

ISABELLA BANK CORP
Form 10-Q
August 08, 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 June 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 7,750,559 as of August 6, 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	OTC: Over-the-Counter
FASB: Financial Accounting Standards Board	OTTI: Other-than-temporary impairment
FDI Act: Federal Deposit Insurance Act	PBO: Projected benefit obligation
FDIC: Federal Deposit Insurance Corporation	PCAOB: Public Company Accounting Oversight Board
FFIEC: Federal Financial Institutions Examinations Council	Rabbi Trust: A trust established to fund the Directors Plan
FRB: Federal Reserve Bank	SEC: U.S. Securities & Exchange Commission
FHLB: Federal Home Loan Bank	SOX: Sarbanes-Oxley Act of 2002
Freddie Mac: Federal Home Loan Mortgage Corporation	TDR: Troubled debt restructuring
FTE: Fully taxable equivalent	XBRL: eXtensible Business Reporting Language

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PART I – FINANCIAL INFORMATION

Item 1. Interim Condensed Consolidated Financial Statements (Unaudited)

INTERIM CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in thousands)

	June 30 2014	December 31 2013
ASSETS		
Cash and cash equivalents		
Cash and demand deposits due from banks	\$26,484	\$21,755
Interest bearing balances due from banks	896	19,803
Total cash and cash equivalents	27,380	41,558
Certificates of deposit held in other financial institutions	580	580
Trading securities	—	525
AFS securities (amortized cost of \$546,102 in 2014 and \$517,614 in 2013)	550,518	512,062
Mortgage loans AFS	340	1,104
Loans		
Commercial	407,791	392,104
Agricultural	97,661	92,589
Residential real estate	278,545	289,931
Consumer	32,310	33,413
Gross loans	816,307	808,037
Less allowance for loan and lease losses	10,700	11,500
Net loans	805,607	796,537
Premises and equipment	25,701	25,719
Corporate owned life insurance policies	24,775	24,401
Accrued interest receivable	5,448	5,442
Equity securities without readily determinable fair values	19,303	18,293
Goodwill and other intangible assets	46,216	46,311
Other assets	16,267	20,605
TOTAL ASSETS	\$1,522,135	\$1,493,137
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest bearing	\$162,537	\$158,428
NOW accounts	186,705	192,089
Certificates of deposit under \$100 and other savings	463,497	455,547
Certificates of deposit over \$100	248,189	237,702
Total deposits	1,060,928	1,043,766
Borrowed funds	279,457	279,326
Accrued interest payable and other liabilities	10,651	9,436
Total liabilities	1,351,036	1,332,528
Shareholders' equity		
Common stock — no par value 15,000,000 shares authorized; issued and outstanding 7,735,156 shares (including 6,697 shares held in the Rabbi Trust) in 2014 and 7,723,023 shares (including 12,761 shares held in the Rabbi Trust) in 2013	137,945	137,580
Shares to be issued for deferred compensation obligations	3,984	4,148
Retained earnings	28,702	25,222
Accumulated other comprehensive income (loss)	468	(6,341)
Total shareholders' equity	171,099	160,609
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$1,522,135	\$1,493,137

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		Six Months Ended	
	June 30 2014	2013	June 30 2014	2013
Interest income				
Loans, including fees	\$9,799	\$10,280	\$19,550	\$20,610
AFS securities				
Taxable	1,993	1,798	3,991	3,632
Nontaxable	1,486	1,244	2,943	2,478
Trading securities	1	9	6	23
Federal funds sold and other	112	109	265	225
Total interest income	13,391	13,440	26,755	26,968
Interest expense				
Deposits	1,589	1,822	3,205	3,696
Borrowings	879	959	1,763	1,906
Total interest expense	2,468	2,781	4,968	5,602
Net interest income	10,923	10,659	21,787	21,366
Provision for loan losses	(200	) 215	(442	) 515
Net interest income after provision for loan losses	11,123	10,444	22,229	20,851
Noninterest income				
Service charges and fees	1,360	1,445	2,754	2,726
Net gain on sale of mortgage loans	151	249	266	607
Earnings on corporate owned life insurance policies	190	190	374	359
Net gains (losses) on sale of AFS securities	—	—	—	99
Other	733	852	1,289	1,392
Total noninterest income	2,434	2,736	4,683	5,183
Noninterest expenses				
Compensation and benefits	5,385	5,236	10,871	10,681
Furniture and equipment	1,219	1,192	2,487	2,381
Occupancy	676	641	1,418	1,306
Other	2,020	2,255	4,010	4,147
Total noninterest expenses	9,300	9,324	18,786	18,515
Income before federal income tax expense	4,257	3,856	8,126	7,519
Federal income tax expense	692	643	1,252	1,219
NET INCOME	\$3,565	\$3,213	\$6,874	\$6,300
Earnings per common share				
Basic	\$0.46	\$0.42	\$0.89	\$0.82
Diluted	\$0.45	\$0.41	\$0.87	\$0.80
Cash dividends per common share	\$0.22	\$0.21	\$0.44	\$0.42

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		Six Months Ended	
	June 30		June 30	
	2014	2013	2014	2013
Net income	\$3,565	\$3,213	\$6,874	\$6,300
Unrealized gains (losses) on AFS securities				
Unrealized gains (losses) arising during the period	4,448	(11,997	) 9,968	(13,958
Reclassification adjustment for net realized (gains) losses included in net income	—	—	—	(99
Net unrealized gains (losses)	4,448	(11,997	) 9,968	(14,057
Tax effect (1)	(1,420	) 3,979	(3,159	) 4,902
Other comprehensive income (loss), net of tax	3,028	(8,018	) 6,809	(9,155
Comprehensive income (loss)	\$6,593	\$(4,805	) \$13,683	\$(2,855

(1) See "Note 12 – 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)	—	—	—	6,300	(9,155)	(2,855)
Issuance of common stock	77,568	1,900	—	—	—	1,900
Common stock issued for deferred compensation obligations	—	—	—	—	—	—
Common stock transferred from the Rabbi Trust to satisfy deferred compensation obligations	—	121	(121)	—	—	—
Share-based payment awards under equity compensation plan	—	—	258	—	—	258
Common stock purchased for deferred compensation obligations	—	(166)	—	—	—	(166)
Common stock repurchased pursuant to publicly announced repurchase plan	(45,825)	(1,114)	—	—	—	(1,114)
Cash dividends (\$0.42 per share)	—	—	—	(3,224)	—	(3,224)
Balance, June 30, 2013	7,703,589	\$ 137,321	\$ 3,871	\$ 22,244	\$ (4,148)	\$ 159,288
Balance, January 1, 2014	7,723,023	\$ 137,580	\$ 4,148	\$ 25,222	\$ (6,341)	\$ 160,609
Comprehensive income (loss)	—	—	—	6,874	6,809	13,683
Issuance of common stock	76,341	1,778	—	—	—	1,778
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	—	—	237	—	—	237
Common stock purchased for deferred compensation obligations	—	(166)	—	—	—	(166)
Common stock repurchased pursuant to publicly announced repurchase plan	(70,334)	(1,648)	—	—	—	(1,648)
Cash dividends (\$0.44 per share)	—	—	—	(3,394)	—	(3,394)

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Balance, June 30, 2014	7,735,156	\$ 137,945	\$ 3,984	\$ 28,702	\$ 468	\$ 171,099
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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)

	Six Months Ended		
	June 30		
	2014	2013	
OPERATING ACTIVITIES			
Net income	\$6,874	\$6,300	
Reconciliation of net income to net cash provided by operating activities:			
Provision for loan losses	(442	) 515
Impairment of foreclosed assets	63	92	
Depreciation	1,242	1,249	
Amortization of OMSRs	139	210	
Amortization of acquisition intangibles	95	114	
Net amortization of AFS securities	920	1,131	
Net (gains) losses on sale of AFS securities	—	(99)
Net unrealized (gains) losses on trading securities	5	18	
Net gain on sale of mortgage loans	(266) (607)
Increase in cash value of corporate owned life insurance policies	(374) (359)
Share-based payment awards under equity compensation plan	237	258	
Origination of loans held-for-sale	(12,878) (35,014)
Proceeds from loan sales	13,908	38,511	
Net changes in operating assets and liabilities which provided (used) cash:			
Trading securities	520	605	
Accrued interest receivable	(6) (5)
Other assets	(250	) 914
Accrued interest payable and other liabilities	1,215	761	
Net cash provided by (used in) operating activities	11,002	14,594	
INVESTING ACTIVITIES			
Net change in certificates of deposit held in other financial institutions	—	2,655	
Activity in AFS securities			
Sales	—	9,857	
Maturities and calls	32,354	46,780	
Purchases	(61,762) (67,140)
Loan principal (originations) collections, net	(9,551) (32,185)
Proceeds from sales of foreclosed assets	1,140	1,556	
Purchases of premises and equipment	(1,224) (1,314)
Purchases of corporate owned life insurance policies	—	(1,092)
Proceeds from redemption of corporate owned life insurance policies	—	123	
Net cash provided by (used in) investing activities	(39,043) (40,760)

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INTERIM CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)

(Dollars in thousands)

	Six Months Ended	
	June 30	
	2014	2013
FINANCING ACTIVITIES		
Net increase (decrease) in deposits	17,162	3,757
Increase (decrease) in borrowed funds	131	21,459
Cash dividends paid on common stock	(3,394	) (3,224
Proceeds from issuance of common stock	1,778	1,900
Common stock repurchased	(1,648	) (1,114
Common stock purchased for deferred compensation obligations	(166	) (166
Net cash provided by (used in) financing activities	13,863	22,612
Increase (decrease) in cash and cash equivalents	(14,178	) (3,554
Cash and cash equivalents at beginning of period	41,558	24,920
Cash and cash equivalents at end of period	\$27,380	\$21,366
SUPPLEMENTAL CASH FLOWS INFORMATION:		
Interest paid	\$5,074	\$5,667
Federal income taxes paid	715	702
SUPPLEMENTAL NONCASH INFORMATION:		
Transfers of loans to foreclosed assets	\$923	\$735

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 six month periods ended June 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		Six Months Ended	
	June 30		June 30	
	2014	2013	2014	2013
Average number of common shares outstanding for basic calculation	7,722,367	7,701,042	7,721,814	7,689,092
Average potential effect of common shares in the Directors Plan (1)	168,715	168,323	170,984	166,800
Average number of common shares outstanding used to calculate diluted earnings per common share	7,891,082	7,869,365	7,892,798	7,855,892
Net income	\$3,565	\$3,213	\$6,874	\$6,300
Earnings per common share				
Basic	\$0.46	\$0.42	\$0.89	\$0.82
Diluted	\$0.45	\$0.41	\$0.87	\$0.80

(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.

Note 4 – AFS Securities

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

June 30, 2014

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Government sponsored enterprises	\$24,706	\$5	\$607	\$24,104
States and political subdivisions	208,564	6,962	1,316	214,210
Auction rate money market preferred	3,200	—	333	2,867
Preferred stocks	6,800	6	592	6,214
Mortgage-backed securities	162,949	1,732	1,689	162,992
Collateralized mortgage obligations	139,883	1,652	1,404	140,131
Total	\$546,102	\$10,357	\$5,941	\$550,518

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