ISABELLA BANK CORP
Form 10-Q
November 06, 2009

Table of Contents

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

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**
For the quarterly period ended September 30, 2009

or

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

Commission File Number: 0-18415
Isabella Bank Corporation

(Exact name of registrant as specified in its charter)

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

(989) 772-9471

(Registrant s telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
þ Yes o No

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

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

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

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Common Stock no par value, 7,505,109 as of October 31, 2009

ISABELLA BANK CORPORATION
QUARTERLY REPORT ON FORM 10-Q
Table of Contents

Table of Contents

PART I FINANCIAL INIFORMATION

Item 1 Interim Condensed Consolidated Financial Statements (Unaudited)

INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(Dollars in thousands)

	September 30 2009	December 31 2008
ASSETS		
Cash and demand deposits due from banks	$ 21,910	$ 23,554
Trading securities	15,459	21,775
Available-for-sale securities (amortized cost of $247,017 in 2009; $248,741 in 2008)	251,138	246,455
Mortgage loans available for sale	929	898
Loans		
Agricultural	67,877	58,003
Commercial	334,616	324,806
Installment	33,051	33,179
Residential real estate mortgage	290,031	319,397
Total loans	**725,575**	**735,385**
Less allowance for loan losses	12,627	11,982
Net loans	**712,948**	**723,403**
Accrued interest receivable	6,574	6,322
Premises and equipment	23,661	23,231
Corporate-owned life insurance policies	16,606	16,152
Acquisition intangibles and goodwill, net	47,518	47,804
Equity securities without readily determinable fair values	17,808	17,345
Other assets	10,559	12,324
TOTAL ASSETS	**$ 1,125,110**	**$ 1,139,263**
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits		
Noninterest bearing	$ 91,570	$ 97,546
NOW accounts	114,067	113,973
Certificates of deposit and other savings	414,718	422,689
Certificates of deposit over $100,000	171,724	141,422
Total deposits	**792,079**	**775,630**
Borrowed funds ($17,969 carried at fair value in 2009; $23,130 in 2008)	183,241	222,350
Accrued interest and other liabilities	7,410	6,807
Total liabilities	**982,730**	**1,004,787**
Shareholders Equity		
Common stock no par value 15,000,000 shares authorized; outstanding 7,505,109 (including 26,458 shares to be issued) in 2009 and 7,518,856 (including 5,248 shares to be issued) in 2008	132,923	133,602

Shares to be issued for deferred compensation obligations	4,382	4,015
Retained earnings	5,296	2,428
Accumulated other comprehensive loss	(221)	(5,569)
Total shareholders equity	**142,380**	**134,476**
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	**$ 1,125,110**	**$ 1,139,263**

See notes to interim condensed consolidated financial statements.

Table of Contents

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

(Dollars in thousands except per share data)

	Common Stock Shares Outstanding	Common Stock	Shares to be issued for deferred compensation obligations	Retained Earnings	Accumulated Other Comprehensive Loss	Totals
Balances, January 1, 2008	6,364,120	$ 112,547	$ 3,772	$ 7,027	$ (266)	$ 123,080
Cumulative effect to apply EITF 06-4, net of tax				(1,571)		(1,571)
Comprehensive income				6,142	(2,568)	3,574
Common stock dividends (10%)	687,599	30,254		(30,254)		
Regulatory capital transfer		(28,000)		28,000		
Bank acquisition	514,809	22,652				22,652
Issuance of common stock	36,580	1,612				1,612
Common stock issued for deferred compensation obligations	27,004	360	(360)			
Share-based payment awards under equity compensation plan			321			321
Common stock repurchased pursuant to publically announced repurchase plan	(148,336)	(6,440)				(6,440)
Cash dividends ($0.36 per share)				(2,708)		(2,708)
Balances, September 30, 2008	7,481,776	$ 132,985	$ 3,733	$ 6,636	$ (2,834)	$ 140,520
Balances, January 1, 2009	7,518,856	$ 133,602	$ 4,015	$ 2,428	$ (5,569)	$ 134,476
Comprehensive income				5,727	5,348	11,075
Issuance of common stock	70,683	1,582				1,582
Common stock issued for deferred	10,067	274	(144)			130

compensation obligations						
Share-based payment awards under equity compensation plan			511			511
Common stock purchased for deferred compensation obligations		(646)				(646)
Common stock repurchased pursuant to publically announced repurchase plan	(94,497)	(1,889)				(1,889)
Cash dividends ($0.38 per share)				(2,859)		(2,859)
Balances, September 30, 2009	7,505,109	$ 132,923	$ 4,382	$ 5,296	$ (221)	$ 142,380

See notes to interim condensed consolidated financial statements.

Table of Contents

INTERIM CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)
(Dollars in thousands except per share data)

	Three Months Ended September 30		Nine Months Ended September 30	
	2009	2008	2009	2008
Interest Income				
Loans, including fees	$ 11,968	$ 12,566	$ 35,884	$ 37,511
Investment securities				
Taxable	1,112	1,288	3,482	4,023
Nontaxable	1,153	1,161	3,495	3,466
Trading account securities	158	221	543	856
Federal funds sold and other	125	165	290	430
Total interest income	**14,516**	**15,401**	**43,694**	**46,286**
Interest Expense				
Deposits	3,372	4,773	10,464	15,720
Borrowings	1,556	1,536	4,718	4,050
Total interest expense	**4,928**	**6,309**	**15,182**	**19,770**
Net interest income	**9,588**	**9,092**	**28,512**	**26,516**
Provision for loan losses	1,542	975	4,549	3,775
Net interest income after provision for loan losses	**8,046**	**8,117**	**23,963**	**22,741**
Noninterest Income				
Service charges and fees	1,907	1,747	5,321	4,870
Gain on sale of mortgage loans	240	38	768	195
Net gain (loss) on trading securities	112	20	142	(22)
Net (loss) gain on borrowings measured at fair value	(55)	182	161	304
Gain on sale of investment securities			648	15
Title insurance revenue				234
Other	362	390	1,014	1,076
Total noninterest income	**2,566**	**2,377**	**8,054**	**6,672**
Noninterest Expenses				
Compensation and benefits	4,440	4,156	13,836	12,693
Occupancy	554	512	1,631	1,533
Furniture and equipment	1,071	959	3,100	2,829
FDIC insurance premiums	110	76	1,410	161
Other	1,820	1,727	5,530	5,111
Total noninterest expenses	**7,995**	**7,430**	**25,507**	**22,327**
Income before federal income tax expense	**2,617**	**3,064**	**6,510**	**7,086**
Federal income tax expense	420	540	783	944
NET INCOME	**$ 2,197**	**$ 2,524**	**$ 5,727**	**$ 6,142**
Earnings per share				

Basic	**$ 0.29**	**$ 0.34**	**$ 0.76**	**$ 0.82**
Diluted	**$ 0.28**	**$ 0.33**	**$ 0.74**	**$ 0.80**
Cash dividends per basic share	**$ 0.13**	**$ 0.12**	**$ 0.38**	**$ 0.36**

See notes to interim condensed consolidated financial statements.

Table of Contents

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

	Three months Ended September 30		Nine Months Ended September 30	
	2009	2008	2009	2008
Net Income	**$ 2,197**	**$ 2,524**	**$ 5,727**	**$ 6,142**
Unrealized gains on available-for-sale securities:				
Unrealized holding gains (losses) arising during the period	7,673	(2,299)	7,055	(3,877)
Reclassification adjustment for net realized gains included in net income		(15)	(648)	(15)
Net unrealized gains (losses)	7,673	(2,314)	6,407	(3,892)
Tax effect	(2,066)	787	(1,059)	1,324
Other comprehensive income (loss)	5,607	(1,527)	5,348	(2,568)
Comprehensive income	**$ 7,804**	**$ 997**	**$ 11,075**	**$ 3,574**

See notes to interim condensed consolidated financial statements.

Table of Contents

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

	Nine Months Ended September 30	
	2009	2008
OPERATING ACTIVITIES		
Net income	$ 5,727	$ 6,142
Reconciliation of net income to net cash provided by operations:		
Provision for loan losses	4,549	3,775
Provision for foreclosed asset losses	54	8
Depreciation	1,752	1,608
Amortization and impairment of mortgage servicing rights	489	167
Amortization of acquisition intangibles	286	316
Net amortization of available-for-sale investment securities	534	228
Realized gain on sale of available-for-sale investment securities	(648)	(15)
Unrealized (gains) losses on trading securities	(142)	22
Unrealized gains on borrowings measured at fair value	(161)	(304)
Increase in cash value of corporate owned life insurance policies	(454)	(385)
Share-based payment awards under equity compensation plan	511	321
Deferred income tax benefit		(212)
Net changes in operating assets and liabilities which provided (used) cash, net in 2008 of bank acquisition and joint venture formation:		
Trading securities	6,458	7,393
Mortgage loans available for sale	(31)	1,508
Accrued interest receivable	(252)	(338)
Other assets	(1,996)	(1,555)
Escrow funds payable		(46)
Accrued interest and other liabilities	603	(1,459)
Net Cash Provided By Operating Activities	**17,279**	**17,174**
INVESTING ACTIVITIES		
Activity in available-for-sale securities		
Maturities, calls, and sales	109,779	51,346
Purchases	(107,941)	(67,138)
Loan principal collections (originations), net	4,157	(34,715)
Proceeds from sales of foreclosed assets	3,445	1,680
Purchases of premises and equipment	(2,182)	(1,372)
Bank acquisition, net of cash acquired		(9,465)
Cash contributed to title company joint venture formation		(4,542)
Purchase of corporate owned life insurance policies		(1,250)
Net Cash Provided By (Used In) Investing Activities	**7,258**	**(65,456)**
FINANCING ACTIVITIES		
Net increase (decrease) in deposits	16,449	(4,536)
Net (decrease) increase in other borrowed funds	(38,948)	58,602
Cash dividends paid on common stock	(2,859)	(2,708)
Proceeds from issuance of common stock	1,438	1,612
Common stock repurchased	(1,615)	(6,440)

Common stock purchased for deferred compensation obligations		(646)		
Net Cash (Used In) Provided By Financing Activities		**(26,181)**		**46,530**
DECREASE IN CASH AND CASH EQUIVALENTS		**(1,644)**		**(1,752)**
Cash and cash equivalents at beginning of period		23,554		25,583
CASH AND CASH EQUIVALENTS AT END OF PERIOD	**$**	**21,910**	**$**	**23,831**
Supplemental cash flows information:				
Interest paid	$	15,350	$	19,721
Transfer of loans to foreclosed assets		1,749		2,475

See notes to interim condensed consolidated financial statements.

Table of Contents

ISABELLA BANK CORPORATION
NOTES TO INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 1 BASIS OF PRESENTATION

The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. Operating results for the three and nine month periods ended September 30, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009. For further information, refer to the consolidated financial statements and footnotes thereto included in the Corporation s annual report for the year ended December 31, 2008.

In preparing these interim condensed consolidated financial statements we have evaluated, for potential recognition or disclosure events or transactions subsequent to the end of the most recent quarterly period through November 4, 2009, the issuance date of these interim condensed consolidated financial statements.

All amounts other than share and per share amounts have been rounded to the nearest thousand ($000) in this report.

Effective January 1, 2008, the Corporation acquired Greenville Community Financial Corporation (GCFC). The interim condensed consolidated financial statements include the results of operations of GCFC since January 1, 2008.

Effective March 1, 2008, the Corporation entered into a joint venture with Corporate Title Agency, LLC. The investment in the joint venture is accounted for under the equity method and is included in the line item equity securities without readily determinable fair values on the consolidated balance sheets. The results of operations since the date of the joint venture are recorded in other income on the accompanying statements of income.

The accounting policies are the same as those discussed in Note 1 to the Consolidated Financial Statements included in the Corporation s annual report for the year ended December 31, 2008.

Table of Contents

NOTE 2 COMPUTATION OF EARNINGS PER SHARE

Basic earnings per share represents income available to common stockholders divided by the weighted average number of common shares outstanding during the period, which includes shares held in the Rabbi Trust controlled by the Corporation. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustments to income that would result from the assumed issuance. In accordance with FASB ASC Topic 260, *Earnings Per Share*, the Corporation s obligations to issue shares of stock to participants in its Deferred Directors fee plan have been treated as outstanding shares of common stock in the diluted earnings per share calculation. Potential common shares that may be issued by the Corporation relate solely to outstanding shares in the Corporation s Deferred Director fee plan.

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

	Three Months Ended September 30		Nine Months Ended September 30	
	2009	2008	2009	2008
Average number of common shares outstanding for basic calculation*	7,507,964	7,477,290	7,514,617	7,492,152
Potential effect of shares in the Deferred Director fee plan*	204,746	184,667	199,201	183,891
Average number of common shares outstanding used to calculate diluted earnings per common share	7,712,710	7,661,957	7,713,818	7,676,043
Net income	$ 2,197	$ 2,524	$ 5,727	$ 6,142
Earnings per share				
Basic	$ 0.29	$ 0.34	$ 0.76	$ 0.82
Diluted	$ 0.28	$ 0.33	$ 0.74	$ 0.80

* As adjusted for the 10% stock dividend paid February 29, 2008

NOTE 3 OPERATING SEGMENTS

The Corporation s reportable segments are based on legal entities that account for at least 10 percent of net operating results. As of September 30, 2009 and 2008 and each of the three and nine month periods then ended, retail banking operations represented more than 90 percent of the Corporation s total assets and operating results. As such, no segment reporting is presented.

NOTE 4 DEFINED BENEFIT PENSION PLAN

The Corporation has a non-contributory defined benefit pension plan, which was curtailed effective March 1, 2007. Due to the curtailment, future salary increases are no longer considered and plan benefits are based on years of service and the employees five highest consecutive years of compensation out of the last ten years of service through March 1, 2007. As a result of the curtailment, the Corporation does not anticipate contributing to the plan in the reasonably foreseeable future.

The components of net periodic benefit cost (income) for the three and nine month periods ended September 30 are as follows:

	Three Months Ended September 30		Nine Months Ended September 30	
	2009	2008	2009	2008
Net periodic benefit cost (income)				
Interest cost on projected benefit obligation	$ 126	$ 125	$ 378	$ 377
Expected return on plan assets	(131)	(165)	(393)	(495)
Amortization of unrecognized actuarial net loss	43	1	128	3
Net periodic benefit cost (income)	**$ 38**	**$ (39)**	**$ 113**	**$ (115)**

Table of Contents

NOTE 5 FINANCIAL INSTRUMENTS RECORDED AT FAIR VALUE

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

Fair Value Hierarchy

Under FASB ASC Topic 820, the Corporation groups assets and liabilities at fair value into three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

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

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

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

The Corporation has invested $11,000 in auction rate preferred stock investment security instruments, which are classified as available-for-sale securities and reflected at fair value. Due to the continuing uncertainty in credit markets, these investments are illiquid. Due to the illiquidity of these securities, these assets were reclassified as Level 3 during the third quarter of 2008. The fair values of these securities were estimated utilizing a discounted cash flow analysis or other type of valuation adjustment methodology as of September 30, 2009. These analyses consider, among other factors, the collateral underlying the security investments, the creditworthiness of the counterparty, the timing of expected future cash flows, estimates of the next time the security is expected to have a successful auction, and the Corporation s ability to hold such securities until credit markets improve.

The table below represents the activity in investment securities available for sale measured with Level 3 inputs measured on a recurring basis for the three and nine month periods ended September 30:

	Three Months Ended September 30		Nine Months Ended September 30	
	2009	2008	2009	2008
Level 3 inputs at beginning of period	$ 22,881	$ 14,178	$ 19,391	$ 12,694
Purchases	95		3,395	2,379
Maturities	(423)	(434)	(1,291)	(1,159)
Transfers of securities into Level 3 due to changes in the observability of significant inputs (illiquid markets)		11,000		11,000
Net unrealized gains (losses)	1,749	(583)	2,807	(753)
Level 3 inputs September 30	$ 24,302	$ 24,161	$ 24,302	$ 24,161

10

Table of Contents

The tables below present the recorded amount of assets and liabilities measured at fair value on:

	September 30, 2009			December 31, 2008		
Description	Total	(Level 2)	(Level 3)	Total	(Level 2)	(Level 3)
Recurring Items						
Trading securities	$ 15,459	$ 15,459	$	$ 21,775	$ 21,775	$
Available-for-sale investment securities	251,138	226,836	24,302	246,455	227,064	19,391
Mortgage loans available for sale	929	929		898	898	
Borrowed funds	17,969	17,969		23,130	23,130	
Nonrecurring Items						
Impaired loans	12,273		12,273	10,014		10,014
Mortgage servicing rights	2,684	2,684		2,105	2,105	
Foreclosed assets	1,173	1,173		2,923	2,923	
	$ 301,625	$ 265,050	$ 36,575	$ 307,300	$ 277,895	$ 29,405
Percent of assets and liabilities measured at fair value		87.87%	12.13%		90.43%	9.57%

In certain previous Form 10-Q and Form 10-K filings the Corporation disclosed that a portion of trading securities, available-for-sale investment securities and other borrowed funds were measured at Level 1. The Corporation recently determined that documentation provided to the Corporation by its third party securities pricing vendor more closely reflects a Level 2 categorization than Level 1 as previously reported. No significant measurement methodology changes have been made by the Corporation s securities pricing vendor. As a result, $10,175 of trading securities, $89,507 of available-for-sale investment securities and $23,130 of other borrowed funds were reclassified from Level 1 to Level 2 classification for December 31, 2008.

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 impairment was recognized in the three and nine month periods ended September 30, 2009 and 2008, are summarized as follows:

	Three Months Ended September 30					
	2009			2008		
Description	Trading Gains and (Losses)	Other Gains and (Losses)	Total	Trading Gains and (Losses)	Other Gains and (Losses)	Total
Recurring Items						
Trading securities	$ 112	$	$ 112	$ 20	$	$ 20
Other borrowed funds		(55)	(55)		182	182
Nonrecurring Items						
Mortgage servicing rights		107	107		8	8
Foreclosed assets		(20)	(20)			

Total	$ 112	$ 32	$ 144	$ 20	$ 190	$ 210

Table of Contents

	Nine Months Ended September 30					
	2009			2008		
Description	Trading Gains and (Losses)	Other Gains and (Losses)	Total	Trading Gains and (Losses)	Other Gains and (Losses)	Total
Recurring Items						
Trading securities	$ 142	$	$ 142	$ (22)	$	$ (22)
Borrowed funds		161	161		304	304
Nonrecurring Items						
Mortgage servicing rights		99	99		8	8
Foreclosed assets		(54)	(54)		(8)	(8)
Total	$ 142	$ 206	$ 348	$ (22)	$ 304	$ 282

The activity in the trading portfolio of investment securities was as follows for the three and nine month periods ended September 30, 2009 and 2008:

	Three Months Ended September 30		Nine Months Ended September 30	
	2009	2008	2009	2008
Purchases	$	$	$	$ 9,052
Sales, calls, and maturities	(764)	(2,484)	(6,458)	(11,466)
Total	**$ (764)**	**$ (2,484)**	**$ (6,458)**	**$ (2,414)**

During the second quarter of 2009, a $5,001 borrowing carried at fair value matured. There were no other changes in borrowings carried in fair value during the first nine months of 2009 or 2008, other than recurring fair value adjustments.

NOTE 6 FAIR VALUES OF FINANCIAL INSTRUMENTS

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Corporation s various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the estimated amounts provided herein do not necessarily indicate amounts which could be realized in a current exchange. Furthermore, as the Corporation typically holds the majority of its financial instruments until maturity, it does not expect to realize all of the estimated amounts disclosed. The disclosures also do not include estimated fair value amounts for items which are not defined as financial instruments, but which have significant value. These include such items as core deposit intangibles, the future earnings of significant customer relationships and the value of other fee generating businesses. The Corporation believes the imprecision of an estimate could be significant.

The following methods and assumptions were used by the Corporation in estimating fair value disclosures for financial instruments.

Cash and cash equivalents: The carrying amounts of cash and short-term instruments approximate fair values.

Investment securities: Fair values for investment securities are based on quoted market prices, where available. If quoted market prices are unavailable, fair values are based on quoted market prices of comparable instruments 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. See Note 5 for further information.

Mortgage loans available for sale: Fair values of mortgage loans available for sale are based on commitments on hand from investors or prevailing market prices.

Loans receivable: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for other loans (e.g. , real estate mortgage, agricultural, commercial, and installment) 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 declines, if any, in the credit quality of borrowers since the loans were originated. Fair values for non-performing loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

Mortgage servicing rights: Fair value is determined using prices for similar assets with similar characteristics when applicable, or based upon discounted cash flow analyses.

Deposit liabilities: Demand, savings, and money market deposits are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for variable rate certificates of deposit approximate their recorded carrying value. Fair values for fixed-rate certificates of deposit are estimated using discounted cash flow calculations that apply interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Short-term borrowings: The carrying amounts of federal funds purchased, borrowings under repurchase agreements, and other short-term borrowings maturing within ninety days approximate their fair values. Fair values of other short-term borrowings are estimated using discounted cash flow analyses based on the Corporation s current incremental borrowing rates for similar types of borrowing arrangements.

Borrowings: The fair values of the Corporation s long-term borrowings are estimated using discounted cash flow analyses based on the Corporation s current incremental borrowing arrangements. The carrying amounts of federal funds purchased and borrowings under repurchase agreements approximate their fair value. The fair values of other borrowings are estimated using discounted cash flow analyses based on the Corporation s current incremental borrowing rates for similar types of borrowing arrangements.

Accrued interest: The carrying amounts of accrued interest approximate fair value.

Derivative financial instruments: Fair values for derivative loan commitments and forward loan sale commitments are based on fair values of the underlying mortgage loans and the probability of such commitments being exercised.

Table of Contents

The following sets forth the estimated fair value and recorded carrying values of the Corporation s financial instruments as of September 30:

	2009	
	Estimated Fair Value	Carrying Value
ASSETS		
Cash and demand deposits due from banks	$ 21,910	$ 21,910
Trading securities	15,459	15,459
Investment securities available for sale	251,138	251,138
Mortgage loans available for sale	940	929
Net loans	719,097	712,948
Accrued interest receivable	6,574	6,574
Mortgage servicing rights	2,684	2,684
LIABILITIES		
Deposits with no stated maturities	382,426	382,426
Deposits with stated maturities	394,865	409,653
Borrowed funds	186,284	183,241
Accrued interest payable	1,166	1,166

NOTE 7 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 and nine month periods ended September 30:

	Three Months Ended September 30		Nine Months Ended September 30	
	2009	2008	2009	2008
Income taxes at 34% statutory rate	$ 890	$ 1,042	$ 2,213	$ 2,409
Effect of nontaxable income	(478)	(508)	(1,458)	(1,492)
Effect of nondeductible expenses	8	6	28	27
Federal income tax expense	**$ 420**	**$ 540**	**$ 783**	**$ 944**

Included in other comprehensive income for the three and nine month periods ended September 30, 2009 are unrealized gains of $1,594 and $3,290, respectively, related to auction rate preferred stock investment securities. For federal income tax purposes, these securities are considered equity investments for which no federal deferred income taxes are expected or recorded.

Table of Contents

NOTE 8 RECENT ACCOUNTING PRONOUNCEMENTS

On July 1, 2009, the Financial Accounting Standards Board (FASB) completed the FASB Accounting Standards Codification, The FASB Codification"(ASC), as the single source of authoritative U.S. generally accepted accounting principles (GAAP), superseding all then existing authoritative accounting and reporting standards, except for rules and interpretive releases for the SEC under authority of federal securities laws, which are sources of authoritative GAAP for Securities and Exchange Commission registrants. ASC Topic 105 reorganized the authoritative literature comprising GAAP into a topical format. ASC is now the source of authoritative GAAP recognized by the FASB to be applied by all nongovernmental entities. ASC is effective for interim and annual periods ending after September 15, 2009. The Codification did not change GAAP and, therefore, did not impact the Corporation s financial statements. However, since it completely supersedes existing standards, it affected the way we reference authoritative accounting pronouncements in our financial statements and other disclosure documents. Specifically, all references in this report to new or pending financial reporting standards use the ASC Topic number.

FASB ASC Topic 320, Investments Debt and Equity Securities. New authoritative accounting guidance under ASC Topic 320, Investments Debt and Equity Securities, (i) changes existing guidance for determining whether an impairment is other than temporary to debt securities and (ii) replaces the existing requirement that the entity s management assert it has both the intent and ability to hold an impaired security until recovery with a requirement that management assert: (a) it does not have the intent to sell the security; and (b) it is more likely than not it will not have to sell the security before recovery of its cost basis. Under ASC Topic 320, declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of the impairment related to other factors is recognized in other comprehensive income. The Corporation adopted the provisions of the new authoritative accounting guidance under ASC Topic 320 during the first quarter of 2009. Adoption of the new guidance did not significantly impact the Corporation s financial statements.

FASB ASC Topic 805, Business Combinations. On January 1, 2009, new authoritative accounting guidance under ASC Topic 805, Business Combinations, became applicable to the Corporation s accounting for business combinations closing on or after January 1, 2009. ASC Topic 805 applies to all transactions and other events in which one entity obtains control over one or more other businesses. ASC Topic 805 requires an acquirer, upon initially obtaining control of another entity, to recognize the assets, liabilities and any non-controlling interest in the acquiree at fair value as of the acquisition date. Contingent consideration is required to be recognized and measured at fair value on the date of acquisition rather than at a later date when the amount of that consideration may be determinable beyond a reasonable doubt. This fair value approach replaces the cost-allocation process required under previous accounting guidance whereby the cost of an acquisition was allocated to the individual assets acquired and liabilities assumed based on their estimated fair value. ASC Topic 805 requires acquirers to expense acquisition-related costs as incurred rather than allocating such costs to the assets acquired and liabilities assumed, as was previously the case under prior accounting guidance. Assets acquired and liabilities assumed in a business combination that arise from contingencies are to be recognized at fair value if fair value can be reasonably estimated. If fair value of such an asset or liability cannot be reasonably estimated, the asset or liability would generally be recognized in accordance with ASC Topic 450, Contingencies. Under ASC Topic 805, the requirements of ASC Topic 420, Exit or Disposal Cost Obligations, would have to be met in order to accrue for a restructuring plan in purchase accounting. Pre-acquisition contingencies are to be recognized at fair value, unless it is a non-contractual contingency that is not likely to materialize, in which case, nothing should be recognized in purchase accounting and, instead, that contingency would be subject to the probable and estimable recognition criteria of ASC Topic 450, Contingencies.

FASB ASC Topic 810, Consolidation. New authoritative accounting guidance under ASC Topic 810, Consolidation, amended prior guidance to establish accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. Under ASC Topic 810, a non-controlling interest in a subsidiary, which is sometimes referred to as minority interest, is an ownership interest in the consolidated entity that should be reported as a component of equity in the consolidated financial statements. Among other requirements, ASC Topic 810 requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the non-controlling interest. It also requires disclosure, on the face of the consolidated income statement, of the amounts of consolidated net income attributable to the parent and to the non-controlling interest. The new authoritative accounting guidance under ASC Topic 810 became effective for the Corporation on January 1, 2009 and did not have a significant impact on the Corporation s financial statements.

Further new authoritative accounting guidance under ASC Topic 810 amends prior guidance to change how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether a company is required to consolidate an entity is based on, among other factors, an entity s purpose and design and a company s ability to direct the activities of the entity that most significantly impact the entity s economic performance. The new authoritative accounting guidance requires additional disclosures about the reporting entity s involvement with variable-interest entities and any significant changes in risk exposure due to that involvement as well as its affect on the entity s financial

Table of Contents

statements. The new authoritative accounting guidance under ASC Topic 810 will be effective January 1, 2010 and is not expected to have a significant impact on the Corporation s financial statements.

FASB ASC Topic 820, Fair Value Measurements and Disclosures. New authoritative accounting guidance under ASC Topic 820, Fair Value Measurements and Disclosures, affirms that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction, and clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active. ASC Topic 820 requires an entity to base its conclusion about whether a transaction was not orderly on the weight of the evidence. The new accounting guidance amended prior guidance to expand certain disclosure requirements. The Corporation adopted the new authoritative accounting guidance under ASC Topic 820 during the first quarter of 2009. Adoption of the new guidance did not significantly impact the Corporation s financial statements.

Further new authoritative accounting guidance (Accounting Standards Update No. 2009-5) under ASC Topic 820 provides guidance for measuring the fair value of a liability in circumstances in which a quoted price in an active market for the identical liability is not available. In such instances, a reporting entity is required to measure fair value utilizing a valuation technique that uses (i) the quoted price of the identical liability when traded as an asset, (ii) quoted prices for similar liabilities or similar liabilities when traded as assets, or (iii) another valuation technique that is consistent with the existing principles of ASC Topic 820, such as an income approach or market approach. The new authoritative accounting guidance also clarifies that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. The forgoing new authoritative accounting guidance under ASC Topic 820 will be effective for the Corporation s financial statements beginning October 1, 2009 and is not expected to have a significant impact on the Corporation s financial statements.

FASB ASC Topic 825 Financial Instruments. New authoritative accounting guidance under ASC Topic 825, Financial Instruments, requires an entity to provide disclosures about the fair value of financial instruments in interim financial information and amends prior guidance to require those disclosures in summarized financial information at interim reporting periods. The new interim disclosures required under Topic 825 are included in Note 6 Fair Values of Financial Instruments.

FASB ASC Topic 855, Subsequent Events. New authoritative accounting guidance under ASC Topic 855, Subsequent Events, establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. ASC Topic 855 defines (i) the period after the balance sheet date during which a reporting entity s management should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, (ii) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and (iii) the disclosures an entity should make about events or transactions that occurred after the balance sheet date. The new authoritative accounting guidance under ASC Topic 855 became effective for the Corporation s financial statements for periods ending after June 15, 2009 and did not have a significant impact on the Corporation s financial statements.

FASB ASC Topic 860, Transfers and Servicing. New authoritative accounting guidance under ASC Topic 860, Transfers and Servicing, amends prior accounting guidance to enhance reporting about transfers of financial assets, including securitizations, and where companies have continuing exposure to the risks related to transferred financial assets. The new authoritative accounting guidance eliminates the concept of a qualifying special-purpose entity and changes the requirements for derecognizing financial assets. The new authoritative accounting guidance also requires additional disclosures about all continuing involvements with transferred financial assets including information about gains and losses resulting from transfers during the period. The new authoritative accounting guidance under ASC Topic 860 will be effective January 1, 2010 and is not expected to have a significant impact on the Corporation s financial statements.

Table of Contents

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

The following is management s discussion and analysis of the major factors that influenced Isabella Bank Corporation s financial performance. This analysis should be read in conjunction with the Corporation s 2008 annual report and with the unaudited interim condensed consolidated financial statements and notes, beginning on page 3 of this report.

CRITICAL ACCOUNTING POLICIES: A summary of the Corporation s significant accounting policies is set forth in Note 1 of the Consolidated Financial Statements included in the Corporation s Annual Report for the year ended December 31, 2008. Of these significant accounting policies, the Corporation considers its policies regarding the allowance for loan losses, goodwill, acquisition intangibles, and the determination of the fair value of investment securities to be its most critical accounting policies.

The allowance for loan losses requires management s most subjective and complex judgment. Changes in economic conditions can have a significant impact on the allowance for loan losses and, therefore, the provision for loan losses and results of operations. The Corporation has developed appropriate policies and procedures for assessing the adequacy of the allowance for loan losses, recognizing that this process requires a number of assumptions and estimates with respect to its loan portfolio. The Corporation s assessments may be impacted in future periods by changes in economic conditions and the discovery of information with respect to borrowers which is not known to management at the time of the issuance of the consolidated financial statements. For additional discussion concerning the Corporation s allowance for loan losses and related matters, see Provision for Loan Losses and Allowance for Loan Losses in the Corporation s 2008 Annual Report and herein.

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

The Corporation currently has both available-for-sale and trading investment securities which are carried at their fair value. Changes in the fair value of available-for-sale investment securities are included in other comprehensive income, while declines in the fair value of these securities below their cost that are considered to be other than temporary are reflected as realized losses in the consolidated statements of income. The change in value of trading investment securities is included in current earnings.

The market values for available-for-sale and trading investment securities are typically obtained from outside sources and applied to individual securities within the portfolio. The fair values of investment securities with illiquid markets are estimated utilizing a discounted cash flow analysis or other type of valuation adjustment methodology. These securities are also compared, when possible, to other securities with similar characteristics.

RESULTS OF OPERATIONS

The following table outlines the results of operations for the three and nine month periods ended September 30, 2009 and 2008. Return on average assets measures the ability of the Corporation to profitably and efficiently employ its resources. Return on average equity indicates how effectively the Corporation is able to generate earnings on shareholder invested capital.

SUMMARY OF SELECTED FINANCIAL DATA

	Three Months Ended September 30		Nine Months Ended September 30	
	2009	2008	2009	2008
INCOME STATEMENT DATA				
Net interest income	$9,588	$9,092	$28,512	$26,516
Provision for loan losses	1,542	975	4,549	3,775
Net income	2,197	2,524	5,727	6,142
PER SHARE DATA				
Earnings per share:				
Basic	$ 0.29	$ 0.34	$ 0.76	$ 0.82
Diluted	0.28	0.33	0.74	0.80
Cash dividends per common share	0.13	0.12	0.38	0.36
Book value (at end of period)	18.97	18.78	18.97	18.78
RATIOS				
Average primary capital to average assets	13.37%	13.29%	13.25%	13.71%
Net income to average assets (annualized)	0.78	0.90	0.68	0.74
Net income to average equity (annualized)	6.30	7.14	5.50	5.69
Net income to average tangible equity (annualized)	9.55	10.81	8.37	8.60

Net Interest Income

Net interest income equals interest income less interest expense and is the primary source of income for Isabella Bank Corporation. Interest income includes loan fees of $529 and $1,517 for the three and nine month periods ended September 30, 2009, respectively, as compared to $428 and $1,390 during the same periods in 2008. For analytical purposes, net interest income is adjusted to a taxable equivalent basis by adding the income tax savings from interest on tax-exempt loans and securities, thus making year-to-year comparisons more meaningful.

(Continued on page 21)

Table of Contents

AVERAGE BALANCES, INTEREST RATE, AND NET INTEREST INCOME

The following schedules present the daily average amount outstanding for each major category of interest earning assets, nonearning assets, interest bearing liabilities, and noninterest bearing liabilities. This schedule also presents an analysis of interest income and interest expense for the periods indicated. All interest income is reported on a fully taxable equivalent (FTE) basis using a 34% tax rate. Non accruing loans, for the purpose of the following computations, are included in the average loan amounts outstanding. Federal Reserve and Federal Home Loan Bank restricted equity holdings are included in other.

Results for the three month periods ended September 30, 2009 and September 30, 2008 are as follows:

	Three Months Ended					
	September 30, 2009			September 30, 2008		
	Average Balance	Tax Equivalent Interest	Average Yield\ Rate	Average Balance	Tax Equivalent Interest	Average Yield\ Rate
INTEREST EARNING ASSETS:						
Loans	$ 724,927	$ 11,968	6.60%	$ 723,038	$ 12,566	6.95%
Taxable investment securities	113,938	1,112	3.90%	105,163	1,288	4.90%
Nontaxable investment securities	120,709	1,792	5.94%	121,231	1,805	5.96%
Trading account securities	15,948	202	5.07%	24,095	271	4.50%
Federal funds sold				11,863	55	1.85%
Other	35,475	125	1.41%	18,377	110	2.39%
Total earning assets	1,010,997	15,199	6.01%	1,003,767	16,095	6.41%
NON EARNING ASSETS:						
Allowance for loan losses	(12,254)			(8,512)		
Cash and due from banks	15,512			19,330		
Premises and equipment	23,794			22,390		
Accrued income and other assets	84,063			82,743		
Total assets &n						