

ISABELLA BANK CORP  
Form 10-Q  
November 07, 2014  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended September 30, 2014  
or

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File Number: 0-18415

Isabella Bank Corporation  
(Exact name of registrant as specified in its charter)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  Yes  No

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

Large accelerated filer  Accelerated filer

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

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

The number of shares outstanding of the registrant's Common Stock (no par value) was 7,762,481 as of November 4, 2014.

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## Forward Looking Statements

This report contains certain forward looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. We intend such forward looking statements to be covered by the safe harbor provisions for forward looking statements contained in the Private Securities Litigation Reform Act of 1995, and are included in this statement for purposes of these safe harbor provisions. Forward looking statements, which are based on certain assumptions and describe future plans, strategies and expectations, are generally identifiable by use of the words “believe,” “expect,” “intend,” “anticipate,” “estimate,” “project” and similar expressions. Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse effect on the operations and future prospects include, but are not limited to, changes in: interest rates, general economic conditions, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the FRB, the quality or composition of the loan or investment portfolios, demand for loan products, fluctuation in the value of collateral securing our loan portfolio, deposit flows, competition, demand for financial services in our market area, and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating forward looking statements and undue reliance should not be placed on such statements. Further information concerning our business, including additional factors that could materially affect our financial results, is included in our filings with the SEC.

The acronyms and abbreviations identified below may be used throughout this Quarterly Report on Form 10-Q, or in our other filings. You may find it helpful to refer back to this page while reading this report.

AFS: Available-for-sale	GAAP: U.S. generally accepted accounting principles
ALLL: Allowance for loan and lease losses	GLB Act: Gramm-Leach-Bliley Act of 1999
AOCI: Accumulated other comprehensive income (loss)	IFRS: International Financial Reporting Standards
ASC: FASB Accounting Standards Codification	IRR: Interest rate risk
ASU: FASB Accounting Standards Update	JOBS Act: Jumpstart our Business Startups Act
ATM: Automated Teller Machine	LIBOR: London Interbank Offered Rate
BHC Act: Bank Holding Company Act of 1956	N/A: Not applicable
CFPB: Consumer Financial Protection Bureau	N/M: Not meaningful
CIK: Central Index Key	NASDAQ: NASDAQ Stock Market Index
CRA: Community Reinvestment Act	NASDAQ Banks: NASDAQ Bank Stock Index
DIF: Deposit Insurance Fund	NAV: Net asset value
DIFS: Department of Insurance and Financial Services	NOW: Negotiable order of withdrawal
Directors Plan: Isabella Bank Corporation and Related Companies Deferred Compensation Plan for Directors	NSF: Non-sufficient funds
Dividend Reinvestment Plan: Isabella Bank Corporation Stockholder Dividend Reinvestment Plan and Employee Stock Purchase Plan	OCI: Other comprehensive income (loss)
Dodd-Frank Act: Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010	OMSRs: Originated mortgage servicing rights
ESOP: Employee stock ownership plan	OREO: Other real estate owned
Exchange Act: Securities Exchange Act of 1934	OTTI: Other-than-temporary impairment
FASB: Financial Accounting Standards Board	PBO: Projected benefit obligation
FDI Act: Federal Deposit Insurance Act	PCAOB: Public Company Accounting Oversight Board
FDIC: Federal Deposit Insurance Corporation	Rabbi Trust: A trust established to fund the Directors Plan
FFIEC: Federal Financial Institutions Examinations Council	SEC: U.S. Securities & Exchange Commission
FRB: Federal Reserve Bank	SOX: Sarbanes-Oxley Act of 2002
FHLB: Federal Home Loan Bank	TDR: Troubled debt restructuring
Freddie Mac: Federal Home Loan Mortgage Corporation	XBRL: eXtensible Business Reporting Language
FTE: Fully taxable equivalent	



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## PART I – FINANCIAL INFORMATION

## Item 1. Interim Condensed Consolidated Financial Statements (Unaudited)

## INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)

	September 30 2014	December 31 2013
<b>ASSETS</b>		
Cash and cash equivalents		
Cash and demand deposits due from banks	\$22,431	\$21,755
Interest bearing balances due from banks	3,100	19,803
Total cash and cash equivalents	25,531	41,558
Certificates of deposit held in other financial institutions	580	580
Trading securities	—	525
AFS securities (amortized cost of \$572,087 in 2014 and \$517,614 in 2013)	575,080	512,062
Mortgage loans AFS	421	1,104
<b>Loans</b>		
Commercial	416,824	392,104
Agricultural	101,795	92,589
Residential real estate	271,033	289,931
Consumer	32,647	33,413
Gross loans	822,299	808,037
Less allowance for loan and lease losses	10,400	11,500
Net loans	811,899	796,537
Premises and equipment	25,843	25,719
Corporate owned life insurance policies	24,957	24,401
Accrued interest receivable	6,906	5,442
Equity securities without readily determinable fair values	19,063	18,293
Goodwill and other intangible assets	46,168	46,311
Other assets	17,526	20,605
<b>TOTAL ASSETS</b>	<b>\$1,553,974</b>	<b>\$1,493,137</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Deposits</b>		
Noninterest bearing	\$175,634	\$158,428
NOW accounts	192,211	192,089
Certificates of deposit under \$100 and other savings	468,909	455,547
Certificates of deposit over \$100	245,136	237,702
Total deposits	1,081,890	1,043,766
Borrowed funds	290,438	279,326
Accrued interest payable and other liabilities	9,570	9,436
Total liabilities	1,381,898	1,332,528
<b>Shareholders' equity</b>		
Common stock — no par value 15,000,000 shares authorized; issued and outstanding 7,741,530 shares (including 10,579 shares held in the Rabbi Trust) in 2014 and 7,723,023 shares (including 12,761 shares held in the Rabbi Trust) in 2013	138,023	137,580
Shares to be issued for deferred compensation obligations	4,129	4,148
Retained earnings	30,410	25,222
Accumulated other comprehensive income (loss)	(486	) (6,341
Total shareholders' equity	172,076	160,609
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$1,553,974</b>	<b>\$1,493,137</b>

See notes to interim condensed consolidated financial statements.

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## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Dollars in thousands except per share amounts)

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2014	2013	2014	2013
Interest income				
Loans, including fees	\$9,863	\$10,330	\$29,413	\$30,940
AFS securities				
Taxable	2,016	1,787	6,007	5,419
Nontaxable	1,485	1,275	4,428	3,753
Trading securities	—	7	6	30
Federal funds sold and other	119	106	384	331
Total interest income	13,483	13,505	40,238	40,473
Interest expense				
Deposits	1,562	1,742	4,767	5,438
Borrowings	936	994	2,699	2,900
Total interest expense	2,498	2,736	7,466	8,338
Net interest income	10,985	10,769	32,772	32,135
Provision for loan losses	(162	) 351	(604	) 866
Net interest income after provision for loan losses	11,147	10,418	33,376	31,269
Noninterest income				
Service charges and fees	1,366	1,700	4,120	4,426
Net gain on sale of mortgage loans	170	215	436	822
Earnings on corporate owned life insurance policies	182	185	556	544
Net gains (losses) on sale of AFS securities	97	72	97	171
Other	401	690	1,690	2,082
Total noninterest income	2,216	2,862	6,899	8,045
Noninterest expenses				
Compensation and benefits	5,174	5,340	16,045	16,021
Furniture and equipment	1,348	1,303	3,835	3,684
Occupancy	697	676	2,115	1,982
Other	2,295	2,001	6,305	6,148
Total noninterest expenses	9,514	9,320	28,300	27,835
Income before federal income tax expense	3,849	3,960	11,975	11,479
Federal income tax expense	444	674	1,696	1,893
NET INCOME	\$3,405	\$3,286	\$10,279	\$9,586
Earnings per common share				
Basic	\$0.44	\$0.43	\$1.33	\$1.25
Diluted	\$0.43	\$0.42	\$1.30	\$1.22
Cash dividends per common share	\$0.22	\$0.21	\$0.66	\$0.63

See notes to interim condensed consolidated financial statements.

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## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Dollars in thousands)

	Three Months Ended		Nine Months Ended		
	September 30		September 30		
	2014	2013	2014	2013	
Net income	\$3,405	\$3,286	\$10,279	\$9,586	
Unrealized gains (losses) on AFS securities					
Unrealized gains (losses) arising during the period	(1,326	) 665	8,642	(13,293	)
Reclassification adjustment for net realized (gains) losses included in net income	(97	) (72	) (97	) (171	)
Net unrealized gains (losses)	(1,423	) 593	8,545	(13,464	)
Tax effect (1)	469	(447	) (2,690	) 4,455	
Other comprehensive income (loss), net of tax	(954	) 146	5,855	(9,009	)
Comprehensive income (loss)	\$2,451	\$3,432	\$16,134	\$577	

(1) See "Note 11 – Accumulated Other Comprehensive Income (Loss)" for tax effect reconciliation.

See notes to interim condensed consolidated financial statements.



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## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(Dollars in thousands except per share amounts)

	Common Stock		Shares to be	Retained	Accumulated	Totals
	Shares	Amount	Issued for	Earnings	Other	
	Outstanding		Deferred		Comprehensive	
			Compensation		Income (Loss)	
			Obligations			
Balance, January 1, 2013	7,671,846	\$ 136,580	\$ 3,734	\$ 19,168	\$ 5,007	\$ 164,489
Comprehensive income (loss)	—	—	—	9,586	(9,009 )	577
Issuance of common stock	111,904	2,754	—	—	—	2,754
Common stock issued for deferred compensation obligations	—	—	—	—	—	—
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	122	(122 )	—	—	—
Share-based payment awards under equity compensation plan	—	—	423	—	—	423
Common stock purchased for deferred compensation obligations	—	(285 )	—	—	—	(285 )
Common stock repurchased pursuant to publicly announced repurchase plan	(73,969 )	(1,815 )	—	—	—	(1,815 )
Cash dividends (\$0.63 per share)	—	—	—	(4,838 )	—	(4,838 )
Balance, September 30, 2013	7,709,781	\$ 137,356	\$ 4,035	\$ 23,916	\$ (4,002 )	\$ 161,305
Balance, January 1, 2014	7,723,023	\$ 137,580	\$ 4,148	\$ 25,222	\$ (6,341 )	\$ 160,609
Comprehensive income (loss)	—	—	—	10,279	5,855	16,134
Issuance of common stock	122,261	2,845	—	—	—	2,845
Common stock issued for deferred compensation obligations	6,126	143	(143 )	—	—	—
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	258	(258 )	—	—	—
Share-based payment awards under equity compensation plan	—	—	382	—	—	382
Common stock purchased for deferred compensation obligations	—	(253 )	—	—	—	(253 )
Common stock repurchased pursuant to publicly announced repurchase plan	(110,680 )	(2,550 )	—	—	—	(2,550 )
Cash dividends (\$0.66 per share)	—	—	—	(5,091 )	—	(5,091 )

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Balance, September 30, 2014	7,740,730	\$ 138,023	\$ 4,129	\$ 30,410	\$ (486	)	\$ 172,076
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See notes to interim condensed consolidated financial statements.

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## INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

	Nine Months Ended September 30	
	2014	2013
<b>OPERATING ACTIVITIES</b>		
Net income	\$10,279	\$9,586
Reconciliation of net income to net cash provided by operating activities:		
Provision for loan losses	(604	) 866
Impairment of foreclosed assets	83	131
Depreciation	1,902	1,903
Amortization of OMSRs	206	453
Amortization of acquisition intangibles	143	171
Net amortization of AFS securities	1,382	1,595
Net (gains) losses on sale of AFS securities	(97	) (171
Net unrealized (gains) losses on trading securities	5	23
Net gain on sale of mortgage loans	(436	) (822
Increase in cash value of corporate owned life insurance policies	(556	) (544
Share-based payment awards under equity compensation plan	382	423
Origination of loans held-for-sale	(21,746	) (45,992
Proceeds from loan sales	22,865	49,735
Net changes in operating assets and liabilities which provided (used) cash:		
Trading securities	520	805
Accrued interest receivable	(1,464	) (1,357
Other assets	(958	) 319
Accrued interest payable and other liabilities	134	622
Net cash provided by (used in) operating activities	12,040	17,746
<b>INVESTING ACTIVITIES</b>		
Net change in certificates of deposit held in other financial institutions	—	2,420
Activity in AFS securities		
Sales	13,362	16,229
Maturities and calls	47,527	70,164
Purchases	(116,647	) (98,328
Loan principal (originations) collections, net	(15,952	) (37,385
Proceeds from sales of foreclosed assets	1,482	1,788
Purchases of premises and equipment	(2,026	) (2,134
Purchases of corporate owned life insurance policies	—	(1,092
Proceeds from redemption of corporate owned life insurance policies	—	196
Net cash provided by (used in) investing activities	(72,254	) (48,142

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

(Dollars in thousands)

	Nine Months Ended September 30	
	2014	2013
<b>FINANCING ACTIVITIES</b>		
Net increase (decrease) in deposits	38,124	6,264
Increase (decrease) in borrowed funds	11,112	25,000
Cash dividends paid on common stock	(5,091	) (4,838
Proceeds from issuance of common stock	2,845	2,754
Common stock repurchased	(2,550	) (1,815
Common stock purchased for deferred compensation obligations	(253	) (285
Net cash provided by (used in) financing activities	44,187	27,080
Increase (decrease) in cash and cash equivalents	(16,027	) (3,316
Cash and cash equivalents at beginning of period	41,558	24,920
Cash and cash equivalents at end of period	\$25,531	\$21,604
<b>SUPPLEMENTAL CASH FLOWS INFORMATION:</b>		
Interest paid	\$7,536	\$8,376
Federal income taxes paid	979	1,333
<b>SUPPLEMENTAL NONCASH INFORMATION:</b>		
Transfers of loans to foreclosed assets	\$1,194	\$1,087

See notes to interim condensed consolidated financial statements.

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## NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands except per share amounts)

## Note 1 – Basis of Presentation

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

The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with GAAP for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In our opinion, all adjustments considered necessary for a fair presentation have been included. Operating results for the three and nine month periods ended September 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. For further information, refer to the consolidated financial statements and footnotes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2013. Our accounting policies are materially the same as those discussed in Note 1 to the Consolidated Financial Statements included in our Annual Report on Form 10-K for the year ended December 31, 2013.

## Note 2 – Computation of Earnings Per Common Share

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

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

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2014	2013	2014	2013
Average number of common shares outstanding for basic calculation	7,733,362	7,698,066	7,725,706	7,689,350
Average potential effect of common shares in the Directors Plan (1)	170,897	170,420	170,955	168,020
Average number of common shares outstanding used to calculate diluted earnings per common share	7,904,259	7,868,486	7,896,661	7,857,370
Net income	\$3,405	\$3,286	\$10,279	\$9,586
Earnings per common share				
Basic	\$0.44	\$0.43	\$1.33	\$1.25
Diluted	\$0.43	\$0.42	\$1.30	\$1.22

(1) Exclusive of shares held in the Rabbi Trust

## Note 3 – Pending Accounting Standards Updates

ASU No. 2014-01: "Accounting for Investments in Qualified Affordable Housing Projects (a consensus of the FASB Emerging Issues Task Force)"

In January 2014, ASU No. 2014-01 amended ASC Topic 323, "Investments" to allow investors in low income housing tax credits to use the proportional amortization method if the following criteria are met:

- It is probable that the tax credits allocable to the investor will be available.
- The investor does not have the ability to exercise significant influence over the operating and financial policies of the limited liability entity.
- Substantially all of the projected benefits are from tax credits and other tax benefits (e.g., operating losses).
- The investor's projected yield is based solely on the cash flows from the tax credits and other tax benefits are positive.
- The investor is a limited liability investor in the limited liability entity for both legal and tax purposes, and the investor's liability is limited to its capital investment.



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Investors that do not meet the above criteria must utilize the cost method or equity method in accordance with previously issued authoritative accounting guidance. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2014 and is not expected to have a significant impact on our operations. ASU No. 2014-04: “Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)”

In January 2014, ASU No. 2014-04 amended ASC Topic 310, “Receivables” to reduce diversity by clarifying when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2014 and is not expected to have a significant impact on our operations.

ASU No. 2014-11: “Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures”

In June 2014, ASU No. 2014-11 amended ASC Topic 860, “Transfers and Servicing” to address concerns that current accounting guidance distinguishes between repurchase agreements that settle at the same time as the maturity of the transferred financial asset and those that settle any time before maturity. The update changes the accounting for repurchase-to-maturity transactions to secured borrowing accounting and, for repurchase financing arrangements, separate accounting for a transfer of a financial asset executed contemporaneously with a repurchase agreement with the same counterparty, which will result in secured borrowing accounting for the repurchase agreement. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2014 and is not expected to impact our financial statement disclosures.

ASU No. 2014-14: “Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)”

In August 2014, ASU No. 2014-14 amended ASC Topic 310, “Receivables” to provide specific guidance on how to classify and measure foreclosed loans that are government guaranteed. The update requires that a mortgage loan be derecognized and that a separate other receivable be recognized upon foreclosure if the following conditions are met:

• The loan has a government guarantee that is not separable from the loan before foreclosure.

• At the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim.

• At the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed.

Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. The new authoritative guidance is effective for interim and annual periods beginning after December 15, 2014 and is not expected to have a significant impact on our operations.

ASU No. 2014-15: “Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern”

In August 2014, ASU No. 2014-15 amended ASC Topic 205, “Presentation of Financial Statements” to provide guidance on how to determine whether to disclose relevant conditions or events that raise substantial doubt about the entity’s ability to continue as a going concern. If conditions or events raise substantial doubt about an entity’s ability to continue as a going concern, financial statements would continue to be prepared under the going concern assumption; however, disclosures may be necessary depending upon the conditions or events raising substantial doubt.

Additionally, if identified substantial doubt is not alleviated after consideration of management’s plans, an entity should include a statement in the footnotes indicating that there is substantial doubt about the entity’s ability to continue as a going concern within one year after the date that the financial statements are issued (or available to be issued). The new authoritative guidance is effective for annual periods beginning after December 15, 2016 and is not expected to impact our financial statement disclosures.

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## Note 4 – AFS Securities

The amortized cost and fair value of AFS securities, with gross unrealized gains and losses, are as follows at:  
September 30, 2014

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	\$24,645	\$5	\$733	\$23,917
States and political subdivisions	217,195	7,337	987	223,545
Auction rate money market preferred	3,200	—	337	2,863
Preferred stocks	6,800	13	640	6,173
Mortgage-backed securities	171,856	1,144	2,233	170,767
Collateralized mortgage obligations	148,391	1,361	1,937	147,815
Total	\$572,087	\$9,860	\$6,867	\$575,080

December 31, 2013

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	\$24,860	\$7	\$1,122	\$23,745
States and political subdivisions	200,323	5,212	3,547	201,988
Auction rate money market preferred	3,200	—	623	2,577
Preferred stocks	6,800	20	993	5,827
Mortgage-backed securities	147,292	657	3,834	144,115
Collateralized mortgage obligations	135,139	1,016	2,345	133,810
Total	\$517,614	\$6,912	\$12,464	\$512,062

The amortized cost and fair value of AFS securities by contractual maturity at September 30, 2014 are as follows:

	Maturing				Securities with Variable Monthly Payments or Noncontractual Maturities	
	Due in One Year or Less	After One Year But Within Five Years	After Five Years But Within Ten Years	After Ten Years	Total	Total
Government sponsored enterprises	\$—	\$9,068	\$15,577	\$—	\$ —	\$24,645
States and political subdivisions	16,838	52,050	98,035	50,272	—	217,195
Auction rate money market preferred	—	—	—	—	3,200	3,200
Preferred stocks	—	—	—	—	6,800	6,800
Mortgage-backed securities	—	—	—	—	171,856	171,856
Collateralized mortgage obligations	—	—	—	—	148,391	148,391
Total amortized cost	\$16,838	\$61,118	\$113,612	\$50,272	\$ 330,247	\$572,087
Fair value	\$16,883	\$63,150	\$116,389	\$51,040	\$ 327,618	\$575,080

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





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A summary of the sales activity of AFS securities was as follows for the three and nine month periods ended:

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2014	2013	2014	2013
Proceeds from sales of AFS securities	\$13,362	\$6,372	\$13,362	\$16,229
Gross realized gains (losses)	\$97	\$72	\$97	\$171
Applicable income tax expense (benefit)	\$33	\$24	\$33	\$58

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

Information pertaining to AFS securities with gross unrealized losses at September 30, 2014 and December 31, 2013, respectively, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	September 30, 2014				
	Less Than Twelve Months		Twelve Months or More		Total Unrealized Losses
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	
Government sponsored enterprises	\$—	\$—	\$733	\$23,262	
States and political subdivisions	106	10,836	881	21,430	987
Auction rate money market preferred	—	—	337	2,863	337
Preferred stocks	—	—	640	3,160	640
Mortgage-backed securities	165	33,358	2,068	62,800	2,233
Collateralized mortgage obligations	323	44,308	1,614	40,702	1,937
Total	\$594	\$88,502	\$6,273	\$154,217	\$6,867
Number of securities in an unrealized loss position:		77		96	173

	December 31, 2013				
	Less Than Twelve Months		Twelve Months or More		Total Unrealized Losses
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	
Government sponsored enterprises	\$1,122	\$22,873	\$—	\$—	
States and political subdivisions	2,566	42,593	981	6,115	3,547
Auction rate money market preferred	—	—	623	2,577	623
Preferred stocks	—	—	993	2,807	993
Mortgage-backed securities	2,424	101,816	1,410	21,662	3,834
Collateralized mortgage obligations	2,345	84,478	—	—	2,345
Total	\$8,457	\$251,760	\$4,007	\$33,161	\$12,464
Number of securities in an unrealized loss position:		182		19	201

As of September 30, 2014 and December 31, 2013, we conducted an analysis to determine whether any securities currently in an unrealized loss position should be other-than-temporarily impaired. Such analyses considered, among other factors, the following criteria:

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

• Is the 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 have to sell the security before recovery of its cost basis?

• Has the duration of the investment been extended?

Based on our analyses, the fact that we have asserted that we do not have the intent to sell AFS securities in an unrealized loss position, and considering it is unlikely that we will have to sell AFS securities in an unrealized loss

position before recovery of

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their cost basis, we do not believe that the values of any AFS securities are other-than-temporarily impaired as of September 30, 2014, or December 31, 2013.

Note 5 – Loans and ALLL

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

Loans that we have the intent and ability to hold in our portfolio are reported at their outstanding principal balance adjusted for any charge-offs, the ALLL, and any deferred fees or costs. Interest income is accrued over the term of the loan based on the principal amount outstanding. Loan origination fees and certain direct loan origination costs are capitalized and recognized as a component of interest income over the term of the loan using the level yield method. The accrual of interest on commercial, agricultural, and residential real estate loans is typically discontinued at the time the loan is 90 days or more past due unless the credit is well-secured and in the process of collection. 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. 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. Loans are typically returned to accrual status after six months of continuous performance. For impaired loans not classified as nonaccrual, interest income continues to be accrued over the term of the loan based on the principal amount outstanding.

Commercial and agricultural loans include loans for commercial real estate, commercial operating loans, farmland and agricultural production, and states and political subdivisions. Repayment of these loans is often dependent upon the successful operation and management of a business. We minimize our risk by limiting the amount of credit exposure to any one borrower to \$15,000. Borrowers with credit needs of more than \$15,000 are serviced through the use of loan participations with other commercial banks. Commercial and agricultural real estate loans generally require loan-to-value limits of less than 80%. Depending upon the type of loan, past credit history, and current operating results, we may require the borrower to pledge accounts receivable, inventory, and property and equipment. Personal guarantees are generally required from the owners of closely held corporations, partnerships, and sole proprietorships. In addition, we require annual financial statements, prepare cash flow analyses, and review credit reports as deemed necessary.

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

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 \$500 require the approval of our Internal Loan Committee, the Executive Loan Committee, the Board of Directors' Loan Committee, or the Board of Directors.

Consumer loans include secured and unsecured personal loans. Loans are amortized for a period of up to 12 years based on the age and value of the underlying collateral. 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.

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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 uncollectability 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 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 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 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. Historical loss allocations were calculated at the loan class and segment levels based on a migration analysis of the loan portfolio over the preceding five years. An unallocated component is maintained to cover uncertainties that we believe affect our estimate of probable losses based on qualitative factors. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

	Allowance for Loan Losses Three Months Ended September 30, 2014					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
July 1, 2014	\$5,012	\$219	\$3,981	\$802	\$686	\$10,700
Loans charged-off	(163)	) —	(180)	) (73)	) —	(416)
Recoveries	171	—	68	39	—	278
Provision for loan losses	(704)	) (31)	) 92	(47)	) 528	(162)
September 30, 2014	\$4,316	\$188	\$3,961	\$721	\$1,214	\$10,400
	Allowance for Loan Losses Nine Months Ended September 30, 2014					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2014	\$6,048	\$434	\$3,845	\$639	\$534	\$11,500
Loans charged-off	(434)	) (31)	) (557)	) (255)	) —	(1,277)
Recoveries	477	—	190	114	—	781
Provision for loan losses	(1,775)	) (215)	) 483	223	680	(604)
September 30, 2014	\$4,316	\$188	\$3,961	\$721	\$1,214	\$10,400
	Allowance for Loan Losses and Recorded Investment in Loans September 30, 2014					
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	\$1,318	\$—	\$2,335	\$1	\$—	\$3,654
Collectively evaluated for impairment	2,998	188	1,626	720	1,214	6,746
Total	\$4,316	\$188	\$3,961	\$721	\$1,214	\$10,400
Loans						
Individually evaluated for impairment	\$11,955	\$1,625	\$12,925	\$69		\$26,574

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Collectively evaluated for impairment	404,869	100,170	258,108	32,578	795,725
Total	\$416,824	\$101,795	\$271,033	\$32,647	\$822,299

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Allowance for Loan Losses Three Months Ended September 30, 2013						
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
July 1, 2013	\$6,472	\$335	\$3,676	\$647	\$570	\$11,700
Loans charged-off	(394 )	(12 )	(94 )	(102 )	—	(602 )
Recoveries	66	—	38	47	—	151
Provision for loan losses	69	108	127	74	(27 )	351
September 30, 2013	\$6,213	\$431	\$3,747	\$666	\$543	\$11,600
Allowance for Loan Losses Nine Months Ended September 30, 2013						
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
January 1, 2013	\$6,862	\$407	\$3,627	\$666	\$374	\$11,936
Loans charged-off	(839 )	(12 )	(681 )	(311 )	—	(1,843 )
Recoveries	289	—	152	200	—	641
Provision for loan losses	(99 )	36	649	111	169	866
September 30, 2013	\$6,213	\$431	\$3,747	\$666	\$543	\$11,600

Allowance for Loan Losses and Recorded Investment in Loans December 31, 2013						
	Commercial	Agricultural	Residential Real Estate	Consumer	Unallocated	Total
ALLL						
Individually evaluated for impairment	\$2,035	\$30	\$2,287	\$—	\$—	\$4,352
Collectively evaluated for impairment	4,013	404	1,558	639	534	7,148
Total	\$6,048	\$434	\$3,845	\$639	\$534	\$11,500
Loans						
Individually evaluated for impairment	\$13,816	\$1,538	\$14,302	\$119		\$29,775
Collectively evaluated for impairment	378,288	91,051	275,629	33,294		778,262
Total	\$392,104	\$92,589	\$289,931	\$33,413		\$808,037

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

Rating	September 30, 2014					
	Commercial			Agricultural		
	Real Estate	Other	Total	Real Estate	Other	Total
2 - High quality	\$14,268	\$10,078	\$24,346	\$6,138	\$3,899	\$10,037
3 - High satisfactory	90,321	47,674	137,995	27,278	13,181	40,459
4 - Low satisfactory	186,866	41,368	228,234	30,556	16,908	47,464
5 - Special mention	9,859	1,343	11,202	1,729	68	1,797
6 - Substandard	12,139	137	12,276	1,658	265	1,923
7 - Vulnerable	2,579	179	2,758	115	—	115
8 - Doubtful	—	13	13	—	—	—
Total	\$316,032	\$100,792	\$416,824	\$67,474	\$34,321	\$101,795





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Rating	December 31, 2013					
	Commercial			Agricultural		
	Real Estate	Other	Total	Real Estate	Other	Total
2 - High quality	\$18,671	\$14,461	\$33,132	\$3,527	\$3,235	\$6,762
3 - High satisfactory	91,323	39,403	130,726	26,015	17,000	43,015
4 - Low satisfactory	149,921	43,809	193,730	26,874	10,902	37,776
5 - Special mention	13,747	1,843	15,590	1,609	922	2,531
6 - Substandard	16,974	473	17,447	1,232	1,273	2,505
7 - Vulnerable	1,041	238	1,279	—	—	—
8 - Doubtful	183	17	200	—	—	—
Total	\$291,860	\$100,244	\$392,104	\$59,257	\$33,332	\$92,589

Internally assigned credit 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 credit 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.

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4. LOW SATISFACTORY – Acceptable Risk

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

• Would include most start-up businesses.

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

• Management's abilities are apparent, yet unproven.

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

• Loan structure generally in accordance with policy.

• If secured, loan collateral coverage is marginal.

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

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

5. SPECIAL MENTION – Criticized

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

• Downward trend in sales, profit levels, and margins.

• Impaired working capital position.

• Cash flow is strained in order to meet debt repayment.

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

• Shrinking equity cushion.

• Diminishing primary source of repayment and questionable secondary source.

• Management abilities are questionable.

• Weak industry conditions.

• Litigation pending against the borrower.

• Collateral or guaranty offers limited protection.

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

6. SUBSTANDARD – Classified

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

• Sustained losses have severely eroded the equity and cash flow.

• Deteriorating liquidity.

• Serious management problems or internal fraud.

• Original repayment terms liberalized.

• Likelihood of bankruptcy.

• Inability to access other funding sources.

• Reliance on secondary source of repayment.

• Litigation filed against borrower.

• Collateral provides little or no value.

• Requires excessive attention of the loan officer.

• Borrower is uncooperative with loan officer.

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.

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## 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.

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

	September 30, 2014						
	Accruing Interest and Past Due:				Total Past Due and Nonaccrual	Current	Total
	30-59 Days	60-89 Days	90 Days or More	Nonaccrual			
Commercial							
Commercial real estate	\$315	\$58	\$—	\$2,579	\$2,952	\$313,080	\$316,032
Commercial other	582	—	—	179	761	100,031	100,792
Total commercial	897	58	—	2,758	3,713	413,111	416,824
Agricultural							
Agricultural real estate	—	—	—	115	115	67,359	67,474
Agricultural other	76	—	—	—	76	34,245	34,321
Total agricultural	76	—	—	115	191	101,604	101,795
Residential real estate							
Senior liens	1,373	254	138	1,220	2,985	215,295	218,280
Junior liens	265	—	—	135	400	11,397	11,797
Home equity lines of credit	330	38	—	258	626	40,330	40,956
Total residential real estate	1,968	292	138	1,613	4,011	267,022	271,033
Consumer							
Secured	86	—	—	10	96	28,303	28,399
Unsecured	12	—	26	—	38	4,210	4,248
Total consumer	98	—	26	10	134	32,513	32,647
Total	\$3,039	\$350	\$164	\$4,496	\$8,049	\$814,250	\$822,299

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	December 31, 2013				Total Past Due and Nonaccrual	Current	Total
	Accruing Interest and Past Due:		90 Days or More	Nonaccrual			
	30-59 Days	60-89 Days					
Commercial							
Commercial real estate	\$ 1,226	\$ 296	\$—	\$ 1,136	\$ 2,658	\$ 289,202	\$ 291,860
Commercial other	368	15	13	238	634	99,610	100,244
Total commercial	1,594	311	13	1,374	3,292	388,812	392,104
Agricultural							
Agricultural real estate	34	295	—	—	329	58,928	59,257
Agricultural other	—	—	—	—	—	33,332	33,332
Total agricultural	34	295	—	—	329	92,260	92,589
Residential real estate							
Senior liens	3,441	986	129	1,765	6,321	229,865	236,186
Junior liens	408	44	—	29	481	13,074	13,555
Home equity lines of credit	181	—	—	25	206	39,984	40,190
Total residential real estate	4,030	1,030	129	1,819	7,008	282,923	289,931
Consumer							
Secured	167	11	—	50	228	28,444	28,672
Unsecured	25	5	—	1	31	4,710	4,741
Total consumer	192	16	—	51	259	33,154	33,413
Total	\$ 5,850	\$ 1,652	\$ 142	\$ 3,244	\$ 10,888	\$ 797,149	\$ 808,037

## 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 and agricultural 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. Impairment is measured on a loan-by-loan basis for residential real estate and consumer loans by comparing the loan's unpaid principal balance to the present value of expected future cash flows discounted at the loan's effective interest rate.

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We do not recognize interest income on impaired loans in nonaccrual status. For impaired loans not in nonaccrual status, interest income is recognized daily, as earned, according to the terms of the loan agreement. The following is a summary of information pertaining to impaired loans as of:

	September 30, 2014			December 31, 2013		
	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance
Impaired loans with a valuation allowance						
Commercial real estate	\$7,614	\$7,732	\$1,314	\$6,748	\$6,888	\$1,915
Commercial other	548	767	4	521	521	120
Agricultural real estate	—	—	—	90	90	30
Residential real estate senior liens	12,425	13,679	2,259	14,061	15,315	2,278
Residential real estate junior liens	241	251	50	48	64	9
Home equity lines of credit	259	659	26	—	—	—
Consumer secured	59	59	1	—	—	—
Total impaired loans with a valuation allowance	21,146	23,147	3,654	21,468	22,878	4,352
Impaired loans without a valuation allowance						
Commercial real estate	3,480	3,958		5,622	6,499	
Commercial other	313	324		925	1,035	
Agricultural real estate	1,558	1,558		1,370	1,370	
Agricultural other	67	187		78	198	
Home equity lines of credit	—	—		193	493	
Consumer secured	10	10		119	148	
Total impaired loans without a valuation allowance	5,428	6,037		8,307	9,743	
Impaired loans						
Commercial	11,955	12,781	1,318	13,816	14,943	2,035
Agricultural	1,625	1,745	—	1,538	1,658	30
Residential real estate	12,925	14,589	2,335	14,302	15,872	2,287
Consumer	69	69	1	119	148	—
Total impaired loans	\$26,574	\$29,184	\$3,654	\$29,775	\$32,621	\$4,352

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

	Three Months Ended		Nine Months Ended	
	September 30, 2014		September 30, 2014	
	Average Outstanding Balance	Interest Income Recognized	Average Outstanding Balance	Interest Income Recognized
Impaired loans with a valuation allowance				
Commercial real estate	\$7,063	\$106	\$6,822	\$291
Commercial other	589	11	746	40
Agricultural real estate	102	—	113	—
Agricultural other	—	—	—	—
Residential real estate senior liens	12,440	124	12,938	388
Residential real estate junior liens	167	(8	) 94	(7
Home equity lines of credit	310	2	220	13
Consumer secured	62	1	72	3
Total impaired loans with a valuation allowance	20,733	236	21,005	728
Impaired loans without a valuation allowance				
Commercial real estate	4,594	69	5,396	262
Commercial other	314	5	397	12
Agricultural real estate	1,460	22	1,425	59
Agricultural other	43	1	112	29
Home equity lines of credit	—	—	32	—
Consumer secured	10	—	5	—
Total impaired loans without a valuation allowance	6,421	97	7,367	362
Impaired loans				
Commercial	12,560	191	13,361	605
Agricultural	1,605	23	1,650	88
Residential real estate	12,917	118	13,284	394
Consumer	72	1	77	3
Total impaired loans	\$27,154	\$333	\$28,372	\$1,090



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	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013	
	Average Outstanding Balance	Interest Income Recognized	Average Outstanding Balance	Interest Income Recognized
Impaired loans with a valuation allowance				
Commercial real estate	\$6,471	\$ 157	\$7,546	\$378
Commercial other	1,063	29	976	67
Agricultural real estate	91	2	91	4
Agricultural other	—	—	70	—
Residential real estate senior liens	10,865	230	10,595	439
Residential real estate junior liens	80	4	84	5
Home equity lines of credit	—	—	—	—
Consumer secured	—	—	—	—
Total impaired loans with a valuation allowance	18,570	422	19,362	893
Impaired loans without a valuation allowance				
Commercial real estate	4,531	169	4,037	327
Commercial other	833	29	1,029	88
Agricultural real estate	231	15	144	19
Agricultural other	361	2	402	(2)
Home equity lines of credit	173	8	178	17
Consumer secured	60	1	66	3
Total impaired loans without a valuation allowance	6,189	224	5,856	452
Impaired loans				
Commercial	12,898	384	13,588	860
Agricultural	683	19	707	21
Residential real estate	11,118	242	10,857	461
Consumer	60	1	66	3
Total impaired loans	\$24,759	\$646	\$25,218	\$1,345

As of September 30, 2014 and December 31, 2013, we had committed to advance \$65 and \$134, respectively, in connection with impaired loans, which include TDRs.

**Troubled Debt Restructurings**

Loan modifications are considered to be TDRs 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 loans with similar risk characteristics.
3. Forgiving principal.
4. Forgiving accrued interest.

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

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).

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The following is a summary of information pertaining to TDRs granted for the:

	Three Months Ended September 30, 2014			Nine Months Ended September 30, 2014		
	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
Commercial other	2	\$ 23	\$ 23	7	\$ 386	\$ 386
Agricultural other	1	49	49	1	49	49
Residential real estate						
Senior liens	2	144	144	14	805	805
Junior liens	1	40	40	2	81	81
Home equity lines of credit	—	—	—	1	160	160
Total residential real estate	3	184	184	17	1,046	1,046
Consumer unsecured	1	10	10	4	18	18
Total	7	\$ 266	\$ 266	29	\$ 1,499	\$ 1,499
	Three Months Ended September 30, 2013			Nine Months Ended September 30, 2013		
	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
Commercial other	3	\$ 159	\$ 159	10	\$ 3,313	\$ 3,116
Agricultural other	1	198	198	2	332	332
Residential real estate						
Senior liens	15	1,176	1,176	30	2,611	2,595
Junior liens	1	20	20	1	20	20
Home equity lines of credit	—	—	—	—	—	—
Total residential real estate	16	1,196	1,196	31	2,631	2,615
Consumer unsecured	2	34	34	2	34	34
Total	22	\$ 1,587	\$ 1,587	45	\$ 6,310	\$ 6,097

The following tables summarize concessions we granted to borrowers in financial difficulty for the:

	Three Months Ended September 30, 2014				Nine Months Ended September 30, 2014			
	Below Market Interest Rate		Below Market Interest Rate and Extension of Amortization Period		Below Market Interest Rate		Below Market Interest Rate and Extension of Amortization Period	
	Number of Loans	Pre-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment
Commercial other	2	\$ 23	—	\$ —	6	\$ 378	1	\$ 8
Agricultural other	—	—	1	49	—	—	1	49
Residential real estate								
Senior liens	—	—	2	144	3	98	11	707
Junior liens	—	—	1	40	—	—	2	81
Home equity lines of credit	—	—	—	—	1	160	—	—
Total residential real estate	—	—	3	184	4	258	13	788
Consumer unsecured	1	10	—	—	3	15	1	3
Total	3	\$ 33	4	\$ 233	13	\$ 651	16	\$ 848



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	Three Months Ended September 30, 2013				Nine Months Ended September 30, 2013			
	Below Market Interest Rate		Below Market Interest Rate and Extension of Amortization Period		Below Market Interest Rate		Below Market Interest Rate and Extension of Amortization Period	
	Number of Loans	Pre-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment	Number of Loans	Pre-Modification Recorded Investment
Commercial other	3	\$ 159	—	\$ —	6	\$ 1,517	4	\$ 1,796
Agricultural other	1	198	—	—	2	332	—	—
Residential real estate								
Senior liens	10	924	5	252	17	1,548	13	1,063
Junior liens	—	—	1	20	—	—	1	20
Home equity lines of credit	—	—	—	—	—	—	—	—
Total residential real estate	10	924	6	272	17	1,548	14	1,083
Consumer unsecured	1	16	1	18	1	16	1	18
Total	15	\$ 1,297	7	\$ 290	26	\$ 3,413	19	\$ 2,897

We did not restructure any loans by forgiving principal or accrued interest in the three and nine month periods ended September 30, 2014 or 2013.

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

Following is a summary of loans that defaulted in the three and nine month periods ended September 30, 2014, which were modified within 12 months prior to the default date:

	Three Months Ended September 30, 2014				Nine Months Ended September 30, 2014			
	Number of Loans	Pre-Default Recorded Investment	Charge-Off Recorded Upon Default	Post-Default Recorded Investment	Number of Loans	Pre-Default Recorded Investment	Charge-Off Recorded Upon Default	Post-Default Recorded Investment
Consumer unsecured	2	\$7	\$7	\$—	2	\$7	\$7	\$—

We had no loans that defaulted in the three and nine month periods ended September 30, 2013, which were modified within 12 months prior to the default date.

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

	September 30, 2014	December 31, 2013
TDRs	\$24,015	\$25,865

#### Note 6 – 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 unconsolidated entities accounted for under the equity method of accounting.

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

	September 30, 2014	December 31, 2013
FHLB Stock	\$9,100	\$8,100
Corporate Settlement Solutions, LLC	6,743	6,970
FRB Stock	1,879	1,879
Valley Financial Corporation	1,000	1,000

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Other	341	344
Total	\$19,063	\$18,293

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## Note 7 – Borrowed Funds

Borrowed funds consist of the following obligations as of:

	September 30, 2014		December 31, 2013		
	Amount	Rate	Amount	Rate	
FHLB advances	\$ 182,000	1.94	% \$ 162,000	2.02	%
Securities sold under agreements to repurchase without stated maturity dates	89,535	0.13	% 106,025	0.13	%
Securities sold under agreements to repurchase with stated maturity dates	1,203	4.24	% 11,301	3.30	%
Federal funds purchased	17,700	0.56	% —	—	
Total	\$ 290,438	1.31	% \$ 279,326	1.35	%

FHLB advances are collateralized by a blanket lien on all qualified 1-4 family residential real estate loans, AFS securities, and FHLB stock.

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

	September 30, 2014		December 31, 2013		
	Amount	Rate	Amount	Rate	
Fixed rate advances due 2014	\$ 10,000	0.48	% \$ 10,000	0.48	%
Fixed rate advances due 2015	42,000	0.72	% 32,000	0.84	%
Fixed rate advances due 2016	10,000	2.15	% 10,000	2.15	%
Fixed rate advances due 2017	30,000	1.95	% 30,000	1.95	%
Fixed rate advances due 2018	40,000	2.35	% 40,000	2.35	%
Fixed rate advances due 2019	20,000	3.11	% 20,000	3.11	%
Fixed rate advances due 2020	10,000	1.98	% 10,000	1.98	%
Fixed rate advances due 2021	10,000	2.37	% —	—	
Fixed rate advances due 2023	10,000	3.90	% 10,000	3.90	%
Total	\$ 182,000	1.94	% \$ 162,000	2.02	%

Securities sold under agreements to repurchase are classified as secured borrowings and are reflected at the amount of cash received in connection with the transaction. The securities underlying the agreements have a carrying value and a fair value of \$139,350 and \$148,930 at September 30, 2014 and December 31, 2013, respectively. Such securities remain under our control. We may be required to provide additional collateral based on the fair value of underlying securities.

The following table lists the maturity and weighted average interest rates of securities sold under agreements to repurchase with stated maturity dates as of:

	September 30 2014		December 31 2013		
	Amount	Rate	Amount	Rate	
Repurchase agreements due 2014	\$ 750	4.89	% \$ 10,876	3.30	%
Repurchase agreements due 2015	436	3.25	% 425	3.25	%
Repurchase agreements due 2018	17	1.00	% —	—	
Total	\$ 1,203	4.24	% \$ 11,301	3.30	%

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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 securities sold under repurchase agreements without stated maturity dates, federal funds purchased, and FRB Discount Window advances borrowings for the three and nine month periods ended:

	Three Months Ended September 30, 2014				Three Months Ended September 30, 2013			
	Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period		Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period	
Securities sold under agreements to repurchase without stated maturity dates	\$91,472	\$88,906	0.13	%	\$81,405	\$78,148	0.15	%
Federal funds purchased	17,700	2,252	0.48	%	6,300	5,052	0.62	%
	Nine Months Ended September 30, 2014				Nine Months Ended September 30, 2013			
	Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period		Maximum Month End Balance	Average Balance	Weighted Average Interest Rate During the Period	
Securities sold under agreements to repurchase without stated maturity dates	\$94,741	\$91,231	0.13	%	\$81,405	\$69,224	0.15	%
Federal funds purchased	17,700	4,939	0.48	%	13,700	4,133	0.57	%

We had pledged trading securities, AFS securities, and 1-4 family residential real estate loans in the following amounts at:

	September 30 2014	December 31 2013
Pledged to secure borrowed funds	\$278,512	\$320,173
Pledged to secure repurchase agreements	139,350	148,930
Pledged for public deposits and for other purposes necessary or required by law	18,791	20,922
Total	\$436,653	\$490,025

As of September 30, 2014, we had the ability to borrow up to an additional \$111,890, based on assets pledged as collateral. We had no investment securities that are restricted to be pledged for specific purposes.

## Note 8 – Other Noninterest Expenses

A summary of expenses included in other noninterest expenses is as follows for the:

	Three Months Ended September 30		Nine Months Ended September 30	
	2014	2013	2014	2013
Marketing and community relations	\$512	\$271	\$966	\$945
FDIC insurance premiums	196	267	619	812
Directors fees	191	203	569	607
Audit and related fees	185	189	505	490
Education and travel	154	110	418	348
Postage and freight	105	103	303	296
Printing and supplies	89	106	278	291
Loan underwriting fees	83	97	270	336
Consulting fees	96	68	263	223
All other	684	587	2,114	1,800

Total other	\$2,295	\$2,001	\$6,305	\$6,148
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## Note 9 – Federal Income Taxes

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

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	2014	2013	2014	2013
Income taxes at 34% statutory rate	\$1,309	\$1,347	\$4,072	\$3,903
Effect of nontaxable income				
Interest income on tax exempt municipal securities	(501	) (433	) (1,498	) (1,278
Earnings on corporate owned life insurance policies	(62	) (63	) (189	) (185
Effect of tax credits	(187	) (191	) (575	) (588
Other	(158	) (27	) (235	) (79
Total effect of nontaxable income	(908	) (714	) (2,497	) (2,130
Effect of nondeductible expenses	43	41	121	120
Federal income tax expense	\$444	\$674	\$1,696	\$1,893

## Note 10 – 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 cash equivalents: The carrying amounts of cash and demand deposits due from banks and interest bearing balances due from banks approximate fair values. As such, we classify cash and cash equivalents as Level 1.

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

AFS and trading securities: AFS and trading 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.

Mortgage loans AFS: Mortgage loans AFS are carried at the lower of cost or fair value. The fair value of Mortgage loans AFS are based on what price secondary markets are currently offering for portfolios with similar characteristics. As such, we classify Mortgage loans AFS 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. 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 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. 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.



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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, we utilize independent appraisals, broker price opinions, or internal evaluations. We review these valuations 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 specific reserves or charge-offs 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. The following tables list the quantitative fair value information about impaired loans as of:

		September 30, 2014	
Valuation Techniques	Fair Value	Unobservable Input	Range
		Discount applied to collateral appraisal:	
		Real Estate	20% - 25%
		Equipment	30% - 40%
Discounted appraisal value	\$8,535	Cash crop inventory	40%
		Other inventory	75%
		Accounts receivable	50%
		Liquor license	75%
		December 31, 2013	
Valuation Techniques	Fair Value	Unobservable Input	Range
		Discount applied to collateral appraisal:	
		Real Estate	20% - 30%
		Equipment	50%
Discounted appraisal value	\$13,902	Livestock	50%
		Cash crop inventory	50%
		Other inventory	75%
		Accounts receivable	75%

Discount factors with ranges are based on the age of the independent appraisal, broker price opinion, or internal evaluations.

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

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, LLC and Valley Financial Corporation. The investment in Corporate Settlement Solutions, LLC, a title insurance company, was made in the first quarter 2008. We are not the managing entity of Corporate Settlement Solutions, LLC, and therefore, we account for our investment under the equity method of accounting. Valley Financial Corporation is the parent company of 1st State Bank in Saginaw, Michigan, which is a community bank that opened in 2005. We 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 2014 and 2013, there were no impairments recorded on equity securities without readily determinable fair values.

Foreclosed assets: Upon transfer from the loan portfolio, foreclosed assets (which are included in other 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. Due to the inherent level of estimation in the valuation process, we record foreclosed assets as nonrecurring Level 3.



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The table below lists the quantitative fair value information related to foreclosed assets as of:

Valuation Techniques	September 30, 2014		
	Fair Value	Unobservable Input	Range
Discounted appraisal value	\$1,041	Discount applied to collateral appraisal: Real Estate	20% - 25%
Valuation Techniques	December 31, 2013		
	Fair Value	Unobservable Input	Range
Discounted appraisal value	\$1,412	Discount applied to collateral appraisal: Real Estate	20% - 30%

Discount factors with ranges are based on the age of the independent appraisal, broker price opinion, or internal evaluations.

**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 2014 and 2013, there were no impairments recorded on goodwill and other acquisition intangibles.

**OMSRs:** OMSRs (which are included in other assets) are subject to impairment testing. To test for impairment, we utilize a discounted cash flow analysis using interest rates and prepayment speed assumptions currently quoted for comparable instruments and discount rates. If the valuation model reflects a value less than the carrying value, OMSRs are adjusted to fair value through a valuation allowance as determined by the model. As such, we classify OMSRs subject to nonrecurring fair value adjustments as Level 2.

**Deposits:** The fair value of demand, savings, and money market deposits are, by definition, equal their carrying amounts and are classified as Level 1. Fair values for variable rate certificates of deposit approximate their 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, fixed rate 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. As such, borrowed funds are classified as Level 2.

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

**Commitments to extend credit, standby letters of credit, and undisbursed loans:** Our commitments to extend credit, standby letters of credit, and undisbursed funds have no carrying amount and are estimated to have no realizable fair value. Historically, a majority of the unused commitments to extend credit have not been drawn upon and, generally, we do not receive fees in connection with these commitments other than standby letter of credit fees, which are not significant.

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. 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 were as follows as of:

	September 30, 2014				
	Carrying Value	Estimated Fair Value	(Level 1)	(Level 2)	(Level 3)
<b>ASSETS</b>					
Cash and cash equivalents	\$25,531	\$25,531	\$25,531	\$—	\$—
Certificates of deposit held in other financial institutions	580	580	—	580	—
Mortgage loans AFS	421	434	—	434	—
Total loans	822,299	822,077	—	—	822,077
Less allowance for loan and lease losses	10,400	10,400	—	—	10,400
Net loans	811,899	811,677	—	—	811,677
Accrued interest receivable	6,906	6,906	6,906	—	—
Equity securities without readily determinable fair values (1)	19,063	19,063	—	—	—
OMSRs	2,577	2,655	—	2,655	—
<b>LIABILITIES</b>					
Deposits without stated maturities	637,320	637,320	637,320	—	—
Deposits with stated maturities	444,570	445,129	—	445,129	—
Borrowed funds	290,438	293,881	—	293,881	—
Accrued interest payable	563	563	563	—	—
	December 31, 2013				
	Carrying Value	Estimated Fair Value	(Level 1)	(Level 2)	(Level 3)
<b>ASSETS</b>					
Cash and cash equivalents	\$41,558	\$41,558	\$41,558	\$—	\$—
Certificates of deposit held in other financial institutions	580	582	—	582	—
Mortgage loans AFS	1,104	1,123	—	1,123	—
Total loans	808,037	808,246	—	—	808,246
Less allowance for loan and lease losses	11,500	11,500	—	—	11,500
Net loans	796,537	796,746	—	—	796,746
Accrued interest receivable	5,442	5,442	5,442	—	—
Equity securities without readily determinable fair values (1)	18,293	18,293	—	—	—
OMSRs	2,555	2,667	—	2,667	—
<b>LIABILITIES</b>					
Deposits without stated maturities	593,754	593,754	593,754	—	—
Deposits with stated maturities	450,012	452,803	—	452,803	—
Borrowed funds	279,326	283,060	—	283,060	—
Accrued interest payable	633	633	633	—	—

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

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## Financial Instruments Recorded at Fair Value

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

	September 30, 2014				December 31, 2013				
	Total	(Level 1)	(Level 2)	(Level 3)	Total	(Level 1)	(Level 2)	(Level 3)	
Recurring items									
Trading securities									
States and political subdivisions	\$—	\$—	\$—	\$—	\$525	\$—	\$525	\$—	
AFS securities									
Government-sponsored enterprises	23,917	—	23,917	—	23,745	—	23,745	—	
States and political subdivisions	223,545	—	223,545	—	201,988	—	201,988	—	
Auction rate money market preferred	2,863	—	2,863	—	2,577	—	2,577	—	
Preferred stocks	6,173	6,173	—	—	5,827	5,827	—	—	
Mortgage-backed securities	170,767	—	170,767	—	144,115	—	144,115	—	
Collateralized mortgage obligations	147,815	—	147,815	—	133,810	—	133,810	—	
Total AFS securities	575,080	6,173	568,907	—	512,062	5,827	506,235	—	
Nonrecurring items									
Impaired loans (net of the ALLL)	8,535	—	—	8,535	13,902	—	—	13,902	
Foreclosed assets	1,041	—	—	1,041	1,412	—	—	1,412	
Total	\$584,656	\$6,173	\$568,907	\$9,576	\$527,901	\$5,827	\$506,760	\$15,314	
Percent of assets and liabilities measured at fair value		1.06	% 97.31	% 1.63		1.10	% 96.00	% 2.90	%

The following table provides a summary of 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 gains or losses were recognized in the:

	Three Months Ended September 30, 2014			2013		
	Trading Losses	Other Gains (Losses)	Total	Trading Losses	Other Gains (Losses)	Total
Recurring items						
Trading securities	\$—	\$—	\$—	\$(5)	\$—	\$(5)
Nonrecurring items						
Foreclosed assets	—	(20)	(20)	—	(39)	(39)
Total	\$—	\$(20)	\$(20)	\$(5)	\$(39)	\$(44)
	Nine Months Ended September 30, 2014			2013		
	Trading Losses	Other Gains (Losses)	Total	Trading Losses	Other Gains (Losses)	Total
Recurring items						
Trading securities	\$(5)	\$—	\$(5)	\$(23)	\$—	\$(23)
Nonrecurring items						
Foreclosed assets	—	(83)	(83)	—	(131)	(131)



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Total                    \$(5            ) \$(83            ) \$(88            ) \$(23            ) \$(131            ) \$(154            )

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## Note 11 – Accumulated Other Comprehensive Income (Loss)

The following table summarizes the changes in AOCI by component for the:

	Three Months Ended September 30			2013		
	2014		Total	Unrealized		Total
	Unrealized Holding Gains (Losses) on AFS Securities	Defined Benefit Pension Plan		Unrealized Holding Gains (Losses) on AFS Securities	Defined Benefit Pension Plan	
Balance, July 1	\$2,602	\$(2,134)	\$468	\$(477)	\$(3,671)	\$(4,148)
OCI before reclassifications	(1,326)	—	(1,326)	665	—	665
Amounts reclassified from AOCI	(97)	—	(97)	(72)	—	(72)
Subtotal	(1,423)	—	(1,423)	593	—	593
Tax effect	469	—	469	(447)	—	(447)
OCI, net of tax	(954)	—	(954)	146	—	146
Balance, September 30	\$1,648	\$(2,134)	\$(486)	\$(331)	\$(3,671)	\$(4,002)
	Nine Months Ended September 30			2013		
	2014		Total	Unrealized		Total
	Unrealized Holding Gains (Losses) on AFS Securities	Defined Benefit Pension Plan		Unrealized Holding Gains (Losses) on AFS Securities	Defined Benefit Pension Plan	
Balance, January 1	\$(4,207)	\$(2,134)	\$(6,341)	\$8,678	\$(3,671)	\$5,007
OCI before reclassifications	8,642	—	8,642	(13,293)	—	(13,293)
Amounts reclassified from AOCI	(97)	—	(97)	(171)	—	(171)
Subtotal	8,545	—	8,545	(13,464)	—	(13,464)
Tax effect	(2,690)	—	(2,690)	4,455	—	4,455
OCI, net of tax	5,855	—	5,855	(9,009)	—	(9,009)
Balance, September 30	\$1,648	\$(2,134)	\$(486)	\$(331)	\$(3,671)	\$(4,002)

Included in OCI for the three and nine month periods ended September 30, 2014 and 2013 are changes in unrealized holding gains and losses related to auction rate money market preferred and preferred stocks. For federal income tax purposes, these securities are considered equity investments. As such, no deferred federal income taxes related to unrealized holding gains or losses are expected or recorded.

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

	Three Months Ended September 30			2013		
	2014		Total	Auction Rate		Total
	Auction Rate Money Market Preferred and Preferred Stocks	All Other AFS Securities		Auction Rate Money Market Preferred and Preferred Stocks	All Other AFS Securities	
Unrealized gains (losses) arising during the period	\$253	\$(1,579)	\$(1,326)	\$(653)	\$1,318	\$665
Reclassification adjustment for net realized (gains) losses included in net income	—	(97)	(97)	—	(72)	(72)

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Net unrealized gains (losses)	253	(1,676	) (1,423	) (653	) 1,246	593
Tax effect	—	469	469	—	(447	) (447
Unrealized gains (losses), net of tax	\$253	\$(1,207	) \$(954	) \$(653	) \$799	\$146

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	Nine Months Ended September 30			2013		
	2014			Auction Rate		
	Auction Rate	All Other	Total	Auction Rate	All Other	Total
	Money	AFS		Money	AFS	
	Market	Securities		Market	Securities	
	Preferred and			Preferred and		
	Preferred			Preferred		
	Stocks			Stocks		
Unrealized gains (losses) arising during the period	\$253	\$8,389	\$8,642	\$(358)	\$(12,935)	\$(13,293)
Reclassification adjustment for net realized (gains) losses included in net income	—	(97)	(97)	—	(171)	(171)
Net unrealized gains (losses)	253	8,292	8,545	(358)	(13,106)	(13,464)
Tax effect	—	(2,690)	(2,690)	—	4,455	4,455
Unrealized gains (losses), net of tax	\$253	\$5,602	\$5,855	\$(358)	\$(8,651)	\$(9,009)

The following table details reclassification adjustments and the related affected line items on our interim condensed consolidated statements of income for the noted periods:

Details about AOCI components	Amount Reclassified from AOCI		Affected Line Item in the Interim Condensed Consolidated Statements of Income		
	Three Months Ended September 30 2014	September 30 2013	Nine Months Ended September 30 2014	September 30 2013	
Unrealized holding gains (losses) on AFS securities	\$97	\$72	\$97	\$171	Net gains (losses) on sale of AFS securities
	97	72	97	171	Income before federal income tax expense
	33	24	33	58	Federal income tax expense
	\$64	\$48	\$64	\$113	Net income

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Interim Condensed Balance Sheets

	September 30 2014	December 31 2013
<b>ASSETS</b>		
Cash on deposit at the Bank	\$2,353	\$529
AFS securities	3,279	3,542
Investments in subsidiaries	121,580	110,192
Premises and equipment	1,959	2,013
Other assets	54,604	54,223
<b>TOTAL ASSETS</b>	<b>\$183,775</b>	<b>\$170,499</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Other liabilities	\$11,699	\$9,890
Shareholders' equity	172,076	160,609
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$183,775</b>	<b>\$170,499</b>

## Interim Condensed Statements of Income

	Three Months Ended September 30		Nine Months Ended September 30	
	2014	2013	2014	2013
<b>Income</b>				
Dividends from subsidiaries	\$1,750	\$1,500	\$4,750	\$4,500
Interest income	36	39	114	123
Management fee and other	717	637	1,945	1,704
<b>Total income</b>	<b>2,503</b>	<b>2,176</b>	<b>6,809</b>	<b>6,327</b>
<b>Expenses</b>				
Compensation and benefits	866	680	2,470	2,061
Occupancy and equipment	293	132	514	362
Audit and related fees	109	98	278	256
Other	360	230	926	731
<b>Total expenses</b>	<b>1,628</b>	<b>1,140</b>	<b>4,188</b>	<b>3,410</b>
Income before income tax benefit and equity in undistributed earnings of subsidiaries	875	1,036	2,621	2,917
Federal income tax benefit	298	161	730	549
Income before equity in undistributed earnings of subsidiaries	1,173	1,197	3,351	3,466
Undistributed earnings of subsidiaries	2,232	2,089	6,928	6,120
<b>Net income</b>	<b>\$3,405</b>	<b>\$3,286</b>	<b>\$10,279</b>	<b>\$9,586</b>

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## Interim Condensed Statements of Cash Flows

	Nine Months Ended September 30	
	2014	2013
Operating activities		
Net income	\$10,279	\$9,586
Adjustments to reconcile net income to cash provided by operations		
Undistributed earnings of subsidiaries	(6,928	) (6,120
Undistributed earnings of equity securities without readily determinable fair values	231	14
Share-based payment awards	382	423
Depreciation	109	136
Net amortization of AFS securities	1	1
Changes in operating assets and liabilities which provided (used) cash		
Other assets	89	(65
Accrued interest and other liabilities	1,242	939
Net cash provided by (used in) operating activities	5,405	4,914
Investing activities		
Maturities, calls, and sales of AFS securities	250	395
Purchases of premises and equipment	(23	) (140
Advances to subsidiaries, net of repayments	641	(99
Net cash provided by (used in) investing activities	868	156
Financing activities		
Net increase (decrease) in borrowed funds	600	(800
Cash dividends paid on common stock	(5,091	) (4,838
Proceeds from the issuance of common stock	2,845	2,754
Common stock repurchased	(2,550	) (1,815
Common stock purchased for deferred compensation obligations	(253	) (285
Net cash provided by (used in) financing activities	(4,449	) (4,984
Increase (decrease) in cash and cash equivalents	1,824	86
Cash and cash equivalents at beginning of period	529	332
Cash and cash equivalents at end of period	\$2,353	\$418

## Note 13 – Operating Segments

Our reportable segments are based on legal entities that account for at least 10% of net operating results. The operations of the Bank as of September 30, 2014 and 2013 and each of the three and nine month periods then ended, represent approximately 90% or more of our consolidated total assets and operating results. As such, no additional segment reporting is presented.

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

ISABELLA BANK CORPORATION FINANCIAL REVIEW

(Dollars in thousands except per share amounts)

This section reviews our financial condition and results of our operations for the three and nine month periods ended September 30, 2014 and 2013. This analysis should be read in conjunction with our 2013 Annual Report on Form 10-K and with the unaudited interim condensed consolidated financial statements and notes, beginning on page 4 of this report.

Executive Summary

During the three and nine month periods ended September 30, 2014, we reported record net income of \$3,405 and \$10,279 and earnings per common share of \$0.44 and \$1.33, respectively. Our continued strong earnings have primarily been the result of a continued improvement in various credit quality indicators. These improvements continue to drive declines in the level of the ALLL in both amount and as a percentage of gross loans, resulting in a reversal of provision for loan losses of \$604 for the nine month period ended September 30, 2014. Net loans charged-off during the first nine months of 2014 were \$496 as compared to \$1,202 in the first nine months of 2013. Additionally, we continue to see reductions in loans classified as less than satisfactory. While we experienced reductions in net loans charged-off and in the level of loans classified as less than satisfactory, nonaccrual loans have increased since December 31, 2013. This increase was primarily the result of one loan being classified as nonaccrual in the first quarter of 2014. This loan is well collateralized and closely monitored by management.

While competition for high quality commercial loans continues to be intense, we were able to grow our commercial loan portfolio in the first nine months of 2014 by \$24,720 without relaxing our underwriting standards. The growth in commercial and agricultural loans was partially offset by declines in both residential real estate and consumer loans, resulting in a net increase in total loans of \$14,262 for the year. The lack of demand for residential real estate loans continues to result in noticeable declines in loan fees and the gain on sale of mortgage loans.

We anticipate that competition for commercial loans will continue to be significant, residential mortgage loan activity will remain soft, and growing our deposit base will be challenging throughout the foreseeable future. Despite these challenges, our unwavering commitment to core community banking principles and long term sustainable growth has, and will continue to, enable us to meet the needs of the communities we serve and increase shareholder value.

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## Results of Operations

The following table outlines our results of operations and provides certain performance measures as of, and for the three month periods ended:

	September 30 2014	June 30 2014	March 31 2014	December 31 2013	September 30 2013	
<b>INCOME STATEMENT DATA</b>						
Interest income	\$13,483	\$13,391	\$13,364	\$13,603	\$13,505	
Interest expense	2,498	2,468	2,500	2,683	2,736	
Net interest income	10,985	10,923	10,864	10,920	10,769	
Provision for loan losses	(162 )	(200 )	(242 )	245	351	
Noninterest income	2,216	2,434	2,249	2,130	2,862	
Noninterest expenses	9,514	9,300	9,486	9,578	9,320	
Federal income tax expense	444	692	560	303	674	
Net Income	\$3,405	\$3,565	\$3,309	\$2,924	\$3,286	
<b>PER SHARE</b>						
Basic earnings	\$0.44	\$0.46	\$0.43	\$0.38	\$0.43	
Diluted earnings	\$0.43	\$0.45	\$0.42	\$0.37	\$0.42	
Dividends	\$0.22	\$0.22	\$0.22	\$0.21	\$0.21	
Tangible book value*	\$16.33	\$16.08	\$15.82	\$15.62	\$15.43	
<b>Market value</b>						
High	\$24.00	\$23.50	\$23.94	\$24.84	\$25.50	
Low	\$21.73	\$22.44	\$21.73	\$21.12	\$23.40	
Close*	\$23.60	\$22.95	\$23.00	\$23.85	\$24.85	
Common shares outstanding*	7,740,730	7,735,156	7,727,547	7,723,023	7,709,781	
<b>PERFORMANCE RATIOS (annualized)</b>						
Return on average total assets	0.89	% 0.95	% 0.88	% 0.80	% 0.91	%
Return on average shareholders' equity	7.91	% 8.43	% 8.04	% 7.18	% 8.27	%
Return on average tangible shareholders' equity	10.88	% 11.59	% 10.92	% 9.78	% 11.16	%
Net interest margin yield (FTE)	3.39	% 3.43	% 3.42	% 3.50	% 3.48	%
<b>BALANCE SHEET DATA*</b>						
Gross loans	\$822,299	\$816,307	\$808,411	\$808,037	\$807,849	
AFS securities	\$575,080	\$550,518	\$555,144	\$512,062	\$501,057	
Total assets	\$1,553,974	\$1,522,135	\$1,513,371	\$1,493,137	\$1,459,341	
Deposits	\$1,081,890	\$1,060,928	\$1,065,935	\$1,043,766	\$1,023,931	
Borrowed funds	\$290,438	\$279,457	\$272,536	\$279,326	\$266,001	
Shareholders' equity	\$172,076	\$171,099	\$165,971	\$160,609	\$161,305	
Gross loans to deposits	76.01	% 76.94	% 75.84	% 77.42	% 78.90	%
<b>ASSETS UNDER MANAGEMENT*</b>						
Loans sold with servicing retained	\$290,697	\$290,590	\$292,382	\$293,665	\$294,999	
Assets managed by our Investment and Trust Services Department	\$374,878	\$374,092	\$358,811	\$351,420	\$351,505	
Total assets under management	\$2,219,549	\$2,186,817	\$2,164,564	\$2,138,222	\$2,105,845	
<b>ASSET QUALITY*</b>						
Nonperforming loans to gross loans	0.57	% 0.58	% 0.65	% 0.42	% 0.53	%
Nonperforming assets to total assets	0.37	% 0.38	% 0.42	% 0.32	% 0.37	%
ALLL to gross loans	1.26	% 1.31	% 1.37	% 1.42	% 1.44	%
<b>CAPITAL RATIOS*</b>						



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Shareholders' equity to assets	11.07	% 11.24	% 10.97	% 10.76	% 11.05	%
Tier 1 capital to average assets	8.47	% 8.50	% 8.38	% 8.46	% 8.45	%
Tier 1 risk-based capital	13.86	% 13.84	% 13.88	% 13.67	% 13.75	%
Total risk-based capital	15.11	% 15.09	% 15.13	% 14.92	% 15.00	%

\* At end of period

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The following table outlines our results of operations and provides certain performance measures as of, and for the nine month periods ended:

	September 30 2014	September 30 2013	September 30 2012	September 30 2011	September 30 2010	
<b>INCOME STATEMENT DATA</b>						
Interest income	\$40,238	\$40,473	\$42,556	\$43,439	\$42,677	
Interest expense	7,466	8,338	10,372	12,224	12,987	
Net interest income	32,772	32,135	32,184	31,215	29,690	
Provision for loan losses	(604 )	866	1,100	2,383	3,231	
Noninterest income	6,899	8,045	8,844	5,785	6,671	
Noninterest expenses	28,300	27,835	27,889	25,879	25,249	
Federal income tax expense	1,696	1,893	2,344	1,239	1,154	
Net Income	\$10,279	\$9,586	\$9,695	\$7,499	\$6,727	
<b>PER SHARE</b>						
Basic earnings	\$1.33	\$1.25	\$1.28	\$0.99	\$0.89	
Diluted earnings	\$1.30	\$1.22	\$1.24	\$0.97	\$0.87	
Dividends	\$0.66	\$0.63	\$0.60	\$0.57	\$0.54	
Tangible book value*	\$16.33	\$15.43	\$14.65	\$20.53	\$19.59	
<b>Market value</b>						
High	\$24.00	\$26.00	\$24.98	\$19.25	\$19.00	
Low	\$21.73	\$21.55	\$22.30	\$17.10	\$15.75	
Close*	\$23.60	\$24.85	\$22.50	\$18.75	\$17.39	
Common shares outstanding*	7,740,730	7,709,781	7,611,350	7,578,257	7,532,859	
<b>PERFORMANCE RATIOS (annualized)</b>						
Return on average total assets	0.90	% 0.89	% 0.94	% 0.79	% 0.77	%
Return on average shareholders' equity	8.13	% 7.84	% 8.37	% 6.84	% 6.35	%
Return on average tangible shareholders' equity	10.95	% 11.02	% 11.96	% 10.17	% 9.54	%
Net interest margin yield (FTE)	3.41	% 3.50	% 3.72	% 3.90	% 4.04	%
<b>BALANCE SHEET DATA*</b>						
Gross loans	\$822,299	\$807,849	\$766,751	\$750,163	\$726,069	
AFS securities	\$575,080	\$501,057	\$467,414	\$415,879	\$302,212	
Total assets	\$1,553,974	\$1,459,341	\$1,389,138	\$1,324,093	\$1,215,098	
Deposits	\$1,081,890	\$1,023,931	\$989,491	\$942,441	\$861,066	
Borrowed funds	\$290,438	\$266,001	\$226,580	\$216,888	\$198,895	
Shareholders' equity	\$172,076	\$161,305	\$164,147	\$155,579	\$147,596	
Gross loans to deposits	76.01	% 78.90	% 77.49	% 79.60	% 84.32	%
<b>ASSETS UNDER MANAGEMENT*</b>						
Loans sold with servicing retained	\$290,697	\$294,999	\$304,523	\$303,063	\$313,102	
Assets managed by our Investment and Trust Services Department	\$374,878	\$351,505	\$321,661	\$284,286	\$288,798	
Total assets under management	\$2,219,549	\$2,105,845	\$2,015,322	\$1,911,442	\$1,816,998	
<b>ASSET QUALITY*</b>						
Nonperforming loans to gross loans	0.57	% 0.53	% 0.98	% 0.81	% 1.15	%
Nonperforming assets to total assets	0.37	% 0.37	% 0.68	% 0.61	% 0.86	%
ALLL to gross loans	1.26	% 1.44	% 1.57	% 1.65	% 1.79	%
<b>CAPITAL RATIOS*</b>						
Shareholders' equity to assets	11.07	% 11.05	% 11.82	% 11.75	% 12.15	%
Tier 1 capital to average assets	8.47	% 8.45	% 8.27	% 8.10	% 8.28	%

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Tier 1 risk-based capital	13.86	% 13.75	% 13.35	% 12.43	% 12.42	%
Total risk-based capital	15.11	% 15.00	% 14.60	% 13.68	% 13.67	%
* At end of period						

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## Average Balances, Interest Rate, and Net Interest Income

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

	Three Months Ended			June 30, 2014			September 30, 2013		
	Average Balance	Tax Equivalent Interest	Average Yield / Rate	Average Balance	Tax Equivalent Interest	Average Yield / Rate	Average Balance	Tax Equivalent Interest	Average Yield / Rate
<b>INTEREST EARNING ASSETS</b>									
Loans	\$817,364	\$9,863	4.83 %	\$808,541	\$9,799	4.85 %	\$806,128	\$10,330	5.13 %
Taxable investment securities	358,547	2,016	2.25 %	353,878	1,993	2.25 %	330,832	1,787	2.16 %
Nontaxable investment securities	196,522	2,359	4.80 %	194,307	2,376	4.89 %	166,122	2,056	4.95 %
Trading account securities	—	—	— %	172	2	4.65 %	815	11	5.40 %
Other	28,431	119	1.67 %	21,421	112	2.09 %	23,690	106	1.79 %
Total earning assets	1,400,864	14,357	4.10 %	1,378,319	14,282	4.14 %	1,327,587	14,290	4.31 %
<b>NONEARNING ASSETS</b>									
Allowance for loan losses	(10,705 )			(11,208 )			(11,867 )		
Cash and demand deposits due from banks	20,360			17,403			18,430		
Premises and equipment	25,872			25,960			26,160		
Accrued income and other assets	98,853			97,187			90,993		
Total assets	\$1,535,244			\$1,507,661			\$1,451,303		
<b>INTEREST BEARING LIABILITIES</b>									
Interest bearing demand deposits	\$193,659	40	0.08 %	\$192,798	39	0.08 %	\$183,795	40	0.09 %
Savings deposits	265,814	94	0.14 %	257,628	91	0.14 %	245,318	94	0.15 %
Time deposits	447,046	1,428	1.28 %	455,592	1,459	1.28 %	454,387	1,608	1.42 %
Borrowed funds	274,358	936	1.36 %	263,606	879	1.33 %	260,308	994	1.53 %
Total interest bearing liabilities	1,180,877	2,498	0.85 %	1,169,624	2,468	0.84 %	1,143,808	2,736	0.96 %

NONINTEREST  
BEARING  
LIABILITIES

Demand deposits	171,085	158,804	139,519
Other	11,114	10,166	9,117
Shareholders' equity	172,168	169,067	158,859
Total liabilities and shareholders' equity	\$1,535,244	\$1,507,661	\$1,451,303
Net interest income (FTE)	\$ 11,859	\$ 11,814	\$ 11,554
Net yield on interest earning assets (FTE)	3.39 %	3.43 %	3.48 %

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	Nine Months Ended September 30, 2014			September 30, 2013				
	Average Balance	Tax Equivalent Interest	Average Yield / Rate	Average Balance	Tax Equivalent Interest	Average Yield / Rate		
<b>INTEREST EARNING ASSETS</b>								
Loans	\$810,572	\$29,413	4.84	%	\$784,593	\$30,940	5.26	%
Taxable investment securities	355,146	6,007	2.26	%	338,527	5,419	2.13	%
Nontaxable investment securities	193,276	7,056	4.87	%	161,472	6,080	5.02	%
Trading account securities	232	9	5.17	%	1,180	45	5.08	%
Other	25,485	384	2.01	%	25,866	331	1.71	%
Total earning assets	1,384,711	42,869	4.13	%	1,311,638	42,815	4.35	%
<b>NONEARNING ASSETS</b>								
ALLL	(11,182	)			(11,947	)		
Cash and demand deposits due from banks	18,484				18,083			
Premises and equipment	25,950				26,005			
Accrued income and other assets	96,915				97,513			
Total assets	\$1,514,878				\$1,441,292			
<b>INTEREST BEARING LIABILITIES</b>								
Interest bearing demand deposits	\$194,744	120	0.08	%	\$183,879	121	0.09	%
Savings deposits	258,807	279	0.14	%	242,989	275	0.15	%
Time deposits	451,329	4,368	1.29	%	458,767	5,042	1.47	%
Borrowed funds	269,325	2,699	1.34	%	245,344	2,900	1.58	%
Total interest bearing liabilities	1,174,205	7,466	0.85	%	1,130,979	8,338	0.98	%
<b>NONINTEREST BEARING LIABILITIES</b>								
Demand deposits	161,688				138,654			
Other	10,380				8,631			
Shareholders' equity	168,605				163,028			
Total liabilities and shareholders' equity	\$1,514,878				\$1,441,292			
Net interest income (FTE)		\$35,403				\$34,477		
Net yield on interest earning assets (FTE)			3.41	%			3.50	%
<b>Net Interest Income</b>								
Net interest income is the amount by which interest income on earning assets exceeds the interest expenses on interest bearing 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. For analytical purposes, net interest income is adjusted to an FTE basis by adding the income tax savings from interest on tax exempt loans, AFS securities, and trading securities, thus making year to year comparisons more meaningful. Included in interest income are loan fees for the three and nine month periods ended:								
	Three Months Ended			Nine Months Ended				
	September 30	June 30		September 30	September 30	September 30		
	2014	2014		2013	2014	2013		
Loan fees	\$488	\$566		\$738	\$1,530	\$2,421		

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## Volume and Rate Variance Analysis

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

Volume—change in volume multiplied by the previous period's rate.

Rate—change in the FTE rate multiplied by the previous period's volume.

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

	Three Months Ended September 30, 2014 Compared to June 30, 2014			Three Months Ended September 30, 2014 Compared to September 30, 2013			Nine Months Ended September 30, 2014 Compared to September 30, 2013		
	Increase (Decrease) Due to Volume	Rate	Net	Increase (Decrease) Due to Volume	Rate	Net	Increase (Decrease) Due to Volume	Rate	Net
Changes in interest income									
Loans	\$107	\$(43)	) \$64	\$142	\$(609)	) \$(467)	) \$1,000	\$(2,527)	) \$(1,527)
Taxable AFS securities	26	(3)	) 23	154	75	229	273	315	588
Nontaxable AFS securities	27	(44)	) (17)	) 367	(64)	) 303	1,166	(190)	) 976
Trading securities	(1)	) (1)	) (2)	) (5)	) (6)	) (11)	) (37)	) 1	) (36)
Other	32	(25)	) 7	20	(7)	) 13	(5)	) 58	53
Total changes in interest income	191	(116)	) 75	678	(611)	) 67	2,397	(2,343)	) 54
Changes in interest expense									
Interest bearing demand deposits	—	1	1	2	(2)	) —	7	(8)	) (1)
Savings deposits	3	—	3	8	(8)	) —	17	(13)	) 4
Time deposits	(27)	) (4)	) (31)	) (26)	) (154)	) (180)	) (81)	) (593)	) (674)
Borrowed funds	36	21	57	52	(110)	) (58)	) 267	(468)	) (201)
Total changes in interest expense	12	18	30	36	(274)	) (238)	) 210	(1,082)	) (872)
Net change in interest margin (FTE)	\$179	\$(134)	) \$45	\$642	\$(337)	) \$305	\$2,187	\$(1,261)	) \$926

Our net yield on interest earning assets remains at historically low levels which is a direct result of FRB monetary policy. While we do anticipate that the FRB will increase short term interest rates in 2015, we do not expect any significant improvements in our net yield on interest earning assets as the rates paid on interest bearing liabilities will likely increase faster than those of interest earning assets. In the interim, net interest income will increase only through continued balance sheet growth.

	Average Yield / Rate for the Three Month Periods Ended:				
	September 30 2014	June 30 2014	March 31 2014	December 31 2013	September 30 2013
Total earning assets	4.10	% 4.14	% 4.14	% 4.30	% 4.31
Total interest bearing liabilities	0.85	% 0.84	% 0.85	% 0.94	% 0.96
Net yield on interest earning assets (FTE)	3.39	% 3.43	% 3.42	% 3.50	% 3.48

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	Quarter to Date Net Interest Income (FTE)				
	September 30 2014	June 30 2014	March 31 2014	December 31 2013	September 30 2013
Total interest income (FTE)	\$ 14,357	\$ 14,282	\$ 14,242	\$ 14,441	\$ 14,290
Total interest expense	2,498	2,468	2,500	2,683	2,736
Net interest income (FTE)	\$ 11,859	\$ 11,814	\$ 11,742	\$ 11,758	\$ 11,554

One of the the primary contributors to the decline in the net yield on interest earning assets during 2014 was a drastic decline in loan fees. Loan fees have declined as the demand for residential mortgage loans has diminished and the competition for commercial loans remains intense. As shown in the following table, the net yield on interest earning assets and net interest income excluding the impact of loan fees (FTE) has remained essentially unchanged since the third quarter of 2013.

	September 30 2014	June 30 2014	March 31 2014	December 31 2013	September 30 2013
Net interest income (FTE)	\$ 11,859	\$ 11,814	\$ 11,742	\$ 11,758	\$ 11,554
Less loan fees	488	566	476	761	738
Net interest income excluding loan fees (FTE)	\$ 11,371	\$ 11,248	\$ 11,266	\$ 10,997	\$ 10,816
Net yield on interest earning assets excluding loan fees (FTE)	3.25	% 3.26	% 3.28	% 3.27	% 3.26

## Allowance for Loan and Lease Losses

The viability of any financial institution is ultimately determined by its management of credit risk. Loans represent our single largest concentration of risk. The ALLL is our estimation of losses within 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 valuation allowances, historical charge-offs, internally assigned credit risk ratings, and past due and nonaccrual balances. A portion of the ALLL is not allocated to any one loan segment, but is instead a reflection of other qualitative risks that 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 summarizes our charge-off and recovery activity for the three and nine month periods ended September 30:

	Three Months Ended September 30		Nine Months Ended September 30	
	2014	2013	2014	2013
ALLL at beginning of period	\$ 10,700	\$ 11,700	\$ 11,500	\$ 11,936
Loans charged-off				
Commercial and agricultural	163	406	465	851
Residential real estate	180	94	557	681
Consumer	73	102	255	311
Total loans charged-off	416	602	1,277	1,843
Recoveries				
Commercial and agricultural	171	66	477	289
Residential real estate	68	38	190	152
Consumer	39	47	114	200
Total recoveries	278	151	781	641
Net loans charged-off	138	451	496	1,202
Provision for loan losses	(162	) 351	(604	) 866
ALLL at end of period	\$ 10,400	\$ 11,600	\$ 10,400	\$ 11,600
Net loans charged-off to average loans outstanding	0.02	% 0.06	% 0.06	% 0.15





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The following table summarizes our charge-offs, recoveries, provisions for loan losses, and ALLL balances as of, and for the three month periods ended:

	September 30 2014	June 30 2014	March 31 2014	December 31 2013	September 30 2013		
Total loans charged-off	\$416	\$411	\$450	\$497	\$602		
Total recoveries	278	211	292	152	151		
Net loans charged-off	138	200	158	345	451		
Net loans charged-off to average loans outstanding	0.02	% 0.02	% 0.02	% 0.04	% 0.06	%	%
Provision for loan losses	\$(162)	) \$(200)	) \$(242)	) \$245	\$351		
Provision for loan losses to average loans outstanding	(0.02)	)% (0.02)	)% (0.03)	)% 0.03	% 0.04	%	%
ALLL	\$10,400	\$10,700	\$11,100	\$11,500	\$11,600		
ALLL as a% of loans at end of period	1.26	% 1.31	% 1.37	% 1.42	% 1.44	%	%

As the level of net loans charged-off continues to decline and credit quality indicators continue to improve, we have reduced the ALLL in both amount and as a percentage of loans. For further discussion of the allocation of the ALLL, see “Note 5 – Loans and ALLL” of our interim condensed consolidated financial statements.

**Loans Past Due and Loans in Nonaccrual Status**

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

	Total Past Due and Nonaccrual						
	September 30 2014	June 30 2014	March 31 2014	December 31 2013	September 30 2013		
Commercial and agricultural	\$3,904	\$5,045	\$4,986	\$3,621	\$5,371		
Residential real estate	4,011	4,613	7,067	7,008	6,339		
Consumer	134	98	113	259	152		
Total	\$8,049	\$9,756	\$12,166	\$10,888	\$11,862		
Total past due and nonaccrual loans to gross loans	0.98	% 1.20	% 1.50	% 1.35	% 1.47	%	%

Loans past due and nonaccrual have continued to decline during the third quarter of 2014. Overall, declines in past due and nonaccrual loans during 2014 are the result of strengthened loan performance, as the majority of the loans were current as of September 30, 2014.

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 5 – Loans and ALLL” of our interim condensed consolidated financial statements.

**Troubled Debt Restructurings**

We have taken a proactive approach to avoid foreclosures on borrowers who are willing to work with us in modifying their loans, thus making them more affordable. While this approach has allowed certain borrowers to develop a payment structure that will allow them to continue making payments in lieu of foreclosure, it has contributed to a significant increase in the level of loans classified as TDRs. The modifications have been 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, forgive interest, or a combination of these modifications. Typically, the modifications are for a period of five years or less. There were no

TDRs that were Government sponsored as of September 30, 2014 or December 31, 2013.

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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 analysis of the ALLL estimation each reporting period to ensure its continued appropriateness.

The following tables provide a roll-forward of TDRs for the:

	Three Months Ended September 30, 2014					
	Accruing Interest		Nonaccrual		Total	
	Number	Balance	Number	Balance	Number	Balance
	of Loans		of Loans		of Loans	
July 1, 2014	162	\$21,265	18	\$2,927	180	\$24,192
New modifications	7	266	—	—	7	266
Principal advances (payments)	—	(241)	—	34	—	(207)
Loans paid-off	(5)	(101)	(1)	(2)	(6)	(103)
Partial charge-off	—	—	—	(75)	—	(75)
Balances charged-off	(2)	(7)	(1)	(51)	(3)	(58)
Transfers to OREO	—	—	—	—	—	—
Transfers to accrual status	1	109	(1)	(109)	—	—
Transfers to nonaccrual status	(1)	(55)	1	55	—	—
September 30, 2014	162	\$21,236	16	\$2,779	178	\$24,015
	Nine Months Ended September 30, 2014					
	Accruing Interest		Nonaccrual		Total	
	Number	Balance	Number	Balance	Number	Balance
	of Loans		of Loans		of Loans	
January 1, 2014	165	\$24,423	15	\$1,442	180	\$25,865
New modifications	25	1,254	4	245	29	1,499
Principal advances (payments)	—	(1,323)	—	(40)	—	(1,363)
Loans paid-off	(20)	(1,371)	(3)	(90)	(23)	(1,461)
Partial charge-off	—	(70)	—	(193)	—	(263)
Balances charged-off	(3)	(13)	(1)	(51)	(4)	(64)
Transfers to OREO	—	—	(4)	(198)	(4)	(198)
Transfers to accrual status	4	429	(4)	(429)	—	—
Transfers to nonaccrual status	(9)	(2,093)	9	2,093	—	—
September 30, 2014	162	\$21,236	16	\$2,779	178	\$24,015
	Three Months Ended September 30, 2013					
	Accruing Interest		Nonaccrual		Total	
	Number	Balance	Number	Balance	Number	Balance
	of Loans		of Loans		of Loans	
July 1, 2013	123	\$19,134	15	\$1,723	138	\$20,857
New modifications	18	1,262	4	326	22	1,588
Principal advances (payments)	—	(180)	—	(22)	—	(202)
Loans paid-off	(4)	(1,273)	(1)	(103)	(5)	(1,376)
Partial charge-off	—	—	—	(197)	—	(197)
Balances charged-off	—	—	—	—	—	—
Transfers to OREO	—	—	(4)	(333)	(4)	(333)
Transfers to accrual status	—	—	—	—	—	—
Transfers to nonaccrual status	(3)	(317)	3	317	—	—
September 30, 2013	134	\$18,626	17	\$1,711	151	\$20,337



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	Nine Months Ended September 30, 2013						
	Accruing Interest Number of Loans	Balance	Nonaccrual Number of Loans	Balance	Total Number of Loans	Balance	
January 1, 2013	115	\$16,531	19	\$2,824	134	\$19,355	
New modifications	40	5,673	5	424	45	6,097	
Principal advances (payments)	—	(643	) —	(265	) —	(908	)
Loans paid-off	(14	) (2,492	) (6	) (800	) (20	) (3,292	)
Partial charge-off	—	(15	) —	(408	) —	(423	)
Balances charged-off	(3	) (147	) —	—	(3	) (147	)
Transfers to OREO	—	—	(5	) (345	) (5	) (345	)
Transfers to accrual status	1	105	(1	) (105	) —	—	
Transfers to nonaccrual status	(5	) (386	) 5	386	—	—	
September 30, 2013	134	\$18,626	17	\$1,711	151	\$20,337	

The following table summarizes our TDRs as of:

	September 30, 2014			December 31, 2013			Total Change
	Accruing Interest	Nonaccrual	Total	Accruing Interest	Nonaccrual	Total	
Current	\$20,410	\$868	\$21,278	\$21,690	\$1,189	\$22,879	\$(1,601)
Past due 30-59 days	635	307	942	2,158	37	2,195	(1,253)
Past due 60-89 days	191	4	195	575	—	575	(380)
Past due 90 days or more	—	1,600	1,600	—	216	216	1,384
Total	\$21,236	\$2,779	\$24,015	\$24,423	\$1,442	\$25,865	\$(1,850)

Additional disclosures about TDRs are included in “Note 5 – Loans and ALLL” of our interim condensed consolidated financial statements.

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## Impaired Loans

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

	September 30, 2014			December 31, 2013		
	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance	Outstanding Balance	Unpaid Principal Balance	Valuation Allowance
<b>TDRs</b>						
Commercial real estate	\$10,254	\$10,614	\$1,303	\$10,663	\$11,193	\$1,585
Commercial other	778	1,008	4	1,310	1,340	62
Agricultural real estate	1,443	1,443	—	1,459	1,459	30
Agricultural other	67	187	—	79	199	—
Residential real estate senior liens	11,156	11,761	2,064	12,266	12,841	2,010
Residential real estate junior liens	99	99	20	20	20	4
Home equity lines of credit	159	459	16	—	—	—
Consumer secured	59	59	1	68	69	—
<b>Total TDRs</b>	<b>24,015</b>	<b>25,630</b>	<b>3,408</b>	<b>25,865</b>	<b>27,121</b>	<b>3,691</b>
<b>Other impaired loans</b>						
Commercial real estate	841	1,077	11	1,707	2,193	330
Commercial other	82	82	—	136	217	58
Agricultural real estate	115	115	—	—	—	—
Agricultural other	—	—	—	—	—	—
Residential real estate senior liens	1,269	1,918	195	1,795	2,473	268
Residential real estate junior liens	142	152	30	28	45	5
Home equity lines of credit	100	200	10	193	493	—
Consumer secured	10	10	—	51	79	—
<b>Total other impaired loans</b>	<b>2,559</b>	<b>3,554</b>	<b>246</b>	<b>3,910</b>	<b>5,500</b>	<b>661</b>
<b>Total impaired loans</b>	<b>\$26,574</b>	<b>\$29,184</b>	<b>\$3,654</b>	<b>\$29,775</b>	<b>\$32,621</b>	<b>\$4,352</b>

Additional disclosure related to impaired loans is included in “Note 5 – Loans and ALLL” of our interim condensed consolidated financial statements.

## Nonperforming Assets

The following table summarizes our nonperforming assets as of:

	September 30 2014	June 30 2014	March 31 2014	December 31 2013	September 30 2013	
Nonaccrual loans	\$4,496	\$4,587	\$4,345	\$3,244	\$3,812	
Accruing loans past due 90 days or more	164	119	893	142	457	
<b>Total nonperforming loans</b>	<b>4,660</b>	<b>4,706</b>	<b>5,238</b>	<b>3,386</b>	<b>4,269</b>	
Foreclosed assets	1,041	1,132	1,126	1,412	1,186	
<b>Total nonperforming assets</b>	<b>\$5,701</b>	<b>\$5,838</b>	<b>\$6,364</b>	<b>\$4,798</b>	<b>\$5,455</b>	
Nonperforming loans as a % of total loans	0.57	% 0.58	% 0.65	% 0.42	% 0.53	%
Nonperforming assets as a % of total assets	0.37	% 0.38	% 0.42	% 0.32	% 0.37	%

After a loan is 90 days past due, it is generally placed in nonaccrual status unless it is well secured and in the process of collection. 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 months of continued performance.



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Included in the nonaccrual loan balances above were loans currently classified as TDRs as of:

	September 30 2014	December 31 2013
Commercial and agricultural	\$2,071	\$833
Residential real estate	708	609
Total	\$2,779	\$1,442

The following table lists individually significant commercial and agricultural loan relationships in nonaccrual status as of September 30, 2014 and December 31, 2013. To be classified as individually significant, the recorded investment in nonaccrual loans to each borrower must have exceeded \$1,000 as of the end of either period.

	September 30, 2014		December 31, 2013	
	Outstanding Balance	Specific Allocation	Outstanding Balance	Specific Allocation
Borrower 1	\$1,179	\$—	<sup>1</sup> \$—	\$—
Others not individually significant	3,317		3,244	
Total	\$4,496		\$3,244	

<sup>1</sup> No specific allocation was established as the loan was collateral dependent and the net realizable value of the underlying collateral value exceeded the loan's carrying balance.

Additional disclosures about nonaccrual loans are included in "Note 5 – Loans and ALLL" of our interim condensed consolidated financial statements.

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.

We believe that the level of the ALLL is appropriate as of September 30, 2014 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.

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## Noninterest Income and Noninterest Expenses

Noninterest income consists of service charges and fees, gains on sale of mortgage loans, earnings on corporate owned life insurance policies, gains and losses on sales of AFS securities, and other income. Significant account balances are highlighted in the following table with additional descriptions of significant fluctuations:

	Three Months Ended September 30		Change		
	2014	2013	\$	%	
Service charges and fees					
NSF and overdraft fees	\$565	\$601	\$(36)	(5.99)	)%
ATM and debit card fees	538	509	29	5.70	%
Freddie Mac servicing fee	178	183	(5)	(2.73)	)%
Service charges on deposit accounts	92	96	(4)	(4.17)	)%
Net OMSRs income (loss)	(41)	) 278	(319)	(114.75)	)%
All other	34	33	1	3.03	%
Total service charges and fees	1,366	1,700	(334)	(19.65)	)%
Gain on sale of mortgage loans	170	215	(45)	(20.93)	)%
Earnings on corporate owned life insurance policies	182	185	(3)	(1.62)	)%
Gains (losses) on sale of AFS securities	97	72	25	34.72	%
Other					
Trust and brokerage advisory fees	506	466	40	8.58	%
Other	(105)	) 224	(329)	(146.88)	)%
Total other	401	690	(289)	(41.88)	)%
Total noninterest income	\$2,216	\$2,862	\$(646)	(22.57)	)%
	Nine Months Ended September 30		Change		
	2014	2013	\$	%	
Service charges and fees					
NSF and overdraft fees	\$1,630	\$1,675	\$(45)	(2.69)	)%
ATM and debit card fees	1,559	1,453	106	7.30	%
Freddie Mac servicing fee	541	554	(13)	(2.35)	)%
Service charges on deposit accounts	267	281	(14)	(4.98)	)%
Net OMSRs income (loss)	22	374	(352)	(94.12)	)%
All other	101	89	12	13.48	%
Total service charges and fees	4,120	4,426	(306)	(6.91)	)%
Gain on sale of mortgage loans	436	822	(386)	(46.96)	)%
Earnings on corporate owned life insurance policies	556	544	12	2.21	%
Gains (losses) on sale of AFS securities	97	171	(74)	(43.27)	)%
Other					
Trust and brokerage advisory fees	1,532	1,359	173	12.73	%
Other	158	723	(565)	(78.15)	)%
Total other	1,690	2,082	(392)	(18.83)	)%
Total noninterest income	\$6,899	\$8,045	\$(1,146)	(14.24)	)%

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Significant changes in noninterest income are detailed below:

As customers continue to increase their dependence on ATM and debit cards, we have realized 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 ATM and debit cards increase.

Offering rates on residential mortgage loans, as well as the decline in loan demand, are the most significant drivers behind fluctuations in the gain on sale of mortgage loans and net OMSRs income (loss). As a result of the lack of demand in residential mortgage loan originations, we are experiencing declines in both the gain on sale of mortgage loans and net OMSRs income (loss). As mortgage rates are expected to approximate current levels in the foreseeable future and purchase money mortgage activity will likely remain soft, we do not anticipate any significant changes in origination volumes or the gain on sale of mortgage loans.

We are continually analyzing our AFS securities for potential sale opportunities. These analyses identified several mortgage-backed securities pools in 2014 and 2013 that made economic sense to sell. We do not anticipate any significant investment sales for the remainder of 2014.

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

The fluctuations in all other income is spread throughout various categories, none of which are individually significant. We do not anticipate any significant fluctuations from current levels for the remainder of 2014.

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Noninterest expenses include compensation and benefits, furniture and equipment, occupancy, and other expenses. Significant account balances are highlighted in the following table with additional descriptions of significant fluctuations:

	Three Months Ended September 30				
	2014	2013	Change	%	
			\$		%
Compensation and benefits					
Employee salaries	\$4,026	\$3,920	\$106	2.70	%
Employee benefits	1,148	1,420	(272)	(19.15)	)%
Total compensation and benefits	5,174	5,340	(166)	(3.11)	)%
Furniture and equipment					
Service contracts	660	603	57	9.45	%
Depreciation	485	488	(3)	(0.61)	)%
ATM and debit card fees	188	191	(3)	(1.57)	)%
All other	15	21	(6)	(28.57)	)%
Total furniture and equipment	1,348	1,303	45	3.45	%
Occupancy					
Outside services	168	168	—	—	%
Depreciation	175	166	9	5.42	%
Utilities	128	127	1	0.79	%
Property taxes	131	124	7	5.65	%
All other	95	91	4	4.40	%
Total occupancy	697	676	21	3.11	%
Other					
Marketing and community relations	512	271	241	88.93	%
FDIC insurance premiums	196	267	(71)	(26.59)	)%
Directors fees	191	203	(12)	(5.91)	)%
Audit and related fees	185	189	(4)	(2.12)	)%
Education and travel	154	110	44	40.00	%
Postage and freight	105	103	2	1.94	%
Printing and supplies	89	106	(17)	(16.04)	)%
Loan underwriting fees	83	97	(14)	(14.43)	)%
Consulting fees	96	68	28	41.18	%
All other	684	587	97	16.52	%
Total other	2,295	2,001	294	14.69	%
Total noninterest expenses	\$9,514	\$9,320	\$194	2.08	%

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	Nine Months Ended September 30				
	2014	2013	Change \$	%	
Compensation and benefits					
Employee salaries	\$12,114	\$11,640	\$474	4.07	%
Employee benefits	3,931	4,381	(450)	(10.27)	)%
Total compensation and benefits	16,045	16,021	24	0.15	%
Furniture and equipment					
Service contracts	1,871	1,673	198	11.84	%
Depreciation	1,379	1,411	(32)	(2.27)	)%
ATM and debit card fees	542	544	(2)	(0.37)	)%
All other	43	56	(13)	(23.21)	)%
Total furniture and equipment	3,835	3,684	151	4.10	%
Occupancy					
Outside services	543	489	54	11.04	%
Depreciation	523	492	31	6.30	%
Utilities	403	382	21	5.50	%
Property taxes	396	393	3	0.76	%
All other	250	226	24	10.62	%
Total occupancy	2,115	1,982	133	6.71	%
Other					
Marketing and community relations	966	945	21	2.22	%
FDIC insurance premiums	619	812	(193)	(23.77)	)%
Directors fees	569	607	(38)	(6.26)	)%
Audit and related fees	505	490	15	3.06	%
Education and travel	418	348	70	20.11	%
Postage and freight	303	296	7	2.36	%
Printing and supplies	278	291	(13)	(4.47)	)%
Loan underwriting fees	270	336	(66)	(19.64)	)%
Consulting fees	263	223	40	17.94	%
All other	2,114	1,800	314	17.44	%
Total other	6,305	6,148	157	2.55	%
Total noninterest expenses	\$28,300	\$27,835	\$465	1.67	%

Significant changes in noninterest expenses are detailed below:

Employee salaries have increased as a result of normal merit increases and additional staffing required by our continued growth. The decline in employee benefits is related to health care costs as a result of lower than anticipated claims. Employee benefits are expected to increase moderately in future periods as a result of anticipated increases in health care costs.

Service contracts have increased during 2014 due to costs related to data lines as well as increases in various other contracts as we continue to expand our on-line services offered to customers. Service contracts are anticipated to approximate current levels for the remainder of 2014.

We have consistently been a strong supporter of the various communities, schools, and charities in the markets we serve. We sponsor a foundation, which we established in 1996, that is funded by discretionary donations. The affiliated foundation provides centralized oversight for donations to organizations that benefit our communities. Included in marketing and community relations were discretionary donations to the foundation of \$250 and \$200 for the nine month periods ended September 30, 2014 and 2013, respectively.

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FDIC insurance premiums were elevated in 2013 as a result of us receiving less of a refund for prepaid FDIC insurance premiums than we had anticipated. FDIC insurance premiums have returned to normalized levels and are anticipated to approximate current levels for the remainder of 2014.

Loan underwriting fees have declined in 2014 as a result of declines in residential real estate loan originations. The fluctuations in all other expenses are spread throughout various categories, none of which are individually significant.

## Analysis of Changes in Financial Condition

	September 30 2014	December 31 2013	\$ Change	% Change (unannualized)	
<b>ASSETS</b>					
Cash and cash equivalents	\$25,531	\$41,558	\$(16,027)	(38.57)	)%
Certificates of deposit held in other financial institutions	580	580	—	—	
Trading securities	—	525	(525)	(100.00)	)%
AFS securities					
Amortized cost of AFS securities	572,087	517,614	54,473	10.52	%
Unrealized Gains (losses) on AFS securities	2,993	(5,552)	) 8,545	N/M	
AFS securities	575,080	512,062	63,018	12.31	%
Mortgage loans AFS	421	1,104	(683)	(61.87)	)%
Loans					
Gross loans	822,299	808,037	14,262	1.77	%
Less allowance for loan and lease losses	10,400	11,500	(1,100)	(9.57)	)%
Net loans	811,899	796,537	15,362	1.93	%
Premises and equipment	25,843	25,719	124	0.48	%
Corporate owned life insurance policies	24,957	24,401	556	2.28	%
Accrued interest receivable	6,906	5,442	1,464	26.90	%
Equity securities without readily determinable fair values	19,063	18,293	770	4.21	%
Goodwill and other intangible assets	46,168	46,311	(143)	(0.31)	)%
Other assets	17,526	20,605	(3,079)	(14.94)	)%
<b>TOTAL ASSETS</b>	<b>\$1,553,974</b>	<b>\$1,493,137</b>	<b>\$60,837</b>	<b>4.07</b>	<b>%</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>					
Liabilities					
Deposits	\$1,081,890	\$1,043,766	\$38,124	3.65	%
Borrowed funds	290,438	279,326	11,112	3.98	%
Accrued interest payable and other liabilities	9,570	9,436	134	1.42	%
Total liabilities	1,381,898	1,332,528	49,370	3.70	%
Shareholders' equity	172,076	160,609	11,467	7.14	%
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$1,553,974</b>	<b>\$1,493,137</b>	<b>\$60,837</b>	<b>4.07</b>	<b>%</b>

The following table outlines the changes in loans:

	September 30 2014	December 31 2013	\$ Change	% Change (unannualized)	
Commercial	\$416,824	\$392,104	\$24,720	6.30	%
Agricultural	101,795	92,589	9,206	9.94	%
Residential real estate	271,033	289,931	(18,898)	(6.52)	)%
Consumer	32,647	33,413	(766)	(2.29)	)%
Total	\$822,299	\$808,037	\$14,262	1.77	%



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The following table displays loan balances as of:

	September 30 2014	June 30 2014	March 31 2014	December 31 2013	September 30 2013
Commercial	\$416,824	\$407,791	\$399,702	\$392,104	\$388,973
Agricultural	101,795	97,661	92,059	92,589	92,927
Residential real estate	271,033	278,545	284,586	289,931	291,825
Consumer	32,647	32,310	32,064	33,413	34,124
Total	\$822,299	\$816,307	\$808,411	\$808,037	\$807,849

We continue to see declines in residential real estate loans which have been offset by increases in commercial and agricultural loans. This trend is likely to continue as the demand for residential real estate loans is anticipated to remain soft due to continuing uncertainty in the residential real estate markets, increases in interest rates, and the implementation of CFPB underwriting guidelines.

The following table outlines the changes in deposits:

	September 30 2014	December 31 2013	\$ Change	% Change (unannualized)	
Noninterest bearing demand deposits	\$175,634	\$158,428	\$17,206	10.86	%
Interest bearing demand deposits	192,211	192,089	122	0.06	%
Savings deposits	269,475	243,237	26,238	10.79	%
Certificates of deposit	341,153	362,473	(21,320)	(5.88)	%
Brokered certificates of deposit	74,132	56,329	17,803	31.61	%
Internet certificates of deposit	29,285	31,210	(1,925)	(6.17)	%
Total	\$1,081,890	\$1,043,766	\$38,124	3.65	%

The following table displays deposit balances as of:

	September 30 2014	June 30 2014	March 31 2014	December 31 2013	September 30 2013
Noninterest bearing demand deposits	\$175,634	\$162,537	\$158,241	\$158,428	\$143,013
Interest bearing demand deposits	192,211	186,705	194,407	192,089	186,630
Savings deposits	269,475	260,038	261,444	243,237	245,217
Certificates of deposit	341,153	346,200	356,847	362,473	366,349
Brokered certificates of deposit	74,132	75,031	65,273	56,329	51,410
Internet certificates of deposit	29,285	30,417	29,723	31,210	31,312
Total	\$1,081,890	\$1,060,928	\$1,065,935	\$1,043,766	\$1,023,931

Overall, deposits have grown considerably since September 30, 2013. As a result of the current interest rate environment, we continue to see declines in certificates of deposits, but these declines have been offset by increases in noninterest bearing demand deposits, interest bearing demand deposits, and savings accounts. We expect this trend to continue for the foreseeable future.



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The current interest rate environment has made it almost impossible to increase net interest income without increasing earning assets. As deposit growth has generally outpaced loan demand, we continue to deploy deposits into purchases of AFS securities to provide additional interest income. In addition to utilizing deposits, we also utilize borrowings and brokered deposits to fund earning assets. We anticipate that future increases in our AFS securities will be in the form of mortgage-backed securities and collateralized mortgage obligations. The following table displays fair values of AFS securities as of:

	September 30 2014	June 30 2014	March 31 2014	December 31 2013	September 30 2013
Government sponsored enterprises States and political subdivisions	\$23,917	\$24,104	\$23,883	\$23,745	\$24,155
Auction rate money market preferred	2,863	2,867	2,755	2,577	2,639
Preferred stocks	6,173	6,214	6,053	5,827	6,144
Mortgage-backed securities	170,767	162,992	157,856	144,115	146,393
Collateralized mortgage obligations	147,815	140,131	144,953	133,810	127,940
Total	\$575,080	\$550,518	\$555,144	\$512,062	\$501,057

The following table displays borrowed funds balances as of:

	September 30 2014	June 30 2014	March 31 2014	December 31 2013	September 30 2013
FHLB advances	\$182,000	\$182,000	\$162,000	\$162,000	\$162,000
Securities sold under agreements to repurchase without stated maturity dates	89,535	87,058	94,741	106,025	81,405
Securities sold under agreements to repurchase with stated maturity dates	1,203	1,199	1,195	11,301	16,296
Federal funds purchased	17,700	9,200	14,600	—	6,300
Total	\$290,438	\$279,457	\$272,536	\$279,326	\$266,001

Capital

Capital consists solely of common stock, retained earnings, and accumulated other comprehensive income (loss). 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 122,261 shares or \$2,845 of common stock during the first nine months of 2014, as compared to 111,904 shares or \$2,754 of common stock during the same period in 2013. We also offer the Directors Plan in which participants either directly purchase stock or purchase stock units through deferred fees, in lieu of cash payments. Pursuant to this plan, we increased shareholders' equity by \$382 and \$423 during the nine month periods ended September 30, 2014 and 2013, respectively.

We have approved a publicly announced common stock repurchase plan. Pursuant to this plan, we repurchased 110,680 shares or \$2,550 of common stock compared to 73,969 shares for \$1,815 during the first nine months of 2014 and 2013, respectively. As of September 30, 2014, we were authorized to repurchase up to an additional 26,716 shares of common stock.

There are no significant regulatory constraints placed on our capital. The FRB's current recommended minimum primary capital to assets requirement is 6.00%. Our primary capital to adjusted average assets, which consists of shareholders' equity plus the ALLL acquisition intangibles, was 8.47% as of September 30, 2014.

The FRB has established minimum risk based capital guidelines. Pursuant to these guidelines, 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 8.00%, of which at least 4.00% 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:

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	September 30	December 31	Required	
	2014	2013		
Equity Capital	13.86	% 13.67	% 4.00	%
Secondary Capital	1.25	% 1.25	% 4.00	%
Total Capital	15.11	% 14.92	% 8.00	%

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

The FRB and FDIC also prescribe minimum capital requirements for Isabella Bank. At September 30, 2014, the Bank exceeded these minimum capital requirements. On July 2, 2013, the FRB published revised BASEL III Capital standards for banks. The rules redefine what is included or deducted from equity capital, changes risk weighting for certain on and off-balance sheet assets, increases the minimum required equity capital to be considered well capitalized, and introduces a capital cushion buffer. The rules, which will be gradually phased in between 2015 and 2019, are not expected to have a material impact on our operations.

**Contractual Obligations and Loan Commitments**

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

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

	September 30 2014	December 31 2013
Unfunded commitments under lines of credit	\$108,071	\$121,959
Commercial and standby letters of credit	3,375	4,169
Commitments to grant loans	21,125	29,096
Total	\$132,571	\$155,224

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

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

Commitments to grant loans are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The amount of collateral obtained, if it is deemed necessary, is based on management's credit evaluation of the customer. Commitments to grant loans include loans committed to be sold to the secondary market. Our exposure to credit-related loss in the event of nonperformance by the counter parties to the financial instruments for commitments to extend credit and standby letters of credit could be up to the contractual notional amount of those instruments. We use the same credit policies as we do for extending loans to customers. No significant losses are anticipated as a result of these commitments.

**Fair Value**

We utilize fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Trading securities, AFS 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 mortgage loans AFS, foreclosed assets, OMSRs, 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 10 – Fair Value” of our notes to the interim condensed consolidated financial statements.

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## Liquidity

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

Our primary sources of liquidity are cash and cash equivalents, certificates of deposit held in other financial institutions, trading securities, and AFS securities. These categories totaled \$601,191 or 38.69% of assets as of September 30, 2014 as compared to \$554,725 or 37.15% as of December 31, 2013. Liquidity is important for financial institutions because of their need to meet loan funding commitments, depositor withdrawal requests, and various other commitments including expansion of operations, investment opportunities, and payment of cash dividends. Liquidity varies 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 in the form of 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 AFS securities or loans as collateral. As of September 30, 2014, we had available lines of credit of \$111,890.

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

	2014	2013	\$ Variance
Net cash provided by (used in) operating activities	\$ 12,040	\$ 17,746	\$(5,706 )
Net cash provided by (used in) investing activities	(72,254 )	(48,142 )	(24,112 )
Net cash provided by (used in) financing activities	44,187	27,080	17,107
Increase (decrease) in cash and cash equivalents	(16,027 )	(3,316 )	(12,711 )
Cash and cash equivalents January 1	41,558	24,920	16,638
Cash and cash equivalents September 30	\$25,531	\$21,604	\$3,927

## 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 by 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, our Funds Management 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 IRR 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 12 and 24 months of net interest income under an assumed environment of a constant balance sheet and constant market interest rates (base case). We then compare the results of various simulation analyses to the base case. At September 30, 2014, we projected the change in net interest income during the next 12 and 24 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 current interest rate levels. These projections were based on our assets and liabilities remaining static over the next 12 and 24 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 projected net interest income sensitivity to ensure that it remains within established limits.

The following table summarizes our interest rate sensitivity for the:

	12 Months Ending September 30, 2015					
Immediate basis point change assumption (short-term)	(100)	0	100	200	300	400
Percent change in net interest income vs. constant rates	(1.03 )%	—	(1.24 )%	(2.60 )%	(5.01 )%	(7.40 )%
	24 Months Ending September 30, 2016					
Immediate basis point change assumption (short-term)	(100)	0	100	200	300	400
Percent change in net interest income vs. constant rates	(1.11 )%	—	(1.67 )%	(0.87 )%	(1.70 )%	(3.15 )%
	12 Months Ending December 31, 2014					
Immediate basis point change assumption (short-term)	(100)	0	100	200	300	400
Percent change in net interest income vs. constant rates	(2.85 )%	—	0.25 %	(0.28 )%	(0.99 )%	(2.16 )%
	24 Months Ending December 31, 2015					
Immediate basis point change assumption (short-term)	(100)	0	100	200	300	400
Percent change in net interest income vs. constant rates	(3.24 )%	—	0.04 %	0.29 %	0.41 %	(0.35 )%

The following tables provide information about assets and liabilities that are sensitive to changes in interest rates as of September 30, 2014 and December 31, 2013. The principal amounts of investments, loans, other interest earning assets, borrowings, and time deposits maturing were calculated based on the contractual maturity dates. Estimated cash flows for savings and NOW accounts are based on our estimated deposit decay rates.

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	September 30, 2014							Fair Value
	2015	2016	2017	2018	2019	Thereafter	Total	
Rate sensitive assets								
Other interest bearing assets	\$3,580	\$—	\$100	\$—	\$—	\$—	\$3,680	\$3,680
Average interest rates	0.34	% —	0.35	% —	—	—	0.34	%
Trading securities	\$—	\$—	\$—	\$—	\$—	\$—	\$—	\$—
Average interest rates	—	—	—	—	—	—	—	
AFS securities	\$118,904	\$100,245	\$70,790	\$53,291	\$47,563	\$184,287	\$575,080	\$575,080
Average interest rates	2.28	% 2.13	% 2.48	% 2.40	% 2.48	% 2.55	% 2.39	%
Fixed interest rate loans (1)	\$106,995	\$99,861	\$122,666	\$97,838	\$73,782	\$146,046	\$647,188	\$646,966
Average interest rates	5.23	% 4.90	% 4.55	% 4.33	% 4.46	% 4.26	% 4.61	%
Variable interest rate loans (1)	\$69,853	\$27,196	\$20,875	\$14,689	\$14,727	\$27,771	\$175,111	\$175,111
Average interest rates	7.06	% 4.01	% 3.92	% 3.41	% 3.31	% 3.90	% 5.09	%
Rate sensitive liabilities								
Borrowed funds	\$150,421	\$20,000	\$30,000	\$40,017	\$20,000	\$30,000	\$290,438	\$293,881
Average interest rates	0.32	% 1.69	% 1.95	% 2.35	% 3.10	% 2.75	% 1.30	%
Savings and NOW accounts	\$41,131	\$37,074	\$33,300	\$29,942	\$26,951	\$293,288	\$461,686	\$461,686
Average interest rates	0.12	% 0.12	% 0.12	% 0.12	% 0.12	% 0.12	% 0.12	%
Fixed interest rate certificates of deposit	\$219,928	\$76,618	\$61,472	\$56,442	\$22,813	\$6,200	\$443,473	\$444,032
Average interest rates	0.93	% 1.69	% 1.57	% 1.35	% 1.45	% 4.61	% 1.28	%
Variable interest rate certificates of deposit	\$748	\$349	\$—	\$—	\$—	\$—	\$1,097	\$1,097
Average interest rates	0.40	% 0.40	% —	—	—	—	0.40	%
	December 31, 2013							
	2014	2015	2016	2017	2018	Thereafter	Total	Fair Value
Rate sensitive assets								
Other interest bearing assets	\$19,903	\$480	\$—	\$—	\$—	\$—	\$20,383	\$20,385
Average interest rates	0.25	% 1.15	% —	—	—	—	0.27	%



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Average interest rates									
Trading securities	\$525	\$—	\$—	\$—	\$—	\$—	\$525	\$525	
Average interest rates	2.77	% —	—	—	—	—	2.77	%	
AFS securities	\$131,892	\$73,723	\$63,190	\$52,078	\$37,972	\$153,207	\$512,062	\$512,062	
Average interest rates	2.26	% 2.23	% 2.42	% 2.48	% 2.48	% 2.80	% 2.48	%	
Fixed interest rate loans (1)	\$115,183	\$94,841	\$91,140	\$118,479	\$85,448	\$134,614	\$639,705	\$639,914	
Average interest rates	5.31	% 5.17	% 4.93	% 4.53	% 4.33	% 4.33	% 4.75	%	
Variable interest rate loans (1)	\$69,036	\$29,460	\$20,332	\$14,208	\$15,699	\$19,597	\$168,332	\$168,332	
Average interest rates	4.76	% 3.90	% 4.06	% 3.36	% 3.35	% 3.99	% 4.19	%	
Rate sensitive liabilities									
Borrowed funds	\$126,950	\$32,376	\$10,000	\$30,000	\$40,000	\$40,000	\$279,326	\$283,060	
Average interest rates	0.43	% 0.86	% 2.15	% 1.95	% 2.35	% 3.02	% 1.35	%	
Savings and NOW accounts	\$47,000	\$33,569	\$30,200	\$27,198	\$24,522	\$272,837	\$435,326	\$435,326	
Average interest rates	0.19	% 0.12	% 0.11	% 0.11	% 0.11	% 0.11	% 0.12	%	
Fixed interest rate certificates of deposit	\$206,514	\$81,038	\$58,627	\$46,336	\$39,214	\$17,144	\$448,873	\$451,664	
Average interest rates	0.89	% 1.93	% 1.95	% 1.63	% 1.34	% 1.66	% 1.36	%	
Variable interest rate certificates of deposit	\$764	\$375	\$—	\$—	\$—	\$—	\$1,139	\$1,139	
Average interest rates	0.04	% 0.40	% —	—	—	—	0.16	%	

(1) The fair value reported is exclusive of the allocation of the ALLL.

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.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

Item 4. Controls and Procedures

**DISCLOSURE CONTROLS AND PROCEDURES**

We carried out an evaluation, under the supervision and with the participation of the Principal Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15(d)-15(e) under the Exchange Act) as of September 30, 2014, pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures as of September 30, 2014, were effective to ensure that information required to be disclosed in reports that we file or submit under the Exchange Act are recorded, processed, summarized and reported within the time periods specified in SEC rules and forms.

**CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

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

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## PART II – OTHER INFORMATION

## Item 1. Legal Proceedings

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

## Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2013.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(A) None

(B) None

## (C) Repurchases of Common Stock

We have adopted and publicly announced a common stock repurchase plan. The plan was last amended on October 22, 2014, to allow for the repurchase of an additional 150,000 shares of common stock after that date. These authorizations do not have expiration dates. As shares are repurchased under this plan, they are retired and revert back to the status of authorized, but unissued shares.

The following table provides information for the three month period ended September 30, 2014, with respect to this plan:

	Shares Repurchased		Total Number of Shares Purchased as Part of Publicly Announced Plan or Program	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs
	Number	Average Price Per Share		
Balance, June 30				66,812
July 1 - 31	9,399	\$22.02	9,399	57,413
August 1 - 31	16,464	22.11	16,464	40,949
September 1 - 30	14,233	23.33	14,233	26,716
Balance, September 30	40,096	\$22.52	40,096	26,716

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Item 6. Exhibits

(a) Exhibits

31(a) Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by the Principal Executive Officer

31(b) Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by the Principal Financial Officer

32 Section 1350 Certification of Principal Executive Officer and Principal Financial Officer

101.1\* 101.INS (XBRL Instance Document)

101.SCH (XBRL Taxonomy Extension Schema Document)

101.CAL (XBRL Calculation Linkbase Document)

101.LAB (XBRL Taxonomy Label Linkbase Document)

101.DEF (XBRL Taxonomy Linkbase Document)

101.PRE (XBRL Taxonomy Presentation Linkbase Document)

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

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Isabella Bank Corporation

Date: November 7, 2014

/s/ Jae A. Evans  
Jae A. Evans  
Chief Executive Officer  
(Principal Executive Officer)

Date: November 7, 2014

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