FIRST FARMERS & MERCHANTS CORP
Form 10-Q
August 09, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark one)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended **June 30, 2012**

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 Numbers: 000-10972

First Farmers and Merchants Corporation

(Exact name of registrant as specified in its charter)

Tennessee	62-1148660
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

816 South Garden Street	
Columbia, Tennessee	38402-1148
(Address of principal executive offices)	(Zip Code)

931-388-3145

(Registrant s telephone number, including area code)

(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.
[X]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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). [X]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 definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer [ ]	Accelerated filer [X]
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 Act). [ ] Yes [X] No

As of August 6, 2012, the registrant had 5,330,000 shares of common stock outstanding.

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements.

The following unaudited condensed consolidated financial statements of the Registrant and its subsidiaries are included in this Report:

Condensed consolidated balance sheets June 30, 2012 and December 31, 2011.

Condensed consolidated statements of income - For the three months and six months ended June 30, 2012 and June 30, 2011.

Condensed consolidated statements of comprehensive income - For the three months and six months ended June 30, 2012 and June 30, 2011.

Condensed consolidated statements of cash flows - For the six months ended June 30, 2012 and June 30, 2011.

Selected notes to condensed consolidated financial statements.

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FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

	(Dollars in Thousands, Except Per Share Data)	**June 30, 2012 (Unaudited)**	December 31, 2011 (1)
ASSETS	Cash and due from banks	**$ 18,442**	$ 17,927
	Interest-bearing due from banks	**19,560**	16,500
	Federal funds sold	**15,000**	38,594
	Total cash and cash equivalents	**53,002**	73,021
	Securities		
	Available-for-sale (amortized cost $360,392 and $309,374, respectively)	**364,535**	314,270
	Held-to-maturity (fair market value $34,238 and $37,275, respectively)	**32,429**	35,214
	Total securities	**396,964**	349,484
	Loans, net of deferred fees	**518,687**	517,802
	Allowance for loan and lease losses	**(8,772)**	(9,200)
	Net loans	**509,915**	508,602
	Bank premises and equipment, net	**26,947**	25,537
	Other real estate owned	**8,243**	8,827
	Bank owned life insurance	**24,742**	23,621
	Goodwill	**9,018**	9,018
	Other assets	**17,729**	19,339
	TOTAL ASSETS	**$ 1,046,560**	$ 1,017,449
LIABILITIES	Deposits		
	Noninterest-bearing	**$ 150,155**	$ 144,003
	Interest- bearing	**737,293**	712,427
	Total deposits	**887,448**	856,430
	Securities sold under agreements to repurchase	**18,670**	16,347
	Accounts payable and accrued liabilities	**17,071**	16,265
	Federal Home Loan Bank advances	**10,100**	17,100
	TOTAL LIABILITIES	**933,289**	906,142
SHAREHOLDERS' EQUITY	Common stock - $10 par value per share, 8,000,000 shares authorized; 5,330,000 shares issued and outstanding as of June 30, 2012 and December 31, 2011	**53,300**	53,300
	Retained earnings	**57,328**	54,890

Accumulated other comprehensive income	**2,548**	3,022
TOTAL SHAREHOLDERS' EQUITY BEFORE NONCONTROLLING INTEREST - PREFERRED STOCK OF SUBSIDIARY	**113,176**	111,212
Noncontrolling interest - preferred stock of subsidiary	**95**	95
TOTAL SHAREHOLDERS' EQUITY	**113,271**	111,307
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	**$ 1,046,560**	$ 1,017,449

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

(1) Derived from audited financial statements.

FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME *(unaudited)*

	(Dollars in Thousand, Except Per Share Data)	Three Months Ended June 30,		Six Months Ended June 30,	
		2012	**2011**	**2012**	**2011**
INTEREST AND DIVIDEND INCOME	Interest and fees on loans	**$ 6,968**	$ 7,528	**$ 13,948**	$ 15,065
	Income on investment securities				
	Taxable interest	**1,250**	1,143	**2,434**	2,068
	Exempt from federal income tax	**778**	910	**1,587**	1,843
	Dividends	**64**	88	**112**	136
	Other interest income	**35**	11	**79**	29
	Total interest income	**9,095**	9,680	**18,160**	19,141
INTERST EXPENSE	Interest on deposits	**855**	1,077	**1,759**	2,242
	Interest on other borrowings	**124**	178	**291**	385
	Total interest expense	**979**	1,255	**2,050**	2,627
	Net interest income	**8,116**	8,425	**16,110**	16,514
	Provision for loan and lease losses	**520**	750	**1,120**	1,475
	Net interest income after provision	**7,596**	7,675	**14,990**	15,039
NONINTEREST INCOME	Gain on loans sold	**129**	70	**248**	243
	Trust department income	**500**	498	**1,036**	1,024
	Service fees on deposit accounts	**1,642**	1,713	**3,290**	3,316
	Brokerage fees	**68**	-	**110**	-
	Earnings on bank owned life insurance	**216**	180	**335**	357
	Gain on sale of securities	**943**	374	**2,155**	434
	Loss on foreclosed property	**(112)**	(237)	**(526)**	(457)
	Other non-interest income	**(26)**	96	**91**	199
	Total noninterest income	**3,360**	2,694	**6,739**	5,116
NONINTEREST EXPENSE	Salaries and employee benefits	**4,430**	4,144	**8,703**	8,278
	Net occupancy expense	**521**	497	**989**	975
	Depreciation expense	**358**	332	**686**	638
	Data processing expense	**506**	483	**981**	947
	Legal and professional fees	**311**	273	**499**	549
	Stationary and office supplies	**72**	90	**121**	165
	Advertising and promotions	**292**	344	**586**	677
	FDIC insurance premium expense	**356**	383	**712**	767
	Other real estate expense	**47**	182	**158**	293
	Other noninterest expense	**1,523**	1,319	**2,735**	2,671
	Total noninterest expenses	**8,416**	8,044	**16,170**	15,960
	Income before provision for income taxes	**2,540**	2,325	**5,559**	4,195
	Provision for income taxes	**451**	306	**1,141**	631
	Net income before noncontrolling interest - dividends on preferred stock of subsidiary	**2,089**	2,019	**4,418**	3,564
	Noncontrolling interest - dividends on preferred stock of subsidiary	**8**	8	**8**	8
	Net income for common shareholders	**$ 2,081**	$ 2,011	**$ 4,410**	$ 3,556

Weighted average shares outstanding	**5,330,000**	5,392,760	**5,330,000**	5,410,205
Earnings per share	**$ 0.39**	$ 0.37	**$ 0.83**	$ 0.66

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

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FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME *(unaudited)*

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2012	2011	2012	2011
Net Income	$ 2,081	$ 2,011	$ 4,410	$ 3,556
Comprehensive Income				
Unrealized appreciation (depreciation) on available-for-sale securities, net of taxes of $953 and $1,210 for 2012 and 2011, respectively for three months and net of taxes of $533 and $1,213 for six months	1,522	1,934	852	1,938
Less: reclassification adjustment for realized (gains) losses included in net income, net of taxes of $363 and $144, for 2012 and 2011, respectively for three months and net of taxes of ($830) and ($167) for six months	(580)	(230)	(1,325)	(267)
Net unrealized gain (loss) on available-for-sale securities	942	1,704	(473)	1,671
Comprehensive Income	3,023	3,715	3,937	5,227
Less: comprehensive income attributable to the noncontrolling interest	-	-	-	-
Total Comprehensive Income	$ 3,023	$ 3,715	$ 3,937	$ 5,227

FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	(Dollars in Thousands) *(unaudited)*	**Six months ended June 30, 2012**	2011
OPERATING ACTIVITIES	Net income available for common shareholders	**$ 4,410**	$ 3,556
	Adjustments to reconcile net income to net cash provided by (used in) operating activities		
	Provision for loan losses	**1,120**	1,475
	Provision for depreciation and amortization of premises and equipment	**686**	639
	Deferred tax expense	**(50)**	102
	Net securities gains	**(2,155)**	(434)
	Gains on loans sold	**(248)**	-
	Proceeds from sale of mortgage loans held for sale	**14,165**	-
	Funding of mortgage loans held for sale	**(12,597)**	-
	Gain on sale of OREO	**526**	-
	Gain on sale of assets	**(10)**	-
	Amortization of deposit base intangibles	**-**	18
	Amortization of investment security premiums, net of accretion of discounts	**2,128**	718
	Increase in cash surrender value of life insurance contracts	**(335)**	(615)
	(Increase) decrease in Other assets	**814**	4,105
	Increase (decrease) in Other liabilities	**637**	648
	Total adjustments	**4,665**	6,656
	Net cash provided by operating activities	**9,091**	10,212
INVESTING ACTIVITIES	Proceeds from sales of available-for-sale securities	**339,076**	83,446
	Proceeds from maturities and calls of available-for-sale securities	**35,045**	-
	Proceeds from maturities and calls of held-to-maturity securities	**2,770**	2,655
	Purchases of investment securities available-for-sale	**(425,115)**	(107,025)
	Net (increase) decrease in loans	**(3,698)**	10,713
	Proceeds from sale of OREO	**1,323**	-
	Purchase of life insurance premium	**(786)**	-
	Purchases of premises and equipment	**(2,086)**	(2,463)
	Net cash used in investing activities	**(53,471)**	(12,674)
FINANCING ACTIVITIES	Net increase in deposits	**31,018**	22,662
	Net increase in securities sold under agreements to repurchase	**2,323**	5,985
	Payments to FHLB borrowings	**(7,000)**	(7,000)
	Repurchase of common stock	**-**	(1,511)

Cash dividends paid on preferred stock		**(8)**		(8)
Cash dividends paid on common stock		**(1,972)**		-
Net cash provided by financing activities		**24,361**		20,128
Increase (decrease) in cash and cash equivalents		**(20,019)**		17,666
Cash and cash equivalents at beginning of period		**73,021**		32,499
Cash and cash equivalents at end of period	**$**	**53,002**	$	50,165
Supplemental disclosures of cash flow information				
Cash paid during the period for expenses				
Interest on deposits and borrowed funds	**$**	**1,993**	**$**	**7,107**
Income Taxes		**1,563**		**1,607**
Loans to facilitate sale		**74**		**-**
Real estate acquired in settlement of taxes		**1,191**		**1,375**

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

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying unaudited condensed consolidated financial statements reflect all adjustments that are in the opinion of First Farmers and Merchants Corporation s (the Corporation) management, necessary to fairly present the financial position, results of operations and cash flows of the Corporation. Those adjustments consist only of normal recurring adjustments.

The accompanying condensed consolidated financial statements are presented in accordance with the requirements of Form 10-Q and consequently do not include all of the disclosures normally required by accounting principles generally accepted in the United States of America or those normally made in the Registrant s annual report on Form 10-K. Accordingly, the reader of the Form 10-Q should refer to the Registrant s Form 10-K for the year ended December 31, 2011 for further information in this regard. The condensed consolidated balance sheet of the Corporation as of December 31, 2011 has been derived from the audited consolidated balance sheet of the Corporation as of that date. The results of operations for the period are not necessarily indicative of the results to be expected for the full year.

Reclassifications: Certain reclassifications considered to be immaterial have been made in the prior year condensed consolidated financial statements to conform to current year presentation. These reclassifications had no effect on net income.

NOTE 2 FAIR VALUE MEASUREMENT

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. Fair value measurement must maximize the use of observable inputs and minimize the use of unobservable inputs. In estimating fair value, the Corporation utilizes valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. Such valuation techniques are consistently applied. Inputs to valuation techniques include the assumptions that market participants would use in pricing an asset or liability. Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 820, Fair Value Measurements and Disclosures (ASC Topic 820) establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

- *Level 1 Inputs* - Unadjusted quoted prices in active markets for identical assets or liabilities.

- *Level 2 Inputs* - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, market consensus, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

- *Level 3 Inputs* - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity s own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with the Corporation s monthly and/or quarterly valuation process.

Recurring Measurements

The following table summarizes financial assets measured at fair value on a recurring basis as of June 30, 2012 and December 31, 2011, and by the level within the fair value hierarchy utilized to measure fair value (dollars in thousands):

Assets measured at fair value on a recurring basis as of June 30, 2012				
Available-For-Sale Securities	Level 1	Level 2	Level 3	Total
U.S. Government agencies	$ -	$ 79,893	$ -	$ 79,893
U.S. government sponsored agency mortgage backed securities	-	213,796	-	213,796
States and political subdivisions	-	51,972	-	51,972
Corporate bonds	-	18,874	-	18,874
Total assets at fair value	$ -	$ 364,535	$ -	$ 364,535
Assets measured at fair value on a recurring basis as of December 31, 2011				
Available-For-Sale Securities	Level 1	Level 2	Level 3	Total
U.S.Government agencies	$ -	$ 59,001	$ -	$ 59,001
U.S.Government sponsored agency mortgage backed securities	-	176,050	-	176,050
States and political subdivisions	-	59,946	-	59,946
Corporate bonds	-	19,273	-	19,273
Total assets at fair value	$ -	$ 314,270	$ -	$ 314,270

The following is a description of the valuation methodologies and inputs used for assets measured at fair value on a recurring basis and recognized in the accompanying balance sheets, as well as the general classification of such assets pursuant to the valuation hierarchy. There have been no significant changes in the valuation techniques during the three months ended June 30, 2012.

Available-for-Sale Securities

Where quoted market prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. If quoted market prices are not available, the Corporation obtains fair value measurements from an independent pricing service, such as Interactive Data, which utilizes pricing models to determine fair value measurement. The Corporation reviews the pricing quarterly to verify the reasonableness of the pricing. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond s terms and conditions, among other factors. U.S. government agencies, state and political subdivisions, U.S. government sponsored agency mortgage-backed securities, and corporate bonds are classified as Level 2 inputs.

Nonrecurring Measurements:

The following table summarizes financial assets measured at fair value on a nonrecurring basis as of June 30, 2012 and December 31, 2011, and by the level within the fair value hierarchy utilized to measure fair value (dollars in thousands):

Assets measured at fair value on a nonrecurring basis as of June 30, 2012				
	Level 1	Level 2	Level 3	Total
Impaired loans (collateral dependent)	$ -	$ -	$ 6,721	$ 7,265
Other real estate owned	-	-	905	905
Assets measured at fair value on a nonrecurring basis as of December 31, 2011				
	Level 1	Level 2	Level 3	Total
Impaired loans (collateral dependent)	$ -	$ -	$ 13,604	$ 13,604
Other real estate owned	-	-	8,827	8,827

Impaired Loans (Collateral Dependent)

The estimated fair value of collateral-dependent impaired loans is based on the appraised fair value of the collateral, less estimated cost to sell. Collateral-dependent impaired loans are classified within Level 3 of the fair value hierarchy.

The Corporation considers the appraisal or evaluation as the starting point for determining fair value and then considers other factors and events in the environment that may affect the fair value. Appraisals of the collateral underlying collateral-dependent loans are obtained when the loan is determined to be collateral-dependent and subsequently as deemed necessary by the Chief Credit Officer. Appraisals are reviewed for accuracy and consistency by the Chief Credit Officer. Appraisers are selected from the list of approved appraisers maintained by management. The appraised values are reduced by discounts to consider lack of marketability and estimated cost to sell if repayment or satisfaction of the loan is dependent on the sale of the collateral. These discounts and estimates are developed by the Chief Credit Officer by comparison to historical results. Fair value adjustments for the six months ended June 30, 2012 and 2011 were $1.4 million and approximately $448,000, respectively, and $1.2 million for the year ended December 31, 2011.

Loans considered impaired under ASC 310-35, Impairment of a Loan, are loans for which, based on current information and events, it is probable that the creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans are subject to nonrecurring fair value adjustments to reflect (1) subsequent partial write-downs that are based on the observable market price or current appraised value of the collateral or (2) the full charge-off of the loan carrying value.

Other Real Estate Owned

Other real estate owned (OREO) is initially recorded at fair value at the time of acquisition, as determined by independent appraisal or evaluation by the Corporation, less costs to sell when the real estate is acquired in settlement of loans. Quarterly evaluations of OREO are performed to determine if there has been any subsequent decline in the value of OREO properties. Estimated fair value of OREO is based on appraisals or evaluations, less costs to sell. OREO is classified within Level 3 of the fair value hierarchy. OREO assets are subject to nonrecurring fair value adjustments to reflect subsequent partial write-downs that are based on the observable market price or current appraised value of the collateral. Fair value adjustments for the six months ended June 30, 2012 and 2011 were approximately $454,000 and $473,000, respectively, and $1.1 million for the year ended December 31, 2011.

Appraisals of OREO are obtained when the real estate is acquired and subsequently as deemed necessary by the Chief Credit Officer. Appraisals are required annually and reviewed for accuracy and consistency by the Chief Credit Officer. The appraised values are reduced by discounts to consider lack of marketability and estimated cost to sell. Appraisers are selected from the list of approved appraisers maintained by management.

Unobservable (Level 3) Inputs

The following table presents quantitative information about unobservable inputs used in nonrecurring Level 3 fair value measurements (dollars in thousands).

Quantitative Information about Level 3 Fair Value Measurements

	Fair Value at June 30, 2012		Valuation Technique(s)	Unobservable Input	Range (Weighted Average)
Impaired loans (collateral-dependent)	$	7,265	Market comparable properties	Marketability discount	5.0% - 10.0% (7%)
Other real estate/assets owned	$	905	Market comparable properties	Marketability discount	5.0% - 10.0% (7%)

ASC Topic 825, Financial Instruments, requires disclosure of the fair value of financial assets and liabilities, including those financial assets and liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

Cash and due from banks The carrying amount approximates fair value.

Interest bearing deposits in other banks The carrying amount approximates fair value.

Federal funds sold The carrying amount approximates fair value.

Securities held-to-maturity Fair values are based on quoted market prices, if available. If a quoted price is not available, fair value is estimated using quoted prices for similar securities. The fair value estimate is provided to management from a third party using modeling assumptions specific to each type of security that are reviewed and approved by management. Quarterly sampling of fair values provided by additional third parties supplement the fair value review process.

Loans held for sale The fair value is predetermined at origination based on sale price.

Loans (net of the allowance for loan losses) The fair value of fixed rate loans and variable rate mortgage loans is estimated by discounting the future cash flows using current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. For other variable rate loans, the carrying amount approximates fair value

Federal Home Loan Bank stock The carrying value of Federal Home Loan Bank (FHLB) stock approximates fair value based on the redemption provisions of the FHLB.

Federal Reserve Bank stock The carrying value of Federal Reserve Bank stock approximates fair value based on the redemption provisions of the Federal Reserve Bank.

Accrued interest receivable The carrying amount approximates fair value.

Deposits The fair value of fixed maturity time deposits is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities. For deposits including demand deposits, savings accounts, NOW accounts, and certain money market accounts, the carrying value approximates fair value.

Repurchase agreements The fair value is estimated by discounting future cash flows using current rates.

Advances from FHLB The fair value of these fixed-maturity advances is estimated by discounting future cash flows using rates currently offered for advances of similar remaining maturities.

Accrued interest payable The carrying amount approximates fair value.

Commitments to extend credit and letters of credit The fair value of commitments to originate loans is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair values of letters of credit and lines of credit are based on fees currently charged for similar agreements or on the estimated cost to terminate or otherwise settle the obligations with the counterparties at the reporting date. The fair values of these commitments are not material.

The following table presents estimated fair values of the Corporation s financial instruments as of June 30, 2012 and indicates the level within the fair value hierarchy of the valuation techniques (dollars in thousands).

	Fair Value Measurements at June 30, 2012 Using			
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial assets				
Cash and cash equivalents	$ 18,442	$ 18,442	$ -	$ -
Interest-bearing deposits in other banks	19,560	19,560		
Federal funds sold	15,000	15,000		
Federal Home Loan Bank and Federal Reserve bank stock	3,879		3,879	
Securities available-for-sale	364,535		364,535	
Securities held-to-maturity	32,429		34,238	
Loans held for sale	1,185		1,185	
Loans, net	509,915			525,568
Accrued interest receivable	4,141		4,141	
Financial liabilities				
Non-interest bearing deposits	150,155	152,968		
Interest bearing deposits	737,293		739,626	
Repurchase agreements	18,670		18,670	
Advances from Federal Home Loan Bank	10,100		10,337	
Accrued interest payable	821		821	
Off-balance sheet credit related instruments:				
Commitments to extend credit			119	

The estimated fair values of financial instruments as of December 31, 2011 were as follows (dollars in thousands):

	December 31, 2011	
	Carrying Amount	Fair Value
Financial assets		
Cash and due from banks	$ 17,927	$ 17,927
Interest-bearing deposits in banks	38,594	38,594
Federal funds sold	16,500	16,500
Securities available-for-sale	318,166	318,166
Securities held-to-maturity	35,214	37,276
Loans, net	508,602	523,847
Accrued interest receivable	4,095	4,095
Financial liabilities		
Deposits	856,430	858,775
Federal funds purchased and securities sold under agreements to repurchase	16,347	16,347
Other short term liabilities	-	-
Advances from FHLB	17,100	17,521
Accrued interest payable	878	878
Off-balance sheet credit related instruments:		
Commitments to extend credit		- 109

NOTE 3 SECURITIES

The amortized cost and estimated fair value of securities at June 30, 2012 and December 31, 2011 were as follows (dollars in thousands):

June 30, 2012	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities				
U.S. Government agencies	**$ 79,780**	**$ 226**	**$ 113**	**$ 79,893**
U.S. Government sponsored agency mortgage backed securities	**213,438**	**801**	**443**	**213,796**
States and political subdivisions	**48,824**	**3,148**	**-**	**51,972**
Corporate bonds	**18,350**	**537**	**13**	**18,874**
	$ 360,392	**$ 4,712**	**$ 569**	**$ 364,535**
Held-to-maturity securities				
States and political subdivisions	**$ 32,429**	**$ 1,809**	**$ -**	**$ 34,238**

December 31, 2011	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale securities				
U.S. Government agencies	$ 58,793	$ 214	$ 6	$ 59,001
U.S. Government sponsored agency mortgage backed securities	175,352	843	145	176,050
States and political subdivisions	56,452	3,494	-	59,946
Corporate bonds	18,741	582	68	19,273
	$ 309,338	$ 5,133	$ 219	$ 314,270
Held-to-maturity securities				
States and political subdivisions	$ 35,214	$ 2,061	$ -	$ 37,275

Certain investments in debt securities are reported in the financial statements at an amount less than their historical cost. Total fair value of these investments at June 30, 2012 and December 31, 2011, was approximately $130,636 and $85,009, which was approximately 33% and 24%, respectively, of the Corporation s available-for-sale and held-to-maturity investment portfolio. The Corporation evaluates its investment portfolio on a quarterly basis for impairment. The analysis performed as of June 30, 2012 and December 31, 2011 indicated that all impairment was considered temporary, market driven due primarily to fluctuations in market interest rates and not credit-related.

The following table shows the Corporation s investments gross unrealized losses and fair value of the Corporation s investments with unrealized losses that were not deemed to be other-than-temporarily impaired, aggregated by investment class and length of time that individual securities had been in a continuous unrealized loss position at June 30, 2012 and December 31, 2011 (dollars in thousands):

June 30, 2012	**Less than 12 months**		**12 months or Greater**		**Total**	
	Fair	**Unrealized**	**Fair**	**Unrealized**	**Fair**	**Unrealized**
Type of Security	**Value**	**Losses**	**Value**	**Losses**	**Value**	**Losses**
U.S. Government agencies	**$ 29,972**	**$ 113**	**$ -**	**$ -**	**$ 29,972**	**$ 113**
U.S. Government sponsored agency mortgage backed securities	**98,560**	**443**	**-**	**-**	**98,560**	**443**
Corporate bonds	**1,960**	**9**	**144**	**4**	**2,104**	**13**
	$ 130,,492	**$ 565**	**$ 144**	**$ 4**	**$ 130,636**	**$ 569**

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December 30, 2011	Less than 12 months		12 months or Greater		Total	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
Type of Security	Value	Losses	Value	Losses	Value	Losses
U.S. Government agencies	$ 15,063	$ 7	$ -	$ -	$ 15,063	$ 7
U.S. Government sponsored agency mortgage	40,792	145			40,792	145
backed securities						67
Corporate bonds	29,154	67	-	-	29,154	-
	$ 85,009	$ 219	$ -	$ -	$ 85,009	$ 219

The amortized cost and fair value of available-for-sale securities and held-to-maturity securities at June 30, 2012, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Available for Sale		**Held to Maturity**	
June 30, 2012	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Within one year	$ 9,138	$ 9,229	$ 2,325	$ 2,357
One to five years	24,198	24,821	8,503	8,945
Five to ten years	82,061	82,929	11,371	12,093
After ten years	31,557	33,760	10,230	10,843
Mortgage-backed securities	213,438	213,796	-	-
Total	**$ 360,392**	**$ 364,535**	**$ 32,429**	**$ 34,238**

The carrying value of securities pledged as collateral to secure public deposits and for other purposes was $222.7 million at June 30, 2012 and $196.1 million at December 31, 2011.

The book value of securities sold under agreements to repurchase amounted to $26.5 million and $22.2 million at June 30, 2012 and December 31, 2011, respectively.

Gross gains of approximately $943,000, $374,000, $2.2 million and $434,000 resulting from sales of available-for-sale securities were realized for the three months and six month periods ended June 30, 2012 and 2011, respectively.

NOTE 4 LOANS

The following table presents the Corporation s loans by class as of June 30, 2012 and December 31, 2011 (dollars in thousands):

	June 30, 2012	December 31, 2011
Commercial		
Commercial and industrial	**$ 64,875**	$ 60,448
Non-farm, non-residential real estate	**146,697**	140,147
Construction and development	**30,884**	29,042
Commercial loans secured by real estate	**9,578**	6,161
Other commercial	**39,190**	45,630

	291,224	**281,428**
Retail		
Consumer	**12,656**	14,297
Single family residential	**194,830**	196,913
Other retail	**19,977**	25,700
	$ 227,463	**$ 236,910**
Total	**$ 518,687**	$ 518,338

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Loan Origination/Risk Management. The Corporation has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of credit risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies and non-performing and potential problem loans. Diversification in the loan portfolio is a means of managing risk associated with fluctuations in economic conditions.

Commercial and industrial loans are underwritten after evaluating and understanding a borrower s ability to operate profitably and expand its business prudently. Underwriting standards are designed to promote relationship banking rather than transactional banking. Once it is determined that the borrower s management possesses sound ethics and solid business acumen, the Corporation s management examines current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may incorporate a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. As a general rule, the Corporation avoids financing single-purpose projects unless other underwriting factors are present to help mitigate risk. The Corporation also utilizes third-party experts to provide insight and guidance about economic conditions and trends affecting market areas it serves. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans. At June 30, 2012, approximately half of the outstanding principal balance of the Corporation s commercial real estate loans were secured by owner-occupied properties.

With respect to loans to developers and builders (construction and development) that are secured by non-owner occupied properties that the Corporation may originate from time to time, the Corporation generally requires the borrower to have had an existing relationship with the Corporation and have a proven record of success. Construction loans are underwritten utilizing feasibility studies, independent appraisal reviews, sensitivity analysis of absorption and lease rates and financial analysis of the developers and property owners. Construction loans are generally based upon estimates of costs and value associated with the complete project. These estimates may be inaccurate. Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Corporation until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

The Corporation originates consumer retail loans utilizing a computer-based credit scoring analysis to supplement the underwriting process. To monitor and manage consumer retail loan risk, policies and procedures are developed and modified, as needed, jointly by line and staff personnel. This activity, coupled with relatively small loan amounts that are spread across many individual borrowers, minimizes risk. Additionally, trend and outlook reports are reviewed by management on a regular basis. Underwriting standards for home equity loans are heavily influenced by statutory requirements, which include, but are not limited to, a maximum loan-to-value percentage of 80%, collection remedies, the number of such loans a borrower can have at one time and documentation requirements.

The Corporation contracts with a third party vendor to perform loan reviews. The Corporation reviews and validates the credit risk program on an annual basis. Results of these reviews are presented to management. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Corporation s policies and procedures.

The goal of the Corporation is to diversify loans to avoid a concentration of credit in a specific industry, person, entity, product, service, or any area vulnerable to a tax law change or an economic event. A concentration of credit occurs when obligations, direct or indirect, of the same or affiliated interests represent 15% or more of the Corporation's capital structure. The Board of Directors recognizes that the Corporation's geographic trade area imposes some limitations regarding loan diversification if the Corporation is to perform the function for which it has been chartered. Specifically, lending to qualified borrowers within the Corporation's trade area will naturally cause concentrations of real estate loans in the primary communities served by the Corporation and loans to employees of major employers in the area.

All closed-end commercial loans (excluding loans secured by real estate) are charged off no later than 90 days delinquent. If a loan is considered uncollectable, it is charged off earlier than 90 days delinquent. When a commercial loan secured by real estate is past due, a current assessment of the value of the real estate is made. If the balance of the loan exceeds the fair value of the property, the loan is placed on nonaccrual with a specific reserve equal to the difference between book value and fair value assigned to the credit until such time as the property has been foreclosed. When the foreclosed property has been legally assigned to the Corporation, a charge-off is taken with the remaining balance, reflecting the fair value less estimated costs to sell, transferred to other real estate owned.

All closed-end consumer loans (excluding conventional 1-4 family residential loans and installment and revolving loans secured by real estate) are charged off no later than 120 days (five monthly payments) delinquent. If a loan is considered uncollectable, it is charged off earlier than 120 days delinquent. For conventional 1-4 family residential loans and installment and revolving loans secured by real estate, when a loan is 90 days past due, a current assessment of the value of the real estate is made. If the balance of the loan exceeds the fair value of the property, the loan is placed on nonaccrual and foreclosure proceedings are initiated. When the foreclosed property has been legally assigned to the Corporation, a charge-off is taken with the remaining balance, reflecting the fair value less estimated costs to sell, transferred to other real estate owned.

Non-Accrual and Past Due Loans. Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on non-accrual status when, (i) principal or interest has been in default for a period of 90 days or more, or (ii) full payment of principal and interest is not expected. Loans may be placed on non-accrual status regardless of whether or not such loans are considered past due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income on non-accrual loans is recognized only to the extent that cash payments are received in excess of principal due. A loan may be returned to accrual status when all the principal and interest amounts contractually due are brought current and future principal and interest amounts contractually due are reasonably assured, which is typically evidenced by a sustained period (three to six months) of repayment performance by the borrower. The Corporation had no loans that were 90 days or more past due that were not included in nonaccrual loans as of June 30, 2012.

The following table provides details regarding the aging of the Corporation s loan portfolio as of June 30, 2012 and December 31, 2011 (dollars in thousands):

June 30, 2012	30 - 89 Days Past Due	90 Days and Greater Past Due*	Total Past Dues	Current	Total Loans
Retail					
Consumer	$ 28	$ 43	$ 71	$ 12,585	$ 12,656
Single family residential	613	2,789	3,402	191,428	194,830
Other retail	17	329	346	19,631	19,977
Retail total	$ 658	$ 3,161	**$ 3,819**	**$ 223,644**	**$ 227,463**
Commercial					
Commercial and industrial	$ 209	$ 3,922	$ 4,131	$ 60,744	$ 64,875
Non-farm, non-residential real estate	384	1,632	2,016	144,681	146,697
Construction and development		2,253	2,253	28,631	30,884
Commercial loans secured by real estate	-	-	-	9,578	9,578
Other commercial	-	-	-	39,190	39,190
Commercial total	$ 593	$ 7,807	**$ 8,400**	**$ 282,824**	**$ 291,224**
TOTAL	$ 1,251	$ 10,968	**$ 12,219**	**$ 506,468**	**$ 518,687**

December 31, 2011	30 - 89 Days Past Due	90 Days and Greater Past Due*	Total Past Due	Current	Total Loans
Retail					
Consumer	$ 73	$ 4	$ 77	$ 14,220	$ 14,297
Single Family Residential	5,131	1,002	6,133	190,780	196,913
Other retail	1	-	1	25,699	25,700
Retail total	$ 5,205	$ 1,006	$ 6,211	$ 230,699	$ 236,910
Commercial					
Commercial and industrial	$ 3,858	$ 1,419	$ 5,277	$ 55,171	$ 60,448
Non-farm, non-residential real estate	2,166	320	2,486	137,661	140,147
Construction and development	44	-	44	28,998	29,042
Other commercial	1,441	159	1,600	50,191	51,791
Commercial total	$ 7,509	$ 1,898	$ 9,407	$ 272,021	$ 281,428
TOTAL	$ 12,714	$ 2,904	$ 15,618	$ 502,720	$ 518,338

*Includes all loans on non-accrual status and all bankruptcies. Loans are automatically placed on non-accrual status once they reach 90 days past due; therefore ,the Corporation has no loans greater than 90 days past due were still accruing interest.

The following table summarizes the impaired loans by loan type as of June 30, 2012 and December 31, 2011 (dollars in thousands):

						Average Recorded Investment	
June 31, 2012	Unpaid Contractual Principal Balance	Recorded Investment with no allowance	Recorded Investment with allowance	Total Recorded Investment	Related Allowance	Quarter To Date	Year to Date
Commercial							
Commercial and industrial	$ 4,795	$ 374	$ 3,436	$ 3,810	$ 167	$ 3,792	$ 4,318
Non-farm, non-residential real estate	3,203	1,219	-	1,219	-	1,215	1,978
Construction & development	719	-	719	719	53	719	670
Other Commercial	1,379	-	1,379	1,379	-	3,107	1,379
Commercial total	$ 10,096	$ 1,593	$ 5,534	$ 7,127	$ 220	$ 8,833	$ 8,345
Residential							
Consumer loans	$ -		$ -	$ -	$ -	$ -	$ -
Single Family Residential	3,418	2,344	637	2,981	105	1,249	3,018
Other retail	-	-		-		-	-
Retail total	$ 3,418	$ 2,344	$ 637	$ 2,981	$ 105	$ 1,249	$ 3,018
Total	$ 13,514	$ 3,937	$ 6,171	$ 10,108	$ 325	$ 10,082	$ 11,363

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December 31, 2011	Unpaid Contractual Principal Balance	Recorded Investment with no allowance	Recorded Investment with allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment Quarter To Date	Average Recorded Investment Year to Date
Commercial							
Commercial and industrial	$ 5,839	$ 738	$ 5,678	$ 5,446	$ 601	$ 5,069	$ 5,069
Non-farm, non-residential real estate	4,378	2,986	2,115	4,573	307	5,232	5,232
Construction & development	870	-	870	870	203	941	941
Other Commercial	3,238	-	-	1,498	-	1,527	1,527
Commercial total	$ 14,325	$ 3,724	$ 8,663	$ 12,387	$ 1,111	$ 12,769	$ 12,769
Residential							
Consumer loans	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Single Family Residential	1,388	142	1,075	1,217	131	1,269	1,269
Other retail	-	-		-	-	-	-
Retail total	$ 1,388	$ 142	$ 1,075	$ 1,217	$ 131	$ 1,269	$ 1,269
Total	$ 15,713	$ 3,866	$ 9,738	$ 13,604	$ 1,242	$ 14,038	$ 14,038

June 31, 2011	Unpaid Contractual Principal Balance	Recorded Investment with no allowance	Recorded Investment with allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment
Commercial						
Commercial and industrial	$ 11,505	$ 4,032	$ 995	$ 10,038	$ 340	$ 8,703
Non-farm, non-residential real estate	7,685	13,143	-	3,212	-	6,384
Construction & development	1,725	-	208	1,894	108	1,548
Other Commercial	3,309	-	400	3,634	-	3,200
Commercial total	$ 24,224	$ 17,175	$ 1,603	$ 18,778	$ 448	$ 19,835
Residential						
Consumer loans	$ -		$ -	$ -	$ -	$ -
Single Family Residential	1,328	457	668	1,125	103	1,275
Other retail	-	-		-		-
Retail total	$ 1,328	$ 457	$ 668	$ 1,125	$ 103	$ 1,275
Total	$ 25,552	$ 17,632	$ 2,271	$ 19,903	$ 551	$ 21,110

Impaired Loans. Loans are considered impaired when, based on current information and events, it is probable the Corporation will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan s existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible. Interest income recognized on impaired loans (which approximates cash basis interest received on impaired loans) was approximately $225,000 and $578,000 for the six-month periods ended June 30, 2012 and 2011, respectively. The average balance of impaired loans for the six-month period ending June 30, 2012 was $8.4 million for commercial loans and $3.0 million for residential real estate loans, totaling $11.4 million.

Troubled Debt Restructurings. Included in certain loan categories of impaired loans are certain loans that have been modified in a troubled debt restructuring, where economic concessions have been granted to borrowers who have experienced financial difficulties. These concessions typically result from our loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. Modifications of terms for our loans and their inclusion as troubled debt restructurings are based on individual facts and circumstances. Loan modifications that are included as troubled debt restructurings may involve either an increase or reduction of the interest rate, extension of the term of the loan, or deferral of principal and/or interest payments, regardless of the period of the modification. All of the loans identified as troubled debt restructuring were modified due to financial stress of the borrower. In order to determine if a borrower is experiencing financial difficulty, an evaluation is performed to determine the probability that the borrower will be in payment default on any of its debt in the foreseeable future with the modification. This evaluation is performed under the Corporation s internal underwriting policy.

When the Corporation modifies loans in a troubled debt restructuring, the Corporation evaluates any possible impairment similar to other impaired loans based on the present value of expected future cash flows, discounted at the contractual interest rate of the original loan or lease agreement, or use the current fair value of the collateral, less selling costs for collateral dependent loans. If the corporation determined that the value of the modified loan is less than the recorded investment in the loan, impairment is recognized through an allowance estimate or a charge-off to the allowance. In periods subsequent to modification, the Corporation evaluates all troubled debt restructuring, including those that have payment defaults, for possible impairment and recognize impairment through the allowance.

As of June 30, 2012, the Corporation did not have any commitments to extend additional funds to borrowers with loans modified and included as a troubled debt restructuring.

During 2012, certain loans were modified in troubled debt restructurings, where economic concessions were granted to borrowers consisting of reductions in the interest rates, payment extensions, forgiveness of principal, and forbearances. Presented below, segregated by class of loans, are troubled debt restructurings that occurred during the six months and three months ended June 30, 2012 (dollars in thousands):

	Three Months Ended June 30, 2012				
	Number of Loans		**Post-Modification Outstanding Balance**		**Net Charge-offs Resulting from Modifications**
Retail:					
Single family residential	2	$	158	$	-
Total trouble debt restructurings	2	$	158	$	-

	Six Months Ended June 30, 2012		
	Number of Loans	**Post-Modifications Outstanding Balance**	**Net Charge-offs Resulting from Modifications**

Commercial:					
Commercial and industrial	3	$	554	$	197
Non-farm non-residential real estate	1		-		222
Retail:					
Single family residential	2		158		
Total trouble debt restructurings	6	$	712	$	419

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Loans retain their accrual status at the time of their modification. As a result, if a loan is on non-accrual status at the time it is modified, it stays as non-accrual status, and if a loan is on accrual status at the time of the modification, it generally stays on accrual status. Commercial and consumer loans modified in a troubled debt restructuring are closely monitored for delinquency as an early indicator of possible future default. If loans modified in a troubled debt restructuring subsequently default, the Corporation evaluates the loan for possible further impairment. The allowance for loan losses may be increased, adjustments may be made in the allocation of the allowance, or partial charge-offs may be taken to further write-down the carrying value of the loan. The Corporation considers a loan in default when it is 90 days or more past due or transferred to nonaccrual.

As of June 30, 2012, the Corporation did not have any loans that were modified in troubled debt restructurings that have subsequently defaulted.

Credit Quality Indicators. As part of the ongoing monitoring of the credit quality of the Corporation s loan portfolio, management tracks certain credit quality indicators including trends related to (i) the weighted-average risk grade of commercial loans, (ii) the level of classified commercial loans, (iii) net charge-offs, (iv) non-performing loans and (v) the general economic conditions in the State of Tennessee.

The Corporation uses a risk grading matrix to assign a risk grade to each of its commercial loans. Loans are graded on a scale of 1 through 8. A description of the general characteristics of the eight risk grades is as follows:

Risk Rating 1 Minimal Risk

General Characteristics:

- Substantially risk free
- Federal, state, or municipal subdivisions with acceptable investment grade credit rating.
- Large national, regional, or local entity with proven access to capital markets.
- Diversity in borrower s line of business with stable and diversified sales base.
- Borrower is considered to be an industry leader with many consecutive years of strong profits and exhibits a financial condition, equity position, liquidity, and debt service capacity far exceeding industry norms.
- Borrower has an abundance of unpledged financeable assets coupled with superior cash generation capabilities.
- Industry conditions and trends are positive and strong.
- Borrower has strong management with evidence of management succession.
- A credit rating by Moody s, Standard & Poor, or other qualified rating agency that is grade A or higher.
- A cash secured loan with the cash on deposit in the Corporation or a guaranty from the federal government also warrants this risk rating.

Risk Rating 2 Modest Risk

General Characteristics:

- Borrower shows strong profitability, liquidity, and capitalization better than industry norms and a strong market position in the region.
- Borrower may have limited access to public markets for short-term needs or capital requirements, but has ready access to alternative financing.
- Loans may be unsecured based on the financial strength of the borrower or secured by collateral that is considered liquid and marketable.
- Borrower has a proven history of profitability and financial stability.
- Borrower has a strong market position in its industry and has an abundance of financeable assets available to protect the Corporation s position.
- Borrower s proven and steady management with good management succession.
- Borrower can withstand major market instabilities of short duration.
- Credit rating by Moody s, Standard & Poor, or other qualified rating agency that is grade BAA or higher.

Risk Rating 3 Average Risk

General Characteristics:

- Borrower shows a stable earnings history and financial condition in line with industry norms with indications that these trends will continue.
- The credit extension is considered sound, however elements may be present which suggest the borrower may not be free from temporary impairments in the future.
- Borrower s liquidity and leverage is in line with industry norms.
- Borrower has good management with acceptable management succession.
- Under most economic and business conditions, borrower has access to alternative financing but limited or no access to capital markets for short-term or capital needs.
- Borrower may be an individual with a sound financial condition and liquidity with proven historical income to repay the debt as scheduled.
- Credit extensions are generally secured by acceptable collateral.

Risk Rating 4 Acceptable Risk

General Characteristics:

- Credit is to a borrower with smaller margins of debt service coverage and with some elements of reduced financial strength.
- Borrower is generally in a lower average market position in its industry.
- Borrower shows satisfactory asset quality and liquidity, good debt capacity and coverage, and good management in critical positions.
- Borrower s management is of unquestioned character but management succession may be questionable.
- Borrower can obtain similar financing from other financial institutions.
- Interim losses or moderately declining earnings trends may occur, but the borrower has sufficient strength and financial flexibility to offset these issues.
- Credit may be to individuals with a moderately leveraged financial condition but with satisfactory liquidity and income to cover debt repayment requirements.
- Business borrowers may have moderate leverage, but must have historically consistent cash flow to cover debt service and other operating needs.
- Business borrowers may also have erratic or cyclical operating performances but should demonstrate strong equity positions to support these profitability swings.
- Asset-based loans that have stabilized and proven performance with the financial capacity to provide for annual clean up may qualify for this rating.
- Borrower has no access to capital markets but would be financeable by another financial institution or finance company.
- Credit extensions are generally secured by acceptable collateral.

Risk Rating 5 Pass / Watch

General Characteristics:

Loans considered for this risk rating require a heightened level of supervision.

A) Transitional, Event Driven This category of risk rated 5 loans captures responses to early warning signals from a relationship and, therefore, signifies a specific, event-driven, transitional credit grade. The event is generally something unplanned or unexpected such as a death, a disaster, the loss of a major client, product line, or key employee; divorce, or health condition of the owner or key management person. This category may be used in transitional upgrades as well as transitional downgrades of credit relationships. Under these criteria, this category necessitates a plan of action to either upgrade the credit to a Pass rating (i.e., Risk Rating 1-4), downgrade the credit to a criticized asset, or exit the relationship within six months.

B) Ongoing Supervision Warranted **-** This category may also be utilized to identify loans having inherent characteristics which warrant more than the normal level of supervision. Loans meeting these criteria may include larger, more complex loans with unusual structures. Loans, which, due to structure or nature of the collateral require above average servicing, may also be considered for this risk rating. Unlike other criteria listed previously for this category, these particular characteristics tend not to be one-time or transitional in nature; therefore, these loans may be expected to remain in this risk rating category longer than six months. A loan might remain in this risk rating category for its life or until the characteristic warranting the rating can be eliminated or effectively mitigated.

- Borrower may exhibit declining earnings, strained cash flow, increasing leverage, or weakening market positions that indicate a trend toward an unacceptable risk.
- Borrower s liquidity, leverage, and earnings performance is below or trending below industry norms.
- Interim losses and other adverse trends may occur but not to the level that would impair the Corporation s position.
- Borrower may be a newly formed company or in a new line of business or may be an established business with new or unproven management. Borrower should be adequately capitalized, but may not yet have achieved stabilized cash flow.
- Borrower generally has a small market position in its industry.
- Borrower may be engaged in an industry that is experiencing an economic downturn or is particularly susceptible to uncontrollable external factors.
- Borrower management is of good character although some management weakness may exist, including lack of depth or succession.
- Borrower generally has limited additional debt capacity and modest coverage, and average or below-average asset quality, margins, and market share.
- Borrower s ability to obtain financing from other financial institutions may be impaired.
- Credit to individuals with marginal financial condition and liquidity but with income still sufficient to service the debt.

Risk Rating 6 Special Mention

A special mention asset has potential weaknesses that deserve management s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution s credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

General Characteristics:

- Borrower s cash flow may not be sufficient to fund anticipated cash needs.
- Sufficient or modestly sufficient financeable assets are available to protect the Corporation s position.
- Adverse trends in borrower s operations/profits or unbalanced position in borrower s balance sheet but not to the point where repayment is in jeopardy.
- Borrower generally shows limited liquidity or high leverage.
- Borrower s financial position is in the lower quartile of industry norms.
- Borrower s business exhibits a deteriorating market position in the industry.
- Borrower s management lacks depth and succession.
- Business is unable to withstand temporary setbacks without affecting repayment capability.
- Borrower is not financeable by another bank but possibly by a finance company or specialized lender.

Risk Rating 7 Substandard

A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness, or weaknesses, that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Corporation will sustain some loss if the deficiencies are not corrected.

General Characteristics:

- The primary source of borrower s repayment no longer provides satisfactory support and repayment is dependent on secondary sources.
- A substandard loan is inadequately protected by the current sound worth and paying capacity of the obligor or by the collateral pledged, if any.
- Normal repayment from the borrower is impaired although no loss of principal is envisioned.
- A partial loss of interest or principal will occur if the borrower s deficiencies are not corrected.
- Borrower s cash flow is generally not sufficient to fund anticipated cash needs.
- Borrower s financeable assets may not be sufficient to protect the Corporation s position.
- Adverse trends in borrower s operations that jeopardized debt repayment may require the borrower to undertake a significant reorganization of financing or the business.
- Borrower shows poor liquidity and high leverage impairing the repayment of the debt in accordance with agreed upon terms.
- Borrower s management lacks depth and succession; may be inexperienced or of questionable character.
- Borrower s market position in the industry is deteriorating.
- Borrower is not financeable by another bank or finance company.

Risk Rating 8 Doubtful

An asset classified as doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

General Characteristics:

- Inadequate primary source of repayment. Assumes a less than satisfactory secondary source of repayment on a most-likely case basis. There may be adequate secondary source of repayment on a best-case basis.
- Borrower has the same weaknesses found in Substandard borrowers.
- Loss probability is extremely high but because of certain important and reasonably specific factors that may work to strengthen the loan, its classification as an estimated loss is deferred until a more exact status may be determined.
- Pending factors may include a proposed merger or acquisition; liquidation procedures; capital injections; perfecting liens on additional collateral; and refinancing plans.
- Borrower s cash flow is insufficient to fund cash needs.
- Borrower s financeable assets are insufficient to protect the Corporation s position.
- Borrower s source of debt repayment is dependent on liquidation of assets with a probable loss.
- Borrower may no longer be a going concern, or may not exist as a going concern for the foreseeable future.
- No alternative financing sources exist for borrower.

The following tables present risk grades and classified loans by class of commercial loan in the Corporation s portfolios as of June 30, 2012 (dollars in thousands):

June 30, 2012

Commercial Loan Portfolio: Credit risk profile by internally assigned grade	Commercial & Industrial	Non-Farm, Non-Residential Real Estate	Construction & Development	Commercial Loans Secured by Real Estate	Other Commercial	Commercial Loan Totals
Pass	$ 57,934	$ 143,470	$ 29,509	$ 8,402	$ 36,335	**$ 275,650**
Special Mention	2,749	1,350	601	409	-	**5,109**
Substandard	1,124	1,877	774	767	1,476	**6,018**
Doubtful	3,068	-	-	-	1,379	**4,447**
TOTALS	**$ 64,875**	**$ 146,697**	**$ 30,884**	**$ 9,578**	**$ 39,190**	**$ 291,224**

Retail Loan Portfolio: Credit risk profiles based on delinquency status classification	Consumer	Single-Family Residential**	Other Retail	Retail Loan Totals
Performing	$ 12,588	$ 190,757	$ 19,623	$ 222,968
Non-performing*	68	4,073	354	4,495
TOTALS	**$ 12,656**	**$ 194,830**	**$ 19,977**	**$ 227,463**

*Loans are classified as non-performing loans and are automatically placed on non-accrual status once they reach 90 days past due. For the purposes of this calculation, all loans rated at or below Substandard (RR7) are classified as non-performing.

**Single-family residential loans includes first mortgages, closed-end second mortgages, residential construction loans, and home equity lines of credit (HELOC's).

December 31, 2011

Commercial Loan Portfolio: Credit risk profile by internally assigned grade	Commercial & Industrial	Non-Farm, Non-Residential Real Estate	Construction & Development	Commercial Loans Secured by Real Estate	Other Commercial	Commercial Loan Totals
Pass	$ 50,163	$ 132,291	$ 27,613	$ 2,979	$ 44,837	**$ 257,883**
Special Mention	4,137	4,232	504	439	-	**9,312**
Substandard	1,692	2,033	925	677	1,480	**6,807**
Doubtful	4,456	1,591	-	-	1,379	**7,426**
TOTALS	**$ 60,448**	**$ 140,147**	**$ 29,042**	**$ 4,095**	**$ 47,696**	**$ 281,428**

Retail Loan Portfolio: Credit risk profiles based on delinquency status classification	Consumer	Single-Family Residential**	Other Retail	Retail Loan Totals

Performing	$ 14,225	$ 193,784	$ 25,368	$ 233,377
Non-performing*	72	3,129	332	3,533
TOTALS	**$ 14,297**	**$ 196,913**	**$ 25,700**	**$ 236,910**

*Loans are classified as non-performing loans and are automatically placed on non-accrual status once they reach 90 days past due. For the purposes of this calculation, all loans rated at or below Substandard (RR7) are classified as non-performing.
**Single-family residential loans include first mortgages, closed-end second mortgages, residential construction loans, and home equity lines of credit (HELOC's).

Allowance for Loan Losses. The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management s best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The Corporation s allowance for loan loss methodology includes allowance allocations calculated in accordance with ASC Topic 310, Receivables (ASC Topic 310), and allowance allocations calculated in accordance with ASC Topic 450, Contingencies (ASC Topic 450), Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, specific homogeneous risk pools and specific loss allocations, with adjustments for current events and conditions. The Corporation s process for determining the appropriate level of the allowance for loan losses is designed to account for credit deterioration as it occurs. The provision for loan losses reflects loan quality trends, including the levels of and trends related to non-accrual loans, past due loans, potential problem loans, criticized loans and net charge-offs or recoveries, among other factors. The provision for loan losses also reflects the totality of actions taken on all loans for a particular period. Therefore, the amount of the provision reflects not only the necessary increases in the allowance for loan losses related to newly identified criticized loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools.

The level of the allowance reflects management s continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management s judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Corporation s control, including, among other things, the performance of the Corporation s loan portfolio, the economy, and changes in interest.

The Corporation s allowance for loan losses consists of three elements: (i) specific valuation allowances determined in accordance with ASC Topic 310 based on probable losses on specific loans; (ii) historical valuation allowances determined in accordance with ASC Topic 450 based on historical loan loss experience for loans with similar characteristics and trends, adjusted, as necessary, to reflect the impact of current conditions; and (iii) general valuation allowances determined in accordance with ASC Topic 450 based on general economic conditions and other qualitative risk factors both internal and external to the Corporation.

The allowances established for probable losses on specific loans are based on a regular analysis and evaluation of problem loans. Loans are classified based on an internal credit risk grading process that evaluates, among other things: (i) the obligor s ability to repay; (ii) the underlying collateral, if any; and (iii) the economic environment and industry in which the borrower operates. This analysis is performed at the relationship manager level for all commercial loans. When

a loan has an assigned risk rating of 8 (Doubtful) or higher, a special assets officer analyzes the loan to determine whether the loan is impaired and, if impaired, the need to specifically allocate a portion of the allowance for loan losses to the loan. Specific valuation allowances are determined by analyzing the borrower s ability to repay amounts owed, collateral deficiencies, the relative risk grade of the loan and economic conditions affecting the borrower s industry, among other things.

Historical valuation allowances are calculated based on the historical loss experience of specific types of loans and the internal risk grade of such loans at the time they were charged-off. The Corporation calculates historical loss ratios for pools of similar loans with similar characteristics based on the proportion of actual charge-offs experienced to the total population of loans in the pool. The historical loss ratios are updated

quarterly based on actual charge-off experience. A historical valuation allowance is established for each pool of similar loans based upon the product of the historical loss ratio and average balance of the loans in the pool. The Corporation s pools of similar loans include similarly risk-graded groups of commercial and industrial loans, commercial real estate loans, consumer real estate loans and consumer and other loans.

The components of the general valuation allowance include (i) the additional reserves allocated to specific loan portfolio segments as a result of applying an environmental risk adjustment factor to the base historical loss allocation and (ii) the additional reserves that are not allocated to specific loan portfolio segments including allocations for groups of similar loans with risk characteristics that exceed certain concentration limits established by management.

There is an inherent imprecision in calculating the specific portion of the allowance for loan and lease losses (ALLL). Therefore, a factor may be added to the allocation of each of the identified segments of the loan portfolio to account for the imprecision.

Included in the general valuation allowances are allocations for groups of similar loans with risk characteristics that exceed certain concentration limits established by management. Concentration risk limits have been established, among other things, for certain industry concentrations, large balance and highly leveraged credit relationships that exceed specified risk grades, and loans originated with policy exceptions that exceed specified risk grades.

The allowance for loan losses is maintained at a level considered adequate to provide for the losses that can be reasonably anticipated. Management s periodic evaluation of the adequacy of the allowance is based on the Corporation s past loan loss experience, know and inherent risks in the portfolio, adverse situations that may affect the borrower s ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to change. During the first quarter of 2012, as part of the quantitative analysis of the adequacy of the allowance for loan losses, management adjusted its projection of probable loan losses. In prior years, the Corporation used a historic loss period of four quarters for all segments when estimating the historic charge off rates calculated in accordance with ASC Topic 450. During the first quarter 2012, the Corporation changed the historic period to a rolling eight quarter historic look back period to better reflect the risk related to each individual segment of loans. This change did not have a significant impact on the recorded amount of the allowance for loan losses.

The following table summarizes the allocation in the allowance for loan losses by loan segment for the six months ended June 30, 2012 and June 30, 2011 and the year ended December 31, 2011 (dollars in thousands):

Three Months Ended	**Commercial**	**Residential real estate**	**Consumer & other retail**	**Unallocated**	**Totals**
Beginning ALLL balance - 3/31/12	$ 6,648	$ 1,521	$ 170	$ 360	$ 8,699
Less: Charge-offs	(516)	(41)	-	-	(557)
Add: Recoveries	108	1	1	-	110
Add: Provisions	437	83	(12)	12	520
Ending ALLL balance - 06/30/12	**$ 6,677**	**$ 1,564**	**$ 159**	**$ 372**	**$ 8,772**
Six Months Ended					
Beginning ALLL balance - 12/31/11	$ 5,957	$ 2,113	$ 192	$ 938	$ 9,200
Less: Charge-offs	(1,532)	(147)	(5)	-	(1,684)
Add: Recoveries	131	2	3	-	136
Add: Provisions	2,121	(404)	(31)	(566)	1,120
Ending ALLL balance - 06/30/12	**$ 6,677**	**$ 1,564**	**$ 159**	**$ 372**	**$ 8,772**
Three Months Ended					
Beginning ALLL balance - 3/31/11	**$** 5,594	$ 1,723	$ 279	$ 98	$ 7,694
Less: Charge-offs	(464)	(14)	(31)	-	(509)
Add: Recoveries	35	1	33	-	69
Add: Provisions	273	235	(16)	258	750
Ending ALLL balance - 06/30/11	**$ 5,438**	**$ 1,945**	**$ 265**	**$ 356**	**$ 8,004**
Six Months Ended					
Beginning ALLL balance - 12/31/10	$ 6,915	$ 2,001	$ 408	$ 96	$ 9,420

Less: Charge-offs	(2,621)	(258)	(127)	-	(3,006)
Add: Recoveries	73	1	40	-	114
Add: Provisions	1,071	201	(56)	260	1,476
Ending ALLL balance - 06/30/11	**$ 5,438**	**$ 1,945**	**$ 265**	**$ 356**	**$ 8,004**
Beginning ALLL balance - 1/1/11	$ 6,915	$ 2,001	$ 408	$ 96	$ 9,420
Less: Charge-offs	(3,353)	(52)	(147)	-	(3,552)
Add: Recoveries	103	-	104	-	207
Add: Provisions	2,292	164	(173)	842	3,125
Ending ALLL balance - 12/31/11	**$ 5,957**	**$ 2,113**	**$ 192**	**$ 938**	**$ 9,200**

The following table details the amount of the allowance for loan losses allocated to each portfolio segment as of June 30, 2012, June 30, 2011 and December 31, 2011, disaggregated on the basis of the Corporation s impairment methodology (dollars in thousands).

Ending ALLL balance - 6/30/12	**Commercial**	**Residential Real Estate**	**Consumer & Other Retail**	**Unallocated**	**Total**
Loans individually evaluated for impairment	$ 219	$ 106	$ -	$ -	$ 325
Loans collectively evaluated for impairment	6,458	1,458	159	372	8,447
Balance	**$ 6,677**	**$ 1,564**	**$ 159**	**$ 372**	**$ 8,772**
Ending ALLL balance 6/30/11					
Loans individually evaluated for impairment	$ 345	$ -	$ -	$ -	$ 345
Loans collectively evaluated for impairment	5,093	1,945	265	356	7,659
Balance	**$ 5,438**	**$ 1,945**	**$ 265**	**$ 356**	**$ 8,004**
Ending ALLL balance - 12/31/11	**$** 1,111	**$** 131	**$** -	**$** -	**$** 1,242
Loans individually evaluated for impairment	4,846	1,982	192	938	7,958
Loans collectively evaluated for impairment	**$ 5,957**	**$ 2,113**	**$ 192**	**$ 938**	**$ 9,200**
Balance					

The following table shows loans related to each balance in the allowance for loan losses by portfolio segment and disaggregated on the basis of the Corporation s impairment methodology (dollars in thousands):

June 30, 2012	**Commercial**	**Residential Real Estate**	**Consumer & Other Retail**	**Other**	**Totals**
Loans individually evaluated for impairment	$ 2,662	$ 1,274	$ -	$ -	$ 3,936
Loans collectively evaluated for impairment	$ 288,887	$ 211,389	13,637	838	514,751
Balance	**$ 291,549**	**$ 212,663**	**$ 13,637**	**$ 838**	**$ 518,687**
June 30, 2011					
Loans individually evaluated for impairment	$ 17,653	$ 1,125	$ -	$ -	$ 18,778
Loans collectively evaluated for impairment	280,511	230,309	$ 14,838	$ 1,139	526,797
Balance	**$ 298,164**	**$ 231,434**	**$ 14,837**	**$ 1,139**	**$ 545,575**
December 31, 2011					
Loans individually evaluated for impairment	$ 12,625	$ 1,217	$ -	$ -	$ 13,842
Loans collectively evaluated for impairment	268,796	219,881	14,055	1,228	503,960
Balance	**$ 281,421**	**$ 221,098**	**$ 14,055**	**$ 1,228**	**$ 517,802**

NOTE 5 BORROWED FUNDS

The Corporation is a party to the Blanket Agreement for Advances and Security Agreement (the Blanket Agreement) with the FHLB of Cincinnati. Advances made to the Corporation under the Blanket Agreement are collateralized by the FHLB stock and qualifying residential mortgage loans totaling 150% of the outstanding amount borrowed. These collateralization matters are outlined in the Blanket Agreement dated June 20, 2006 between the Corporation and the FHLB. The advances mature at varying dates throughout 2013 at interest rates ranging from 2.61% - 3.76%.

Scheduled annual principal maturities and interest rate terms of borrowings under this credit line as of June 30, 2012 for the next year were as follows (dollars in thousands):

2013	$10,100

FHLB stock totaling $3,009,000 at June 30, 2012 was carried at cost. The stock is restricted and can only be sold back to the FHLB at par value.

The Corporation also has a Cash Management Advance Line of Credit Agreement (the CMA), dated June 21, 2010, with the Federal Home Loan Corporation. The CMA is a component of the Blanket Agreement. The purpose of the CMA is to assist with short-term liquidity management. Under the terms of the CMA, the Corporation may borrow a maximum of $40 million, selecting a variable rate of interest for up to 90 days or a fixed rate for a maximum of 30 days. There were no borrowings outstanding under the CMA as of June 30, 2012.

NOTE 6 POST-RETIREMENT BENEFIT PLAN

(dollars in thousands)	**Six months ended June 30, 2012**	June 30, 2011
Service cost	**$ 46**	$ 12
Interest cost	**192**	78
Expected return on plan assets	**-**	-
Amortization of prior service cost	**(8)**	(120)