TRADING SECURITIES

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

	June 30 2011	December 31 2010
States and political subdivisions	**$4,910**	**$ 5,837**

Included in the net trading losses of $27 during the first six months of 2011 were $32 of net unrealized trading losses on securities that relate to the Corporation s trading portfolio as of June 30, 2011.

NOTE 5 AVAILABLE-FOR-SALE SECURITIES

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

	June 30, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	$ 5,394	$ 9	$	$ 5,403
States and political subdivisions	163,374	4,181	221	167,334
Auction rate money market preferred	3,200		366	2,834
Preferred stocks	7,800	34	264	7,570
Mortgage-backed securities	104,992	2,268	289	106,971
Collateralized mortgage obligations	88,847	1,381	115	90,113
Total	**$ 373,607**	**$ 7,873**	**$ 1,255**	**$ 380,225**

	December 31, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	$ 5,394	$ 10	$	$ 5,404
States and political subdivisions	167,328	3,349	960	169,717
Auction rate money market preferred	3,200		335	2,865
Preferred stocks	7,800		864	6,936
Mortgage-backed securities	101,096	1,633	514	102,215
Collateralized mortgage obligations	44,617	103	1,133	43,587
Total	**$ 329,435**	**$ 5,095**	**$ 3,806**	**$ 330,724**

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The amortized cost and fair value of available-for-sale securities by contractual maturity at June 30, 2011 are as follows:

	Maturing				Securities	
	Due in One Year or Less	After One Year But Within Five Years	After Five Years But Within Ten Years	After Ten Years	With Variable Monthly Payments	Total
Government sponsored enterprises	$	$ 5,000	$ 394	$	$	$ 5,394
States and political subdivisions	3,583	33,405	84,853	41,533		163,374
Auction rate money market preferred					3,200	3,200
Preferred stocks					7,800	7,800
Mortgage-backed securities					104,992	104,992
Collateralized mortgage obligations					88,847	88,847
Total amortized cost	**$ 3,583**	**$ 38,405**	**$ 85,247**	**$ 41,533**	**$ 204,839**	**$ 373,607**
Fair value	**$ 3,574**	**$ 39,475**	**$ 87,853**	**$ 52,222**	**$ 197,101**	**$ 380,225**

Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.
Because of their variable monthly payments, auction rate money market preferreds, preferred stocks, mortgage-backed securities, and collateralized mortgage obligations are not reported by a specific maturity group.
A summary of the activity related to sales of available-for-sale securities is as follows during the six month periods ended June 30, 2010:

Proceeds from sales of securities	$ 3,722
Gross realized gains	$ 59
Gross realized losses	(3)
Net realized gains	$ 56
Applicable income tax expense	$ 19

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

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Information pertaining to available-for-sale securities with gross unrealized losses at June 30, 2011 and December 31, 2010 aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	June 30, 2011				
	Less Than Twelve Months		Over Twelve Months		
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Total Unrealized Losses
States and political subdivisions	$ 221	$ 13,555	$	$	$ 221
Auction rate money market preferred			366	2,834	366
Preferred stocks			264	3,536	264
Mortgage-backed securities	289	23,163			289
Collateralized mortgage obligations	115	4,898			115
Total	**$ 625**	**$ 41,616**	**$ 630**	**$ 6,370**	**$ 1,255**
Number of securities in an unrealized loss position:		**37**		**4**	**41**

	December 31, 2010				
	Less Than Twelve Months		Over Twelve Months		
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Total Unrealized Losses
States and political subdivisions	$ 960	$ 29,409	$	$	$ 960
Auction rate money market preferred			335	2,865	335
Preferred stocks			864	2,936	864
Mortgage-backed securities	514	38,734			514
Collateralized mortgage obligations	1,133	33,880			1,133
Total	**$ 2,607**	**$ 102,023**	**$ 1,199**	**$ 5,801**	**$ 3,806**
Number of securities in an unrealized loss position:		**82**		**4**	**86**

The Corporation invested $11,000 in auction rate money market preferred investment security instruments, which are classified as available-for-sale securities and reflected at estimated fair value. Due to credit market uncertainty, the trading for these securities has been limited. As a result of the limited trading of these securities, $7,800 converted to preferred stock with debt like characteristics in 2009.

Due to the limited trading activity of these securities, the fair values were estimated utilizing a hybrid of market value and discounted cash flow analysis as of June 30, 2011 and a discounted cash flow analysis as of December 31, 2010. These analyses considered creditworthiness of the counterparty, the timing of expected future cash flows, the current volume of trading activity, and recent trade prices. The discount rates used were determined by using the interest rates of similarly rated financial institutions debt based on the weighted average of a range of terms for corporate bond interest rates, which were obtained from published sources. All securities have call dates within the next year. The

Corporation calculated the present value assuming a 3 year nonamortizing balloon using weighted average discount rates between 5.70% and 6.97% as of June 30, 2011.

As of June 30, 2011, the Corporation held an auction rate money market preferred security and preferred stocks which continued to be in an unrealized loss position as a result of the securities interest rates, as they are currently lower than the offering rates of securities with similar characteristics. Despite the limited trading of these securities, management has determined that any declines in the fair value of these securities are the result of changes in interest rates and not risks related to the underlying credit quality of the security. Additionally, none of these securities are deemed to be below investment grade, and management does not intend to sell the securities in an unrealized loss position, and it is more likely than not that the Corporation will not have to sell the securities before recovery of their cost basis. As a result, the Corporation has not recognized an other-than-temporary impairment related to these declines in fair value.

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As of June 30, 2011 and December 31, 2010, management conducted an analysis to determine whether all securities currently in an unrealized loss position, including auction rate money market preferred securities and preferred stocks, should be considered other-than-temporarily-impaired (OTTI). Such analyses considered, among other factors, the following criteria:

- Has the value of the investment declined more than what is deemed to be reasonable based on a risk and maturity adjusted discount rate?
- Is the investment credit rating below investment grade?
- Is it probable that the issuer will be unable to pay the amount when due?
- Is it more likely than not that the Corporation will not have to sell the security before recovery of its cost basis?
- Has the duration of the investment been extended?

Based on the Corporation s analysis using the above criteria, the fact that management has asserted that it does not have the intent to sell these securities in an unrealized loss position, and that it is more likely than not the Corporation will not have to sell the securities before recovery of their cost basis, management does not believe that the values of any such securities are other-than-temporarily impaired as of June 30, 2011 or December 31, 2010.

NOTE 6 LOANS AND ALLOWANCE FOR LOAN LOSSES

A summary of the major classifications of loans is as follows as of:

	June 30 2011	December 31 2010
Mortgage loans on real estate		
Residential 1-4 family	$ 211,879	$ 207,749
Commercial	248,709	239,810
Agricultural	42,817	44,246
Construction and land development	9,838	12,250
Second mortgages	23,810	26,712
Equity lines of credit	38,663	37,318
Total mortgage loans	575,716	568,085
Commercial and agricultural loans		
Commercial	110,234	109,042
Agricultural production	29,309	27,200
Total commercial and agricultural loans	139,543	136,242
Consumer installment loans	31,035	30,977
Total loans	746,294	735,304
Less: allowance for loan losses	12,378	12,373
Net loans	**$ 733,916**	**$ 722,931**

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

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

The accrual of interest on mortgage and commercial 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. Credit card loans and other personal loans are typically charged off no later than 180 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

For loans that are placed on non-accrual status or charged off, all interest accrued in the current calendar year, but not collected, is reversed against interest income while interest accrued in prior calendar years, but not collected is charged against the allowance for loan losses. The interest on these loans is accounted for on the cash-basis, until qualifying for return to accrual status. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured. For impaired loans not classified as nonaccrual, interest income continues to be accrued over the term of the loan based on the principal amount outstanding.

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

The Corporation offers adjustable rate mortgages, fixed rate balloon mortgages, and fixed rate mortgage loans which typically have amortization periods up to a maximum of 30 years. Fixed rate loans with an amortization of greater than 15 years are generally sold upon origination to the Federal Home Loan Mortgage Association. Fixed rate residential mortgage loans with an amortization of 15 years or less may be held in the Corporation s portfolio, held for future sale, or sold upon origination. Factors used in determining when to sell these mortgages include management s judgment about the direction of interest rates, the Corporation s need for fixed rate assets in the management of its interest rate sensitivity, and overall loan demand.

Construction and land development loans consist primarily of 1 to 4 family residential properties. These loans primarily have a 6 to 9 month maturity and are made using the same underwriting criteria as residential mortgages. Loan proceeds are disbursed in increments as construction progresses and inspections warrant. Construction loans are typically converted to permanent loans at the completion of construction.

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

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

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A summary of changes in the allowance for loan losses by loan segments follows:

Allowance for Credit Losses and Recorded Investment in Financing Receivables
For the Three Months Ended June 30, 2011

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
Allowance for loan losses						
April 1, 2011	$ 6,246	$ 776	$ 3,422	$ 622	$ 1,315	$ 12,381
Loans charged off	(214)	(1)	(555)	(139)		(909)
Recoveries	209		29	65		303
Provision for loan losses	497	(11)	(11)	112	16	603
June 30, 2011	**$ 6,738**	**$ 764**	**$ 2,885**	**$ 660**	**$ 1,331**	**$ 12,378**

Allowance for Credit Losses and Recorded Investment in Financing Receivables
For the Six Months Ended June 30, 2011

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
Allowance for loan losses						
January 1, 2011	$ 6,048	$ 1,033	$ 3,198	$ 605	$ 1,489	$ 12,373
Loans charged off	(869)	(1)	(878)	(284)		(2,032)
Recoveries	346		103	168		617
Provision for loan losses	1,213	(268)	462	171	(158)	1,420
June 30, 2011	**$ 6,738**	**$ 764**	**$ 2,885**	**$ 660**	**$ 1,331**	**$ 12,378**
Allowance for loan losses as of June 30, 2011						
Individually evaluated for impairment	$ 485	$ 563	$ 812	$	$	$ 1,860
Collectively evaluated for impairment	6,253	201	2,073	660	1,331	10,518
Total	**$ 6,738**	**$ 764**	**$ 2,885**	**$ 660**	**$ 1,331**	**$ 12,378**
Loans as of June 30, 2011						
Individually evaluated for impairment	$ 10,224	$ 3,161	$ 5,598	$		$ 18,983
Collectively evaluated for impairment	348,719	68,965	278,592	31,035		727,311

Total	**$ 358,943**	**$ 72,126**	**$ 284,190**	**$ 31,035**	**$ 746,294**

Allowance for Credit Losses and Recorded Investment in Financing Receivables
As of December 31, 2010

	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
Allowance for loan losses						
Individually evaluated for impairment	$ 490	$ 558	$ 732	$	$	$ 1,780
Collectively evaluated for impairment	5,558	475	2,466	605	1,489	10,593
Total	**$ 6,048**	**$ 1,033**	**$ 3,198**	**$ 605**	**$ 1,489**	**$ 12,373**
Loans						
Individually evaluated for impairment	$ 4,890	$ 2,629	$ 4,866	$		$ 12,385
Collectively evaluated for impairment	343,962	68,817	279,163	30,977		722,919
Total	**$ 348,852**	**$ 71,446**	**$ 284,029**	**$ 30,977**		**$ 735,304**

Following is a summary of changes in the allowance for loan losses for the three and six months ended June 30, 2010:

	Three Months Ended June 30, 2010	Six Months Ended June 30, 2010
Balance at beginning of period	12,987	$ 12,979
Loans charged off	(1,366)	(2,969)
Recoveries	341	745
Provision charged to income	1,056	2,263
June 30, 2010	**$ 13,018**	**$ 13,018**

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

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

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

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

	June 30, 2011					
	Commercial			Agricultural		
	Real Estate	Other	Total	Real Estate	Other	Total
Rating						
1 - Excellent	$	$ 10	$ 10	$	$	$
2 - High quality	10,344	18,807	29,151	2,713	1,388	4,101
3 - High satisfactory	78,568	24,502	103,070	11,116	3,793	14,909
4 - Low satisfactory	120,620	56,494	177,114	22,727	15,352	38,079
5 - Special mention	21,839	7,514	29,353	3,879	4,118	7,997
6 - Substandard	13,156	2,859	16,015	2,192	4,123	6,315
7 - Vulnerable	377	1	378			
8 - Doubtful	3,805	47	3,852	190	535	725
Total	**$ 248,709**	**$ 110,234**	**$ 358,943**	**$ 42,817**	**$ 29,309**	**$ 72,126**

	December 31, 2010					
	Commercial			Agricultural		
	Real Estate	Other	Total	Real Estate	Other	Total
Rating						
2 - High quality	$ 10,995	$ 13,525	$ 24,520	$ 3,792	$ 1,134	$ 4,926
3 - High satisfactory	74,912	30,322	105,234	11,247	3,235	14,482
4 - Low satisfactory	119,912	57,403	177,315	22,384	14,862	37,246
5 - Special mention	19,560	6,507	26,067	4,169	3,356	7,525
6 - Substandard	10,234	1,104	11,338	2,654	4,613	7,267
7 - Vulnerable	3,339	54	3,393			
8 - Doubtful	858	127	985			
Total	**$ 239,810**	**$ 109,042**	**$ 348,852**	**$ 44,246**	**$ 27,200**	**$ 71,446**

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 abilities apparent yet unproven.

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

Loan structure generally in accordance with policy.

If secured, loan collateral coverage is marginal.

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

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

5. **SPECIAL MENTION- Criticized**

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

Downward trend in sales, profit levels and margins.

Impaired working capital position.

Cash flow is strained in order to meet debt repayment.

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

Shrinking equity cushion.

Diminishing primary source of repayment and questionable secondary source.

Management abilities are questionable.

Weak industry conditions.

Litigation pending against the borrower.

Loan may need to be restructured to improve collateral position or reduce payments.

Collateral / guaranty offers limited protection.

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

6. **SUBSTANDARD Classified**

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

Sustained losses have severely eroded the equity and cash flow.

Deteriorating liquidity.

Serious management problems or internal fraud.

Original repayment terms liberalized.

Likelihood of bankruptcy.

Inability to access other funding sources.

Reliance on secondary source of repayment.

Litigation filed against borrower.

Collateral provides little or no value.

Requires excessive attention of the loan officer.

Borrower is uncooperative with loan officer.

7. **VULNERABLE Classified**

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

Insufficient cash flow to service debt.

Minimal or no payments being received.

Limited options available to avoid the collection process.

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

8. **DOUBTFUL Workout**

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

Normal operations are severely diminished or have ceased.

Seriously impaired cash flow.

Original repayment terms materially altered.

Secondary source of repayment is inadequate.

Survivability as a going concern is impossible.

Collection process has begun.

Bankruptcy petition has been filed.

Judgments have been filed.

Portion of the loan balance has been charged-off.

9. **LOSS Charge off**

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

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

Fraudulently overstated assets and/or earnings.

Collateral has marginal or no value.

Debtor cannot be located.

Over 120 days delinquent.

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

	June 30, 2011					
	Accruing Interest and Past Due:			Total Past Due		
	30-89 Days	90 Days or More	Nonaccrual	and Nonaccrual	Current	Total
Commercial						
Commercial real estate	$ 1,713	$ 525	$ 3,442	$ 5,680	$ 243,029	$ 248,709
Commercial other	549		29	578	109,656	110,234
Total commercial	2,262	525	3,471	6,258	352,685	358,943
Agricultural						
Agricultural real estate	202		189	391	42,426	42,817
Agricultural other	3		535	538	28,771	29,309
Total agricultural	205		724	929	71,197	72,126
Residential mortgage						
Senior liens	2,044	139	1,790	3,973	217,744	221,717
Junior liens	173		55	228	23,582	23,810
Home equity lines of credit	663			663	38,000	38,663
Total residential mortgage	2,880	139	1,845	4,864	279,326	284,190
Consumer						
Secured	159	12		171	25,775	25,946
Unsecured	33			33	5,056	5,089
Total consumer	192	12		204	30,831	31,035
Total	**$ 5,539**	**$ 676**	**$ 6,040**	**$ 12,255**	**$ 734,039**	**$ 746,294**

	December 31, 2010					
	Accruing Interest and Past Due:			Total Past Due		
	30-89 Days	90 Days or More	Nonaccrual	and Nonaccrual	Current	Total
Commercial						
Commercial real estate	$ 4,814	$ 125	$ 4,001	$ 8,940	$ 230,870	$ 239,810
Commercial other	381		139	520	108,522	109,042

Total commercial	5,195	125	4,140	9,460	339,392	348,852
Agricultural						
Agricultural real estate	92			92	44,154	44,246
Agricultural other	4	50		54	27,146	27,200
Total agricultural	96	50		146	71,300	71,446
Residential mortgage						
Senior liens	5,265	310	1,421	6,996	213,003	219,999
Junior liens	476		49	525	26,187	26,712
Home equity lines of credit	598			598	36,720	37,318
Total residential mortgage	6,339	310	1,470	8,119	275,910	284,029
Consumer						
Secured	298			298	24,781	25,079
Unsecured	10	1		11	5,887	5,898
Total consumer	308	1		309	30,668	30,977
Total	**$ 11,938**	**$ 486**	**$ 5,610**	**$ 18,034**	**$ 717,270**	**$ 735,304**

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The following is a summary of information pertaining to impaired loans as of:

	June 30, 2011			December 31, 2010		
	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance
Impaired loans with a valuation allowance						
Commercial real estate	$ 3,969	$ 4,104	$ 485	$ 3,010	$ 4,110	$ 472
Commercial other				18	18	18
Agricultural other	1,356	1,356	563	2,196	2,196	558
Residential mortgage senior liens	5,398	6,717	774	4,292	5,236	698
Residential mortgage junior liens	200	277	38	172	250	34
Total impaired loans with a valuation allowance	**$ 10,923**	**$ 12,454**	**$ 1,860**	**$ 9,688**	&nb	