

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

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended **September 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)

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Tennessee
(State or other jurisdiction of incorporation or
organization)

62-1148660
(I.R.S. Employer Identification No.)

816 South Garden Street
Columbia, Tennessee
(Address of principal executive offices)

38402-1148
(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.

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). 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

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 No

As of November 5, 2012, the registrant had 5,280,000 shares of common stock outstanding.

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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 - September 30, 2012 and December 31, 2011.

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

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

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

Selected notes to condensed consolidated financial statements.

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS**

| | | September 30, | December 31, |
|-----------------------------|---|----------------------|--------------|
| | | 2012 | 2011 |
| | | (Unaudited) | (1) |
| ASSETS | (Dollars in Thousands, Except Per Share Data) | | |
| | Cash and due from banks | \$ 16,601 | \$ 17,927 |
| | Interest-bearing due from banks | 18,767 | 16,500 |
| | Federal funds sold | 16,750 | 38,594 |
| | Total cash and cash equivalents | 52,118 | 73,021 |
| | Securities | | |
| | Available-for-sale (amortized cost \$340,510 and \$309,338, respectively) | 347,743 | 314,270 |
| | Held-to-maturity (fair market value \$34,058 and \$37,275, respectively) | 32,192 | 35,214 |
| | Total securities | 379,935 | 349,484 |
| | Loans, net of deferred fees | 543,209 | 517,802 |
| | Allowance for loan and lease losses | (8,704) | (9,200) |
| | Net loans | 534,505 | 508,602 |
| | Bank premises and equipment, net | 26,660 | 25,537 |
| | Other real estate owned | 6,331 | 8,827 |
| | Bank owned life insurance | 24,940 | 23,621 |
| | Goodwill | 9,018 | 9,018 |
| | Other assets | 16,984 | 19,339 |
| | TOTAL ASSETS | \$ 1,050,491 | \$ 1,017,449 |
| LIABILITIES | Deposits | | |
| | Noninterest-bearing | \$ 158,340 | \$ 144,003 |
| | Interest-bearing | 729,189 | 712,427 |
| | Total deposits | 887,529 | 856,430 |
| | Securities sold under agreements to repurchase | 20,086 | 16,347 |
| | Accounts payable and accrued liabilities | 16,799 | 16,265 |
| | Federal Home Loan Bank advances | 10,100 | 17,100 |
| | TOTAL LIABILITIES | 934,514 | 906,142 |
| SHAREHOLDERS' EQUITY | Common stock - \$10 par value per share, 8,000,000 shares authorized; 5,280,000 and 5,330,000 shares issued and outstanding as of Sept. 30, 2012 and December 31, 2011, respectively | 52,800 | 53,300 |
| | Retained earnings | 58,633 | 54,890 |
| | Accumulated other comprehensive income | 4,449 | 3,022 |
| | TOTAL SHAREHOLDERS' EQUITY BEFORE NONCONTROLLING INTEREST - PREFERRED STOCK OF SUBSIDIARY | 115,882 | 111,212 |
| | Noncontrolling interest - preferred stock of subsidiary | 95 | 95 |
| | TOTAL SHAREHOLDERS' EQUITY | 115,977 | 111,307 |
| | TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | \$ 1,050,491 | \$ 1,017,449 |

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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)

| | | Three Months Ended Sept. 30, | | Nine Months Ended Sept. 30, | |
|--|--|---------------------------------|-----------|--------------------------------|-----------|
| | | 2012 | 2011 | 2012 | 2011 |
| <i>(Dollars in Thousands, Except Per Share Data)</i> | | | | | |
| INTEREST AND DIVIDEND INCOME | Interest and fees on loans | \$ 6,934 | \$ 7,450 | \$ 20,882 | \$ 22,515 |
| | Income on investment securities | | | | |
| | Taxable interest | 1,338 | 1,149 | 3,772 | 3,217 |
| | Exempt from federal income tax | 762 | 895 | 2,349 | 2,738 |
| | Dividends | 45 | 17 | 157 | 153 |
| | Other interest income | 35 | 30 | 114 | 59 |
| | Total interest income | 9,114 | 9,541 | 27,274 | 28,682 |
| INTEREST EXPENSE | Interest on deposits | 812 | 1,013 | 2,571 | 3,255 |
| | Interest on other borrowings | 105 | 166 | 396 | 551 |
| | Total interest expense | 917 | 1,179 | 2,967 | 3,806 |
| | Net interest income | 8,197 | 8,362 | 24,307 | 24,876 |
| | Provision for loan and lease losses | - | 750 | 1,120 | 2,225 |
| | Net interest income after provision | 8,197 | 7,612 | 23,187 | 22,651 |
| NONINTEREST INCOME | Gain on loans sold | 126 | 96 | 374 | 340 |
| | Trust department income | 518 | 491 | 1,554 | 1,515 |
| | Service fees on deposit accounts | 1,667 | 1,754 | 4,957 | 5,070 |
| | Brokerage fees | 51 | - | 161 | - |
| | Earnings on bank owned life insurance | 198 | 179 | 533 | 536 |
| | Gain on sale of securities | 18 | 701 | 2,173 | 1,135 |
| | OREO | (471) | (458) | (997) | (915) |
| | Other non-interest income | 169 | 124 | 260 | 322 |
| | Total noninterest income | 2,276 | 2,887 | 9,015 | 8,003 |
| NONINTEREST EXPENSE | Salaries and employee benefits | 4,361 | 4,001 | 13,064 | 12,293 |
| | Net occupancy expense | 497 | 527 | 1,486 | 1,502 |
| | Depreciation expense | 360 | 319 | 1,046 | 957 |
| | Data processing expense | 498 | 480 | 1,479 | 1,427 |
| | Legal and professional fees | 258 | 249 | 757 | 798 |
| | Stationary and office supplies | 87 | 48 | 208 | 213 |
| | Advertising and promotions | 280 | 253 | 866 | 930 |
| | FDIC insurance premium expense | 402 | 377 | 1,114 | 1,144 |
| | Other real estate expense | 84 | 104 | 242 | 397 |
| | Other noninterest expense | 1,318 | 1,208 | 4,053 | 3,873 |
| | Total noninterest expenses | 8,145 | 7,566 | 24,315 | 23,534 |
| | Income before provision for income taxes | 2,328 | 2,933 | 7,887 | 7,120 |
| | Provision for income taxes | 373 | 632 | 1,514 | 1,263 |
| | Net income before noncontrolling interest - dividends on preferred stock of subsidiary | 1,955 | 2,301 | 6,373 | 5,857 |
| | Noncontrolling interest - dividends on preferred stock of subsidiary | - | - | 8 | 8 |
| | Net income for common shareholders | \$ 1,955 | \$ 2,301 | \$ 6,365 | \$ 5,849 |
| | Weighted average shares outstanding | 5,328,002 | 5,392,760 | 5,329,334 | 5,400,063 |
| | Earnings per share | \$ 0.37 | \$ 0.43 | \$1.19 | \$ 1.08 |

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

FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(unaudited) Dollars in thousands

| | Three Months | | Nine Months | |
|--|----------------------|-----------------|----------------------|-----------------|
| | Ended | | Ended | |
| | September 30, | | September 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| Net Income | \$ 1,955 | \$ 2,301 | \$ 6,365 | \$ 5,849 |
| Comprehensive Income | | | | |
| Unrealized appreciation on available-for-sale securities, net of taxes of \$1,197 and \$1,280 for 2012 and 2011, respectively, for three months and net of taxes of \$1,730 and \$2,492 for nine months | 1,911 | 2,044 | 2,763 | 3,982 |
| Less: reclassification adjustment for realized gains included in net income, net of taxes of \$7 and \$270 for 2012 and 2011, respectively, for three months and net of taxes of \$837 and \$437 for nine months | (11) | (431) | (1,336) | (699) |
| Net unrealized gain on available-for-sale securities | 1,900 | 1,613 | 1,427 | 3,283 |
| Comprehensive Income | 3,855 | 3,914 | 7,792 | 9,132 |
| Less: comprehensive income attributable to the noncontrolling interest | - | - | - | - |
| Total Comprehensive Income | \$ 3,855 | \$ 3,914 | \$ 7,792 | \$ 9,132 |

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

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

| | | Nine months ended September 30, | |
|-------------------------------|---|---------------------------------|-----------|
| | | 2012 | 2011 |
| | | \$ 6,365 | \$ 5,849 |
| <i>(unaudited)</i> | | | |
| <i>(Dollars in Thousands)</i> | | | |
| OPERATING | Net income available for common shareholders | | |
| ACTIVITIES | Adjustments to reconcile net income to net cash provided by (used in) operating activities | | |
| | Provision for loan losses | 1,120 | 2,225 |
| | Provision for depreciation and amortization of premises and equipment | 1,046 | 957 |
| | Deferred tax expense (benefit) | (374) | 124 |
| | Net securities gains | (2,173) | (1,135) |
| | Gain on loans sold | (374) | (340) |
| | Proceeds from sale of mortgage loans held for sale | 21,265 | - |
| | Funding of mortgage loans held for sale | (20,071) | - |
| | Loss on OREO | 997 | 915 |
| | Gain on sale of assets | (10) | - |
| | Amortization of deposit base intangibles | - | 18 |
| | Amortization of investment security premiums, net of accretion of discounts | 2,969 | 1,019 |
| | Increase in cash surrender value of life insurance contracts | (533) | (536) |
| | Decrease (increase) in | | |
| | Other assets | 1,016 | (822) |
| | Increase in | | |
| | Other liabilities | 542 | 1,936 |
| | Total adjustments | 5,420 | 4,361 |
| | Net cash provided by operating activities | 11,785 | 10,210 |
| INVESTING | Proceeds from sales of available-for-sale securities | 339,076 | 174,331 |
| ACTIVITIES | Proceeds from maturities and calls of available-for-sale securities | 55,671 | - |
| | Proceeds from maturities and calls of held-to-maturity securities | 3,000 | 3,540 |
| | Purchases of investment securities | | |
| | available-for-sale | (426,674) | (222,960) |
| | Net (increase) decrease in loans | (26,804) | 18,494 |
| | Proceeds from sale of OREO | 1,280 | - |
| | Purchase of life insurance | (786) | - |
| | Purchases of premises and equipment | (2,159) | (1,616) |
| | Net cash used in investing activities | (57,396) | (28,211) |
| FINANCING | Net increase in deposits | 31,099 | 35,886 |
| ACTIVITIES | Net increase in securities sold under agreements to repurchase | 3,739 | 10,742 |
| | Payments to FHLB borrowings | (7,000) | (7,000) |
| | Repurchase of common stock | (1,150) | (1,511) |
| | Cash dividends paid on preferred stock of subsidiary | (8) | (8) |
| | Cash dividends paid on common stock | (1,972) | (1,991) |
| | Net cash provided by financing activities | 24,708 | 36,118 |
| | Decrease (increase) in cash and cash equivalents | (20,903) | 18,117 |
| | Cash and cash equivalents at beginning of period | 73,021 | 32,499 |
| | Cash and cash equivalents at end of period | \$ 52,118 | \$ 50,616 |
| | Supplemental disclosures of cash flow information | | |
| | Cash paid during the period for expenses | | |
| | Interest on deposits and borrowed funds | \$ 2,843 | \$ 3,617 |
| | Income Taxes | 635 | 956 |
| | Loans to facilitate sale of OREO | 1,774 | - |
| | Real estate acquired in settlement of loans | 1,355 | 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 this Quarterly Report on Form 10-Q should refer to the Registrant's Annual Report on 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 MEASUREMENTS

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.

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- *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 September 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 September 30, 2012

| Available-For-Sale Securities | Level 1 | Level 2 | Level 3 | Total |
|---|-------------|-------------------|-------------|-------------------|
| U.S. government agencies | \$ - | \$ 71,013 | \$ - | \$ 71,013 |
| U.S. government sponsored agency mortgage backed securities | - | 205,406 | - | 205,406 |
| States and political subdivisions | - | 52,326 | - | 52,326 |
| Corporate bonds | - | 18,998 | - | 18,998 |
| Total assets at fair value | \$ - | \$ 347,743 | \$ - | \$ 347,743 |

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 nine months ended September 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 September 30, 2012 and December 31, 2011, by the level within the fair value hierarchy utilized to measure fair value (dollars in thousands):

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Assets measured at fair value on a nonrecurring basis as of September 30, 2012

| | Level 1 | Level 2 | Level 3 | Total |
|---------------------------------------|---------|---------|----------|----------|
| Impaired loans (collateral dependent) | \$ - | \$ - | \$ 7,150 | \$ 7,150 |
| Other real estate owned | - | - | 4,225 | 4,225 |

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 nine months ended September 30, 2012 and 2011 were \$1.0 million and \$1.2 million, 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 nine months ended September 30, 2012 and 2011 were approximately \$914,000 and \$974,000, 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

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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 | Valuation | Unobservable | Range |
| | September 30, 2012 | Technique(s) | Input | (Weighted Average) |
| Impaired loans (collateral-dependent) | \$ 7,150 | Market comparable properties | Marketability discount | 5.0% - 10.0% (7%) |
| Other real estate/assets owned | \$ 4,225 | Market comparable properties | Marketability discount | 5.0% - 10.0% (7%) |

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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.

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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.

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

| | Fair Value Measurements at September 30, 2012 Using | | | |
|---|---|--|---|---|
| | Carrying Amount | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Financial assets | | | | |
| Cash and due from banks | \$ 16,601 | \$ 16,601 | \$ - | \$ - |
| Interest-bearing deposits in other banks | 18,767 | 18,767 | - | - |
| Federal funds sold | 16,750 | 16,750 | - | - |
| Federal Home Loan Bank and Federal Reserve Bank stock | 3,879 | 3,879 | - | - |
| Securities available-for-sale | 347,743 | - | 347,743 | - |
| Securities held-to-maturity | 32,192 | - | 34,058 | - |
| Loans held for sale | 1,685 | - | 1,685 | - |
| Loans, net | 534,505 | - | - | 551,390 |
| Accrued interest receivable | 4,439 | - | 4,439 | - |
| Financial liabilities | | | | |
| Non-interest bearing deposits | 158,340 | 158,340 | - | - |
| Interest bearing deposits | 729,189 | - | 731,893 | - |
| Repurchase agreements | 20,086 | - | 20,086 | - |
| Advances from Federal Home Loan Bank | 10,100 | - | 10,289 | - |
| Accrued interest payable | 754 | - | 754 | - |
| Off-balance sheet credit related instruments: | | | | |
| Commitments to extend credit | | | 123 | - |

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

| | December 31, 2011 | Fair Value |
|--|-------------------|------------|
| | Carrying Amount | |
| 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 |
| 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 September 30, 2012 and December 31, 2011 were as follows (dollars in thousands):

| | Amortized Cost | Gross Gains | Unrealized Losses | Fair Value |
|---|-------------------|----------------|----------------------|---------------|
| September 30, 2012 | | | | |
| Available-for-sale securities | | | | |
| U.S. government agencies | \$ 70,541 | \$ 472 | \$ - | \$71,013 |
| U.S. government sponsored agency mortgage backed securities | 202,813 | 2,712 | 119 | 205,406 |
| States and political subdivisions | 48,794 | 3,532 | - | 52,326 |
| Corporate bonds | 18,362 | 636 | - | 18,998 |
| | \$ 340,510 | \$ 7,352 | \$ 119 | \$347,743 |
| Held-to-maturity securities | | | | |
| States and political subdivisions | \$ 32,192 | \$ 1,866 | \$ - | \$34,058 |
| | | | | |
| | Amortized Cost | Gross Gains | Unrealized Losses | Fair Value |
| December 31, 2011 | | | | |
| 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 September 30, 2012 and December 31, 2011 was approximately \$11,000 and \$85,000, which was approximately 3% 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 September 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 September 30, 2012 and December 31, 2011 (dollars in thousands):

September 30, 2012

| Type of Security | Less than 12 months | | 12 months or Greater | | Total | |
|---|---------------------|-------------------|----------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. government sponsored agency mortgage backed securities | \$ 11,459 | \$ 119 | \$ - | \$ - | \$ 11,459 | \$ 119 |
| | \$ 11,459 | \$ 119 | \$ - | \$ - | \$ 11,459 | \$ 119 |

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| December 30, 2011 | Less than 12 months | | 12 months or Greater | | Total | |
|---|---------------------|-------------------|----------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Type of Security | | | | | | |
| U.S. government agencies | \$ 15,063 | \$ 6 | \$ - | \$ - | \$ 15,063 | \$ 6 |
| U.S. government sponsored agency mortgage backed securities | 40,792 | 145 | - | - | 40,792 | 145 |
| Corporate bonds | 29,154 | 68 | - | - | 29,154 | 68 |
| | \$ 85,009 | \$ 219 | \$ - | \$ - | \$ 85,009 | \$ 219 |

The amortized cost and fair value of available-for-sale securities and held-to-maturity securities at September 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.

| September 30, 2012 | Available for Sale | | Held to Maturity | |
|----------------------------|--------------------|----------------------|------------------|----------------------|
| | Amortized Cost | Estimated Fair Value | Amortized Cost | Estimated Fair Value |
| Within one year | \$ 8,912 | \$ 9,015 | \$ 3,258 | \$ 3,289 |
| One to five years | 20,740 | 21,477 | 7,338 | 7,736 |
| Five to ten years | 78,948 | 80,340 | 13,018 | 13,854 |
| After ten years | 29,097 | 31,505 | 8,578 | 9,179 |
| Mortgage-backed securities | 202,813 | 205,406 | - | - |
| Total | \$ 340,510 | \$ 347,743 | \$ 32,192 | \$ 34,058 |

The carrying value of securities pledged as collateral to secure public deposits and for other purposes was \$205.4 million at September 30, 2012 and \$196.1 million at December 31, 2011.

The book value of securities sold under agreements to repurchase amounted to \$31.5 million and \$22.2 million at September 30, 2012 and December 31, 2011, respectively.

Gross gains of approximately \$18,000, \$701,000, \$2.2 million and \$1.1 million resulting from sales of available-for-sale securities were realized for the three months and nine month periods ended September 30, 2012 and 2011, respectively. A loss of approximately \$2,000 was included in the net gain of \$1.1 million for the nine-month period ended September 30, 2011.

NOTE 4 LOANS

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

| | September 30, 2012 | December 31, 2011 |
|-------------------|--------------------|-------------------|
| <u>Commercial</u> | | |

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| | | |
|---|-------------------|-------------------|
| Commercial and industrial | \$ 68,265 | \$ 60,448 |
| Non-farm, non-residential real estate | 160,357 | 139,642 |
| Construction and development | 37,858 | 29,042 |
| Commercial loans secured by real estate | 9,230 | 6,161 |
| Other commercial | 39,476 | 45,630 |
| | 315,186 | 280,923 |
| <u>Residential</u> | | |
| Consumer loans | 13,378 | 14,297 |
| Single family residential | 194,948 | 196,882 |
| Other retail | 19,697 | 25,700 |
| | \$ 228,023 | \$ 236,879 |
| Total | \$ 543,209 | \$ 517,802 |

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 September 30, 2012, approximately half of the outstanding principal balance of the Corporation's commercial real estate loans was 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.

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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 one loan of approximately \$32,000 that was 90 days or more past due that was not included in nonaccrual loans as of September 30, 2012.

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

| September 30, 2012 | 30 - 89 Days past due | 90 Days and Greater Past Due | Total Past Due | Current | Total loans |
|---|--------------------------|------------------------------------|-------------------|-------------------|-------------------|
| <u>Retail</u> | | | | | |
| Consumer loans | \$ 60 | \$ 8 | \$ 68 | \$ 13,310 | \$ 13,378 |
| Single family residential | 1,421 | 479 | 1,900 | 193,048 | 194,948 |
| Other retail | 35 | - | 35 | 19,662 | 19,697 |
| Retail total | \$ 1,516 | \$ 487 | \$ 2,003 | \$ 226,020 | \$ 228,023 |
| | | | | | |
| <u>Commercial</u> | | | | | |
| Commercial and industrial | \$ 715 | \$ 3,842 | \$ 4,557 | \$ 63,708 | \$ 68,265 |
| Non-farm, non-residential real estate | 37 | 649 | 686 | 159,671 | 160,357 |
| Construction and development | 20 | - | 20 | 37,838 | 37,858 |
| Commercial loans secured by real estate | 156 | 210 | 366 | 8,864 | 9,230 |
| All other commercial | - | 1,379 | 1,379 | 38,097 | 39,476 |
| Commercial total | \$ 928 | \$ 6,080 | \$ 7,008 | \$ 308,178 | \$ 315,186 |
| Total | \$ 2,444 | \$ 6,567 | \$ 9,011 | \$ 534,198 | \$ 543,209 |

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| December 31, 2011 | 30 - 89 Days Past Due | 90 Days and Greater Past Due | Total Past Due | Current | Total Loans |
|---------------------------------------|--------------------------|---------------------------------|-------------------|------------|-------------|
| <u>Retail</u> | | | | | |
| Consumer | \$ 73 | \$ 4 | \$ 77 | \$ 14,220 | \$ 14,297 |
| Single family residential | 5,131 | 1,002 | 6,133 | 190,749 | 196,882 |
| Other retail | 1 | - | 1 | 25,699 | 25,700 |
| Retail total | \$ 5,205 | \$ 1,006 | \$ 6,211 | \$ 230,665 | \$ 236,879 |
| <u>Commercial</u> | | | | | |
| Commercial and industrial | \$ 3,858 | \$ 1,419 | \$ 5,277 | \$ 55,171 | \$ 60,448 |
| Non-farm, non-residential real estate | 2,166 | 320 | 2,486 | 137,156 | 139,642 |
| 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 | \$ 271,516 | \$ 280,923 |
| Total | \$ 12,714 | \$ 2,904 | \$ 15,618 | \$ 502,184 | \$ 517,802 |

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

| | September 30, 2012 | December 31, 2011 |
|---------------------------------------|--------------------|-------------------|
| <u>Retail</u> | | |
| Consumer | \$ 24 | \$ 72 |
| Single family residential | 3,559 | 4,070 |
| Other retail | - | - |
| Retail total | \$ 3,583 | \$ 4,142 |
| <u>Commercial</u> | | |
| Commercial and industrial | \$ 3,867 | \$ 5,030 |
| Non-farm, non-residential real estate | 1,264 | 2,030 |
| Construction and development | 132 | 267 |
| All other commercial | 1,379 | - |
| Commercial total | \$ 6,642 | \$ 7,327 |
| Total | \$ 10,225 | \$ 11,469 |

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

| September 30, 2012 | Unpaid Contractual Principal Balance | Recorded Investment with No Allowance | Recorded Investment with Allowance | Total Recorded Investment | Related Allowance | Average Recorded Investment | |
|---------------------------------------|---|---|--|---------------------------------|----------------------|--------------------------------|-----------------|
| | | | | | | Quarter | Year to Date |
| <u>Commercial</u> | | | | | | | |
| Commercial and industrial | \$ 4,433 | \$ 3,447 | \$ 328 | \$ 3,775 | \$ 103 | \$ 3,759 | \$ 3,839 |
| Non-farm, non-residential real estate | 2,914 | 2,360 | - | \$ 2,360 | - | 2,160 | 1,436 |
| Construction and development | 682 | - | 682 | \$ 682 | 118 | 706 | 681 |
| Other commercial | 1,379 | 1,379 | - | 1,379 | - | 1,379 | 1,379 |
| Commercial total | \$ 9,408 | \$ 7,186 | \$ 1,010 | \$ 8,196 | \$ 221 | \$ 8,004 | \$ 7,335 |
| <u>Retail</u> | | | | | | | |
| Single family residential | 3,126 | 2,157 | 626 | 2,783 | 94 | 2,768 | 2,781 |
| Retail total | \$ 3,126 | \$ 2,157 | \$ 626 | \$ 2,783 | \$ 94 | \$ 2,768 | \$ 2,781 |

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| | | | | | | | | | | | | | | |
|--------------|----|--------|----|-------|----|-------|----|--------|----|-----|----|--------|----|--------|
| Total | \$ | 12,534 | \$ | 9,343 | \$ | 1,636 | \$ | 10,979 | \$ | 315 | \$ | 10,772 | \$ | 10,116 |
|--------------|----|--------|----|-------|----|-------|----|--------|----|-----|----|--------|----|--------|

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| | Unpaid Contractual Principal Balance | Recorded Investment with No Allowance | Recorded Investment with Allowance | Total Recorded Investment | Related Allowance | Average Recorded Investment Year Quarter to Date |
|---|--------------------------------------|---------------------------------------|------------------------------------|---------------------------|-------------------|--|
| December 31, 2011 | | | | | | |
| Commercial | | | | | | |
| Commercial and industrial Non-farm, non-residential real estate | \$ 5,839 | \$ 738 | \$ 5,678 | \$ 5,446 | \$ 01 | \$ 069 \$ 5,069 |
| Construction and development | 4,378 | 2,986 | 2,115 | 4,573 | 307 | 5,232 5,232 |
| Other commercial | 870 | - | 870 | 870 | 203 | 941 941 |
| Commercial total | 3,238 | - | - | 1,498 | - | 1,527 1,527 |
| | \$ 14,325 | \$ 3,724 | \$ 8,663 | \$ 12,387 | \$ 111 | \$ 769 \$ 12,769 |
| Retail | | | | | | |
| Single family residential | 1,388 | 142 | 1,075 | 1,217 | 131 | 1,269 1,269 |
| Retail total | \$ 1,388 | \$ 142 | \$ 1,075 | \$ 1,217 | \$ 1 | \$ 269 \$ 1,269 |
| Total | \$ 15,713 | \$ 3,866 | \$ 9,738 | \$ 13,604 | \$ 242 | \$ 4,038 \$ 14,038 |

| | Unpaid Contractual Principal Balance | Recorded Investment with No Allowance | Recorded Investment with Allowance | Total Recorded Investment | Related Allowance | Average Recorded Investment Year Quarter to Date |
|---|--------------------------------------|---------------------------------------|------------------------------------|---------------------------|-------------------|--|
| September 30, 2011 | | | | | | |
| Commercial | | | | | | |
| Commercial and industrial Non-farm, non-residential real estate | \$ 5,957 | \$ 5,152 | \$ 368 | \$ 520 | \$ 6 | \$ 364 \$ 5,364 |
| Construction and development | 4,627 | 3,503 | - | 3,503 | - | 4,836 4,836 |
| Other commercial | 1,220 | - | 869 | 869 | 203 | 950 950 |
| Commercial total | 1,385 | 1,229 | - | 1,229 | - | 1,508 1,508 |
| | \$ 13,189 | \$ 9,884 | \$ 1,237 | \$ 1,121 | \$ 79 | \$ 658 \$ 12,658 |
| Retail | | | | | | |
| Single family residential | 2,943 | 2,231 | 652 | 2,883 | 93 | 1,861 1,861 |
| Retail total | \$ 2,943 | \$ 2,231 | \$ 652 | \$ 2,883 | \$ 93 | \$ 861 \$ 1,861 |
| Total | \$ 16,132 | \$ 12,115 | \$ 1,889 | \$ 4,004 | \$ 72 | \$ 4,519 \$ 14,519 |

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 \$281,000 and \$554,000 for the nine-month periods ended September 30, 2012 and 2011, respectively. The average balance of impaired loans for the nine-month period ending September 30, 2012 was \$7.3 million for commercial loans and \$2.8 million for residential real estate loans, totaling \$10.1 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 September 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. The Corporation had no troubled debt restructurings during the three months ending September 30, 2012 and September 30, 2011. There was one troubled debt restructuring that subsequently defaulted during the three months ending September 30, 2011. The recorded balance for this loan was approximately \$159,000. Presented below, segregated by class of loans, are troubled debt restructurings that occurred and subsequently defaulted during the nine months ended September 30, 2012 and 2011(dollars in thousands):

| | Nine Months Ended September 30, 2012 | | |
|---|---|---|---|
| | Number of Loans | Post- Modification Outstanding Balance | Net Charge-offs Resulting from Modifications |
| Commercial: | | | |
| Commercial and industrial | 2 | \$ 539 | \$ 197 |
| Retail: | | | |
| Single family residential | 2 | 155 | - |
| Total troubled debt restructurings | 4 | \$ 694 | \$ 197 |

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| Nine Months Ended September 30, 2011 | | | | | |
|---|----------------------------|---|---|-----------|----------|
| <i>(dollars in thousands)</i> | Number of Loans | Post- Modification Outstanding Balance | Net Charge-offs Resulting from Modifications | | |
| Commercial: | | | | | |
| Commercial and industrial | 9 | \$ | 3,179 | \$ | - |
| Nonfarm nonresidential | 6 | | 1,213 | | - |
| Tax Exempt State and Political | 1 | | 1,385 | | - |
| Farmland | 2 | | 178 | | - |
| Retail: | | | | | |
| Consumer | 6 | | 41 | | - |
| Single family residential | 8 | | 1,212 | | - |
| Total troubled debt restructurings | 32 | \$ | 7,208 | \$ | - |

| <i>(dollars in thousands)</i> | Nine Months Ended September 30, 2011 | |
|---|---|-----------------------------|
| | Number of Loans | Recorded Balance |
| Commercial: | | |
| Nonfarm nonresidential | 1 | \$ 329 |
| Retail: | | |
| Consumer | 1 | 22 |
| Single family residential | 1 | 448 |
| Total defaulted restructured loans | 3 | \$ 799 |

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 September 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.

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- 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.

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- 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 September 30, 2012 and December 31, 2011 (dollars in thousands):

September 30, 2012

| | | Non-Farm, Non-Residential | | Commercial Loans | Other Commercial Loans | Commercial Loan Totals |
|---|-------------------------|------------------------------|----------------------------|----------------------------|------------------------------|---------------------------|
| Commercial Loan Portfolio: | | | | | | |
| Credit risk profile by internally assigned grade | Commercial & Industrial | Real Estate Loans | Construction & Development | Secured by Residential R/E | | |
| Pass | \$ 63,851 | \$ 157,360 | \$ 36,576 | \$ 8,118 | \$ 36,620 | \$ 302,525 |
| Special Mention | 283 | 834 | 600 | 403 | - | 2,120 |
| Substandard | 1,054 | 2,163 | 682 | 709 | 1,477 | 6,085 |
| Doubtful | 3,077 | - | - | - | 1,379 | 4,456 |
| Total | \$ 68,265 | \$ 160,357 | \$ 37,858 | \$ 9,230 | \$ 39,476 | \$ 315,186 |
| Retail Loan Portfolio: | | | | | | |
| Credit risk profiles based on delinquency status classification | | | Other Retail Loans | | | Retail Loan Totals |
| Performing | Consumer Loans | Single-Family Residential** | | | | |
| Non-performing* | \$ 13,354 | \$ 191,357 | \$ 19,697 | | \$ 224,408 | |
| | 24 | 3,591 | - | | 3,615 | |
| Total | \$ 13,378 | \$ 194,948 | \$ 19,697 | \$ 228,023 | | |

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*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).

December 31, 2011

| Commercial Loan Portfolio: | Commercial & Industrial | Non-Farm, Non-Residential Real Estate | Construction & Development | Commercial Loans Secured by Real Estate | Other Commercial | Commercial Loan Totals |
|--|-------------------------|---------------------------------------|----------------------------|---|------------------|------------------------|
| Credit risk profile by internally assigned grade | | | | | | |
| Pass | \$ 50,163 | \$ 131,786 | \$ 27,613 | \$ 5,045 | \$ 42,771 | \$ 257,378 |
| 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 |
| Total | \$ 60,448 | \$ 139,642 | \$ 29,042 | \$ 6,161 | \$ 45,630 | \$ 280,923 |

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Retail Loan Portfolio:

| Credit risk profiles based on delinquency status classification | Consumer | Single-Family Residential** | Other Retail | Retail Loan Totals |
|---|------------------|-----------------------------|------------------|--------------------|
| Performing | \$ 14,225 | \$ 193,753 | \$ 25,368 | \$ 233,346 |
| Non-performing* | 72 | 3,129 | 332 | 3,533 |
| Total | \$ 14,297 | \$ 196,882 | \$ 25,700 | \$ 236,879 |

*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 has been 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, known 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 of 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. During the third quarter of 2012, management adjusted the number of loan segments and incorporated soft factors for various components such as economic conditions, trends in delinquencies, loan review assessments, credit concentrations and level of underperforming ratios. None of these changes have had 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 three months and nine months ended September 30, 2012 and September 30, 2011 and the year ended December 31, 2011 (dollars in thousands):

| Three Month Ended | Commercial | Residential Real Estate | Consumer & Other Retail | Unallocated | Total |
|--------------------------------|-------------------|------------------------------------|--|--------------------|--------------|
| Beginning ALLL balance 6/30/12 | \$ 6,677 | \$ 1,564 | \$ 159 | \$ 372 | \$ 8,772 |
| Less: Charge-offs | (144) | (12) | (4) | - | (160) |

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| | | | | | |
|--------------------------------------|-------------------|--------------------|-----------------------|--------------------|-----------------|
| Add: Recoveries | 88 | - | 4 | - | 92 |
| Add: Provisions | 579 | (270) | 39 | (348) | - |
| Ending ALLL balance - 9/30/12 | \$ 7,200 | \$ 1,282 | \$ 198 | \$ 24 | \$ 8,704 |
| | | Residential | Consumer & | | |
| Nine Months Ended | Commercial | Real Estate | Other Retail | Unallocated | Total |
| Beginning ALLL balance - 12/31/11 | \$ 5,957 | \$ 2,113 | \$ 192 | \$ 938 | \$ 9,200 |
| Less: Charge-offs | (1,676) | (159) | (9) | - | (1,844) |
| Add: Recoveries | 219 | 2 | 7 | - | 228 |
| Add: Provisions | 2,700 | (674) | 8 | (914) | 1,120 |
| Ending ALLL balance - 9/30/12 | \$ 7,200 | \$ 1,282 | \$ 198 | \$ 24 | \$ 8,704 |

| Three Months Ended | Commercial | Residential Real Estate | Consumer & Other Retail | Unallocated | Total |
|--------------------------------------|-------------------|------------------------------------|--|--------------------|-----------------|
| Beginning ALLL balance - 6/30/11 | \$ 5,438 | \$ 1,945 | \$ 265 | \$ 356 | \$ 8,004 |
| Less: Charge-offs | (495) | (23) | (4) | - | (522) |
| Add: Recoveries | 15 | - | 27 | - | 42 |
| Add: Provisions | 945 | 10 | (84) | (121) | 750 |
| Ending ALLL balance - 9/30/11 | \$ 5,903 | \$ 1,932 | \$ 204 | \$ 235 | \$ 8,274 |
| Nine Months Ended | Commercial | Residential Real Estate | Consumer & Other Retail | Unallocated | Total |
| Beginning ALLL balance - 12/31/10 | \$ 6,915 | \$ 2,001 | \$ 408 | \$ 96 | \$ 9,420 |
| Less: Charge-offs | (3,115) | (281) | (130) | - | (3,526) |
| Add: Recoveries | 65 | 20 | 70 | - | 155 |
| Add: Provisions | 2,038 | 192 | (144) | 139 | 2,225 |
| Ending ALLL balance - 9/30/11 | \$ 5,903 | \$ 1,932 | \$ 204 | \$ 235 | \$ 8,274 |

| | Commercial | Residential Real Estate | Consumer & Other Retail | Unallocated | Total |
|---------------------------------------|-------------------|------------------------------------|--|--------------------|-----------------|
| 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 September 30, 2012, December 31, 2011 and September 30, 2011, disaggregated on the basis of the Corporation's impairment methodology (dollars in thousands):

| September 30, 2012 | Commercial | Residential Real Estate | Consumer & Other Retail | Unallocated | Total |
|---|-------------------|------------------------------------|--|--------------------|-----------------|
| Loans individually evaluated for impairment | \$ 221 | \$ 94 | \$ - | \$ - | \$15 |
| Loans collectively evaluated for impairment | 6,979 | 1,188 | 198 | 24 | 8,389 |
| | \$ 7,200 | \$ 1,282 | \$ 198 | \$ 24 | \$ 8,704 |
| December 31, 2011 | | | | | |
| Loans individually evaluated for impairment | \$ 1,111 | \$ 131 | \$ - | \$ - | \$1,242 |

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| | | | | | |
|---|-----------------|-----------------|---------------|---------------|-----------------|
| Loans collectively evaluated for impairment | 4,846 | 1,982 | 192 | 938 | 7,958 |
| | \$ 5,957 | \$ 2,113 | \$ 192 | \$ 938 | \$ 9,200 |
| September 30, 2011 | | | | | |
| Loans individually evaluated for impairment | \$ 279 | \$ 93 | \$ 204 | \$ - | \$ 372 |
| Loans collectively evaluated for impairment | 5,624 | 1,839 | - | 235 | 7,902 |
| | \$ 5,903 | \$ 1,932 | \$ 204 | \$ 235 | \$ 8,274 |

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):

| | Commercial | Residential Real Estate | Consumer & Other Retail | Unallocated | Total |
|---|-------------------|------------------------------------|--|--------------------|-------------------|
| September 30, 2012 | | | | | |
| Loans individually evaluated for impairment | \$ 9,939 | \$ 1,038 | \$ - | \$ - | \$ 10,977 |
| Loans collectively evaluated for impairment | 305,247 | 193,910 | 33,075 | - | 532,232 |
| | \$ 315,186 | \$ 194,948 | \$ 33,075 | \$ - | \$ 543,209 |
| December 31, 2011 | | | | | |
| Loans individually evaluated for impairment | \$ 12,625 | \$ 1,217 | \$ - | \$ - | \$ 13,842 |
| Loans collectively evaluated for impairment | 268,298 | 220,379 | 14,055 | 1,228 | 503,960 |
| | \$ 280,923 | \$ 221,596 | \$ 14,055 | \$ 1,228 | \$ 517,802 |
| September 30, 2011 | | | | | |
| Loans individually evaluated for impairment | \$ 12,760 | \$ 1,244 | \$ - | \$ - | \$ 14,004 |
| Loans collectively evaluated for impairment | 282,267 | 225,179 | 14,549 | 1,315 | 523,310 |
| | \$ 295,027 | \$ 226,423 | \$ 14,549 | \$ 1,315 | \$ 537,314 |

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% to 3.76%. One scheduled principal payment of \$10.1 million is due in the first quarter of 2013 under this credit line.

FHLB stock totaling \$3.0 million at September 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 September 30, 2012 or December 31, 2011.

NOTE 6 POST-RETIREMENT BENEFIT PLAN

| (Dollars in thousands) | Three Months Ended September 30, 2012 | September 30, 2011 |
|------------------------------------|--|--------------------|
| Service cost | \$ 23 | \$ 6 |
| Interest cost | 96 | 39 |
| Expected return on plan assets | - | - |
| Amortization of prior service cost | (4) | (60) |
| Amortization of net loss | - | - |
| Net periodic pension cost | \$ 115 | \$ (15) |
| | Nine Months Ended September 30, 2012 | September 30, 2011 |
| Service cost | \$ 69 | \$ 18 |
| Interest cost | 288 | 117 |
| Expected return on plan assets | - | - |
| Amortization of prior service cost | (12) | (180) |
| Amortization of net loss | - | - |
| Net periodic pension cost | \$ 345 | \$ (45) |

The Corporation currently expects to contribute approximately \$472,000 to its post retirement benefit plan during the year ending December 31, 2012, of which approximately \$354,000 was contributed in the first nine months of 2012.

NOTE 7 RECENT ACCOUNTING PRONOUNCEMENTS

ASU No. 2011-03, Transfers and Servicing (Topic 860) - Reconsideration of Effective Control for Repurchase Agreements. ASU 2011-03 is intended to improve financial reporting of repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. ASU 2011-03 removes from the assessment of effective control (i) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (ii) the collateral maintenance guidance related to that criterion. ASU 2011-03 was adopted on January 1, 2012 and did not have a significant impact on the Corporation's financial statements.

ASU 2011-04, Fair Value Measurement (Topic 820) - Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs. ASU 2011-04 amends ASC Topic 820, to converge the fair value measurement guidance in U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards. ASU 2011-04 clarifies the application of existing fair value

measurement requirements, changes certain principles in ASC Topic 820 and requires additional fair value disclosures. ASU 2011-04 was effective for interim and annual periods beginning after December 15, 2011, and the adoption of this ASU did not have a significant impact on the Corporation's financial statements.

ASU 2011-05, Comprehensive Income (Topic 220) - Presentation of Comprehensive Income. ASU 2011-05 amends Topic 220, Comprehensive Income, to require that all non-owner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements. Additionally, ASU 2011-05 requires entities to present, on the face of the financial statements, reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement or statements where the components of net income and the components of other comprehensive income are presented. The option to present components of other comprehensive income as part of the statement of changes in stockholders' equity was eliminated. ASU 2011-05 is effective for interim and annual periods beginning after December 15, 2011 and the adoption of this ASU did not have a significant impact on the Corporation's financial statements. The Corporation now includes a condensed consolidated statement of comprehensive income with its financial statements.

ASU 2011-08, Intangibles - Goodwill and Other (Topic 350) - Testing Goodwill for Impairment. ASU 2011-08 amends Topic 350, Intangibles - Goodwill and Other, to give entities the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the prescribed two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the prescribed two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. ASU 2011-08 is effective for annual and interim impairment tests

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beginning after December 15, 2011, and the adoption did not have a significant impact on the Corporation's financial statements.

ASU 2011-11, *Balance Sheet (Topic 210) - Disclosures about Offsetting Assets and Liabilities*. ASU 2011-11 amends Topic 210, Balance Sheet, to require an entity to disclose both gross and net information about financial instruments, such as sales and repurchase agreements and reverse sale and repurchase agreements and securities borrowing/lending arrangements, and derivative instruments that are eligible for offset in the statement of financial position and/or subject to a master netting arrangement or similar agreement. ASU 2011-11 is effective for annual and interim periods beginning on or after January 1, 2013, and is not expected to have a significant impact on the Corporation's financial statements.

ASU 2011-12 *Comprehensive Income (Topic 220) - Deferral of the Effective Date for Amendments to the presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*. ASU 2011-12 defers changes in ASU No. 2011-05 that relate to the presentation of reclassification adjustments to allow the FASB time to deliberate whether to require presentation of such adjustments on the face of the financial statements to show the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income. ASU 2011-12 allows entities to continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU No. 2011-05. All other requirements in ASU No. 2011-05 are not affected by ASU No. 2011-12. ASU 2011-12 became effective for the Corporation on January 1, 2012 and did not have a significant impact on the Corporation's financial statements.

ASU 2012-02 *Intangibles - Goodwill and Other (Topic 350) - Testing Indefinite-Lived Intangible Assets for Impairment*. ASU 2012-02 give entities the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that an indefinite-lived intangible asset is impaired. If, after assessing the totality of events or circumstances, an entity determines it is more likely than not that an indefinite-lived intangible asset is impaired, then the entity must perform the quantitative impairment test. If, under the quantitative impairment test, the carrying amount of the intangible asset exceeds its fair value, an entity should recognize an impairment loss in the amount of that excess. Permitting an entity to assess qualitative factors when testing indefinite-lived intangible assets for impairment results in guidance is similar to the goodwill impairment testing guidance in ASU 2011-08. ASU 2012-02 is effective for the Corporation beginning January 1, 2013 (early adoption permitted) and is not expected to have a significant impact on the Corporation's financial statements.

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

FORWARD-LOOKING STATEMENTS

Certain statements contained in this report may not be based on historical facts and are 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 (the Exchange Act). These forward-looking statements may be identified by, among other things, the use of forward-looking terminology such as could, would, expect, believe, intend, may, will, can, or should or future or conditional verb tenses, and variations or negatives of such terms. These forward-looking statements include, without limitation, those relating to the Corporation's valuation methodologies, contributions to the Corporation's post-retirement benefit plan and returns on the plan's assets, characterization of accrual and non-accrual loans, concessions granted for troubled debt restructurings, impairment of securities, repayment of loans, loan portfolio concentrations, fair value of impaired loans, satisfaction of capital adequacy requirements, payments on advances from the FHLB, risk rating classifications of loans, calculation of our allowance for loan losses, adequacy of traditional sources of cash generated from operating activities to meet liquidity needs and the realization of deferred income tax assets. We caution you not to place undue reliance on such forward-looking statements in this report because results could differ materially from those anticipated due to a variety of factors. These factors include, but are not limited to, conditions in the financial market, liquidity needs, the sufficiency of our allowance for loan losses, economic conditions in the communities in the State of Tennessee where the Corporation does business, the impact of government regulation and supervision, interest rate risk, including changes in monetary policy and fluctuating interest rates, the Corporation's ability to attract and retain key personnel, competition from other financial services providers, other factors generally understood to affect the financial results of financial services companies and other factors detailed from time to time in our filings with the Securities and Exchange Commission (the SEC). We undertake no obligation to update these forward-looking statements to reflect events or circumstances that occur after the date of this report.

EXECUTIVE OVERVIEW

At September 30, 2012, the consolidated total assets of the Corporation were \$1.1 billion, its consolidated net loans were \$534.5 million, its total deposits were \$887.5 million and its total shareholders' equity was \$116.0 million. The Corporation's loan portfolio at September 30, 2012 reflected an increase of \$25.4 million, or 4.9%, compared to December 31, 2011. Total deposits increased \$31.1 million, or 3.6%, and shareholders' equity increased by 4.2% during the first nine months of 2012. Total shareholders' equity included an unrealized gain, net of tax, on available-for-sale securities of \$4.4 million.

Financial Condition

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Average earning assets for the quarter ended September 30, 2012 increased 7.9%, or \$69.0 million, from average earning assets for the quarter ended December 31, 2011. Average overnight investments for the quarter ended September 30, 2012 increased 23.5% compared to the quarter ended December 31, 2011. Average investment securities for the quarter ended September 30, 2012 increased 26.6% compared to the quarter ended December 31, 2011. Average total assets increased 7.5% or \$72.7 million, from \$975.3 million for the quarter ended December 31, 2011 to \$1.048 billion for the quarter ended September 30, 2012.

Securities

Available-for-sale securities are an integral part of the asset/liability management process of the Corporation. Accordingly, they represent an important source of liquidity available to fund loans and accommodate asset reallocation strategies dictated by changes in the Corporation's operating and tax plans, shifting yield spread relationships and changes in configuration of the yield curve. At September 30, 2012, the Corporation's investment securities portfolio had \$347.7 million of available-for-sale securities, which are valued at fair market value, and \$32.2 million of held-to-maturity securities, which are valued at cost on the balance sheet. These compare to \$314.2 million of available-for-sale securities and \$35.2 million of held-to-maturity securities as of December 31, 2011.

Loans and Loan Losses

The loan portfolio is the largest component of earning assets for the Corporation and, consequently, provides the largest amount of revenue for the Corporation. The loan portfolio also contains the highest exposure to risk as a result of the possibility of unexpected deterioration in the credit quality of borrowers. When analyzing potential loans, management of the Corporation assesses both interest rate objectives and credit quality objectives in determining whether to make a given loan and the appropriate pricing for that loan. All loans are expected to be repaid from cash flow or proceeds from the sale of selected assets of the borrowers. Collateral requirements for the loan portfolio are based on credit evaluation of the borrowers.

Loan volume increased in the third quarter of 2012, with total loans increasing by \$24.5 million, or 4.7% during the three-month period. Commercial loans increased by \$23.2 million, or 8.0%, in the third quarter, and the retail portfolio increased by \$1.3 million, or 0.6%. At \$543.2 million, total loans outstanding increased by \$5.9 million, or 1.1%, at September 30, 2012 compared to September 30, 2011. Loan demand has shown an improvement during the three and nine months ended September 30, 2012, especially in the commercial portfolio.

The Corporation continues to reserve more heavily against its construction and development portfolio than any other segment of the commercial portfolio, given the comparatively high level of losses that have been incurred within this segment of the portfolio over the previous year. Additionally, higher reserves are being placed against property types which are believed to be higher risk, such as retail and multi-family real estate.

Loans identified with losses by management, internal loan review and/or Corporation examiners are charged off. Furthermore, consumer loan accounts are charged off automatically based on regulatory requirements.

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, and allowance allocations calculated in accordance with ASC Topic 450. Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, specific homogeneous

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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, classified and 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. In other words, 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 unallocated portion of the allowance for loan losses represents general valuation allowances that are not allocated to specific loan portfolio segments. See Note 4 - Loans in the accompanying notes to consolidated financial statements included elsewhere in this report for further details regarding the Corporation's methodology for estimating the appropriate level of the allowance for loan losses.

Collectability. A formal process is in place to enhance control over the underwriting of loans and to monitor loan collectability. This process includes education and training of personnel about the Corporation's loan policies and procedures, assignment of credit analysts to support lenders, timely identification of loans with adverse characteristics, control of corrective actions and objective monitoring of loan reviews. The Special Assets Department of the Corporation identifies and monitors assets that need special attention. At September 30, 2012, this process identified loans totaling \$3.4 million that were classified as other assets especially mentioned compared to loans totaling \$9.3 million at December 31, 2011. Loans totaling \$10.1 million were classified as substandard at September 30, 2012, compared to loans totaling \$6.8 million at December 31, 2011. Loans totaling \$4.5 million were classified as doubtful at September 30, 2012, compared to loans totaling \$7.4 million at December 31, 2011.

Loans having average recorded investments of \$10.1 million and \$14.0 million at September 30, 2012 and December 31, 2011, respectively, have been identified as impaired. Nonaccrual loans amounting to \$10.2 million and \$11.5 million at September 30, 2012 and December 31, 2011, respectively, were not accruing interest. Interest received on these loans during the third quarter of 2012 was approximately \$353,000, compared to approximately \$809,000 over the same period in 2011. The gross interest income that would have been recorded if the loans had been current in accordance with their original terms and had been outstanding throughout the period or since origination, if held for part of the period, was approximately \$825,000, and \$1.1 million for the nine-month period ended September 30, 2012 and the nine-month period ended September 30, 2011, respectively. The Corporation had one loan for approximately \$32,000 that was 90 days or more past due that was not included in nonaccrual loans as of September 30, 2012.

Deposits

The Corporation does not have any foreign offices and all deposits are serviced in its 18 domestic offices. The Corporation's average deposits increased 8.3% during the first nine months of 2012 compared to an increase of 2.1% in the first nine months of 2011. Average total noninterest-bearing deposits were 17.1% of total deposits at September 30, 2012, contributing to the Corporation's low cost of deposits, compared to 16.5% at December 31, 2011.

Regulatory Requirements for Capital

The Corporation and First Farmers and Merchants Bank, the Corporation's sole direct subsidiary (the Bank), are subject to federal regulatory capital adequacy standards. Failure to meet capital adequacy requirements could result in certain mandatory, and possibly additional discretionary, actions by regulators that could have a direct material adverse effect on the financial condition of the Corporation and the Bank. Federal regulations require the Corporation and the Bank to meet specific capital adequacy guidelines that involve quantitative measures of assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital classification is also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Under federal regulatory standards, to be well-capitalized, the Corporation's and the Bank's Tier 1 Risk-Based Capital Ratio (ratio of Tier 1 Capital to risk-weighted assets) must be at least 6%, its Total Risk-Based Capital Ratio (ratio of total capital to risk-weighted assets) must be at least 10%, and its Tier 1 Leverage Capital Ratio (ratio of Tier 1 Capital to average assets) must be at least 5%. Equity capital (net of certain adjustments for intangible assets and investments in non-consolidated subsidiaries and certain classes of preferred stock) and other certain equity like instruments are considered Tier 1 Capital. Tier 2 Capital consists of core capital plus supplementary or temporary capital such as subordinated debt, some types of preferred stock, and a defined percentage of the allowance for loan losses.

As of September 30, 2012, the Bank's Tier 1 Risk-Based Capital Ratio, Total Risk-Based Capital Ratio and Tier 1 Leverage Capital Ratios were 15.2%, 16.4%, and 9.7%, respectively, compared to 15.2%, 16.5%, and 9.7% at December 31, 2011. At September 30, 2012, the Corporation's Tier 1 Risk-Based Capital Ratio, Total Risk-Based Capital Ratio and Tier 1 Leverage Capital Ratios were 15.5%, 16.7% and 9.9%, respectively. The ratios were 15.6%, 16.8% and 10.0%, respectively, at December 31, 2011. Management believes, as of September 30, 2012, that the Corporation and the Bank each met all capital adequacy requirements to which they are subject.

Liquidity and Capital Resources

Most of the capital needs of the Corporation historically have been financed with retained earnings and deposits received.

The Corporation and the subsidiary Bank are subject to Tennessee statutes and regulations that impose restrictions on the amount of dividends that may be declared. Furthermore, any dividend payments are subject to the continuing ability of the Corporation to maintain its compliance with minimum federal regulatory capital requirements and to retain its characterization under federal regulations as a well-capitalized institution. The Corporation's Board of Directors has adopted a liquidity policy that outlines specific liquidity target balances. Compliance with this policy is reviewed quarterly by the Corporation's Asset/Liability Committee and results are reported to the Corporation's Board of Directors.

The Corporation's formal asset and liability management process is used to manage interest rate risk and assist management in maintaining reasonable stability in the gross interest margin as a result of changes in the level of interest rates and/or the spread relationships among interest rates. The Corporation uses an earnings simulation model to evaluate the impact of different interest rate scenarios on the gross margin. Each quarter, the Corporation's Asset/Liability Committee monitors the relationship of rate sensitive earning assets to rate sensitive interest-bearing liabilities (interest rate sensitivity), which is the principal factor in determining the effect that fluctuating interest rates will have on future net interest income. Rate sensitive earning assets and interest bearing liabilities are financial instruments that can be repriced to current market rates within a defined time period.

Management believes that the Corporation's traditional sources of cash generated from operating activities are adequate to meet the liquidity needs for normal ongoing operations; however, the Corporation also has access to additional liquidity, if necessary, through additional advances from the FHLB or the CMA with the FHLB. The borrowings from the FHLB have been used generally for investment strategies to enhance the Corporation's portfolio. At September 30, 2012, the Corporation had \$65.5 million in borrowing capacity.

Critical Accounting Policies

The accounting principles the Corporation follows and the methods of applying these principles conform with GAAP and with general practices within the banking industry. In connection with the application of those principles, the Corporation's management has made judgments and estimates that with respect to the determination of the ALLL and the recognition of deferred income tax assets, have been critical to the determination of the Corporation's financial position, results of operations and cash flows.

Allowance for Loan Losses

The Corporation's management assesses the adequacy of the ALLL prior to the end of each month and prepares a more formal review quarterly to assess the risk in the Corporation's loan portfolio. This assessment includes procedures to estimate the allowance and test the adequacy and appropriateness of the resulting balance. The ALLL represents calculated amounts for specifically identified credit exposure and exposures readily predictable by historical or comparative experience. Even though this calculation considers specific credits, the entire allowance is available to absorb any credit losses.

These calculated amounts are determined by assessing loans identified as not in compliance with loan agreements. These loans are generally in two different risk groups. One group is unique loans (commercial loans, including those loans considered impaired). The second group consists of pools of homogenous loans (generally retail and mortgage loans). The calculation for unique loans is based primarily on risk rating grades assigned to each of these loans as a result of the Corporation's loan management and review processes. Each risk-rating grade is assigned a loss ratio, which is determined based on the experience of management, discussions with banking regulators and the independent loan review process. The amount allocated for an impaired loan is based on estimated cash flows discounted at the loan's original effective interest rate or the underlying collateral value. Historical data, including actual loss experience on specific types of homogenous loans, is used to allocate amounts for loans or groups of loans meeting the specified criteria. Management has implemented procedures that give more detailed historical data by category of retail and consumer credit and performance characteristics to broaden the analysis and improve monitoring of potential credit risk.

Criteria considered and processes utilized in evaluating the adequacy of the ALLL are:

- Portfolio quality trends;
- Changes in the nature and volume of the portfolio;
- Present and prospective economic and business conditions, locally and nationally;
- Management review systems and board oversight, including external loan review processes;
- Changes in credit policy, credit administration, portfolio management and procedures;
- Changes in personnel, management and staff; and
- Existence and effect of any concentrations of credit.

In assessing the adequacy of the ALLL, the risk characteristics of the entire loan portfolio are evaluated. This process includes the judgment of the Corporation's management, input from independent loan reviews and reviews that may have been conducted by Corporation regulators as part of their usual examination process.

Results of Operations

Total interest income for the nine months ended September 30, 2012 was \$27.3 million compared to \$28.7 million for the nine months ended September 30, 2011 and \$9.1 million for the three months ended September 30, 2012 compared to \$9.5 million for the three months ended September 30, 2011. Interest and fees earned on loans and investments are the primary components of total interest income. Interest and fees earned on loans were \$20.9 million, a decrease of \$1.6 million, or 7.3%, during the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011 and \$7.0 million for the three months ended September 30, 2012 compared to \$7.5 million for the three months ended September 30, 2011. The lower interest rates for loans along with a decreased loan volume in the first half of 2012 were the primary reasons for the lower interest income. Interest earned on investment securities and other earning assets was \$6.4 million, an increase of approximately \$225,000, or 3.6%, during the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011 and \$2.2 million for the three months ended September 30, 2012 compared to \$2.1 million for the three months ended September 30, 2011.

Total interest expense in the nine months ended September 30, 2012 was \$3.0 million, a decrease of approximately \$839,000, or 22.1%, compared to the nine months ended September 30, 2011 and approximately \$917,000 for the three months ended September 30, 2012 compared to \$1.2 million for the three months ended September 30, 2011. The lower interest rates for certificates of deposits and public funds during the third quarter of 2012 were the primary reason for the lower expense. As a policy, budgeted financial goals are monitored on a quarterly basis by the Corporation's Asset/Liability Committee, which reviews the actual dollar change in net interest income for different interest rate movements. A negative dollar change in net interest income for a 12-month and 24-month period of less than 10.0% of net interest income given a 100 to 200 basis point shift in interest rates is considered an acceptable rate risk position. The rate risk analysis for the 24-month period beginning October 1, 2012 and ending September 30, 2014 showed a worst-case potential change to net interest income, in the very unlikely event of a negative 100 basis point shift in interest rates, of 9.4%, or a decrease in net interest income of \$2.9 million by the end of the period.

Net interest income of the Corporation on a fully taxable equivalent basis is influenced primarily by changes in:

- (1) the volume and mix of earning assets and sources of funding;

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- (2) market rates of interest; and
- (3) income tax rates.

The impact of some of these factors can be controlled by management policies and actions. External factors also can have a significant impact on changes in net interest income from one period to another. Some examples of such factors are:

- (1) the strength of credit demands by customers;
- (2) Federal Reserve Board monetary policy; and
- (3) fiscal and debt management policies of the federal government, including changes in tax laws.

The net interest margin, on a tax equivalent basis, at September 30, 2012, June 30, 2012, and December, 31, 2011 was 3.66%, 3.65% and 4.07%, respectively. The decline during the first nine months of 2012 was due, in part, to lower yields on earnings assets.

No additions were made to the provision for loan losses in the third quarter of 2012, compared to additions of approximately \$750,000 in the third quarter of 2011. This decrease was primarily because of the net charge-off ratios trending down.

Noninterest income was \$9.0 million, an increase of \$1.0 million, or 12.6%, during the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011 and \$2.3 million for the three months ended September 30, 2012 compared to \$2.9 million for the three months ended September 30, 2011. The gain on sales of securities for the nine months ended September 30, 2012 was \$2.2 million, an increase of \$1.0 million compared to the nine months ended September 30, 2011, and accounted for most of the increase in noninterest income over the nine-month period.

Noninterest expense, excluding the provision for loan losses, was \$24.3 million in the nine months ended September 30, 2012, an increase of approximately \$781,000, or 3.3%, as compared to the interest expense for the nine months ended September 30, 2011 and \$8.1 million for the three months ended September 30, 2012 compared to \$7.5 million for the three months ended September 30, 2011. An increase in salary and benefits was the primary contributor to the higher noninterest expense.

Net income for the nine months ended September 30, 2012 was \$6.4 million, compared to \$5.8 million for the nine months ended September 30, 2011 and \$1.9 million for the three months ended September 30, 2012 compared to \$2.3 million for the three months ended September 30, 2011. The Corporation earned \$1.19 per share for the nine months ended in September 30, 2012, compared to \$1.08 per share for the nine months ended September 30, 2011.

Off-Balance Sheet Arrangements

The Corporation is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and stand-by letters of credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the Corporation has in those financial instruments. Loan commitments are agreements to lend to a customer as long as there is not a violation of any condition established in the loan commitment contract. Stand-by letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing and similar transactions. The credit risk involved in issuing letters of credit is essentially the same as that involved in making a loan.

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The total outstanding balance of loan commitments and stand-by letters of credit in the normal course of business at September 30, 2012 were \$122.6 million and \$8.6 million, respectively.

At September 30, 2012, the Corporation and the Bank did not have any off-balance sheet arrangements other than commitments to extend credit and stand-by letters of credit.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

During the three months ended September 30, 2012, there were no material changes in the quantitative and qualitative disclosures about market risk presented in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2011.

Item 4. Controls and Procedures.

(a) Evaluation of Disclosure Controls and Procedures. The Corporation, with the participation of its management, including the Corporation's Chief Executive Officer and Treasurer (principal financial officer), carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rules 13a-15e and 15d-15e under the Exchange Act) as of the end of the period covered by this report. Based upon that evaluation and as of the end of the period covered by this report, the Corporation's Chief Executive Officer and Treasurer (principal financial officer) concluded that the Corporation's disclosure controls and procedures were effective in ensuring that information required to be disclosed in its reports that the Corporation files or submits to the SEC under the Exchange Act is recorded, processed, summarized and reported on a timely basis.

(b) Changes in Internal Control Over Financial Reporting. There has been no change in the Corporation's internal control over financial reporting that occurred during the third quarter of 2012 that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1A. Risk Factors.

There have been no material changes in the risk factors previously disclosed in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2011.

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

The following table provides information regarding purchases of the Corporation's common stock made by the Corporation during the third quarter of 2012:

| CORPORATION'S PURCHASES OF EQUITY SECURITIES | | | | |
|---|---|-------------------------------------|---|---|
| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs |
| July 1 - July 31, 2012 | | | | |
| August 1 - August 31, 2012 | | | | |
| September 1 - September 30, 2012 | 50,000* | \$23.00 | | |
| Total | 50,000* | \$23.00 | | |

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*Purchased through negotiated transactions with several third-party sellers.

Item 6. Exhibits.

EXHIBIT

| NUMBER | DESCRIPTION |
|---------|---|
| 3.1 | Charter. (1) |
| 3.2 | Articles of Amendment to Charter. (1) |
| 3.3 | Second Amended and Restated By-laws. (2) |
| 31.1 | Certification of the Chief Executive Officer of First Farmers and Merchants Corporation Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of the Treasurer (principal financial officer) of First Farmers and Merchants Corporation Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32 | Certification of the Chief Executive Officer and Treasurer (principal financial officer) of First Farmers and Merchants Corporation Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS | XBRL Instance Document. |
| 101.SCH | XBRL Taxonomy Extension Schema Document. |
| 101.CAL | XBRL Taxonomy Calculation Linkbase Document. |
| 101.DEF | XBRL Taxonomy Definition Linkbase Document. |

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101.LAB XBRL Taxonomy Label Linkbase Document.

101.PRE XBRL Taxonomy Presentation Linkbase Document.

(1) Incorporated by reference from the First Farmers and Merchants Corporation Amendment No. 1 to the Annual Report on Form 10-K/A for the year ended December 31, 2003, as filed with the Securities and Exchange Commission on May 7, 2004 (File Number 000-10972).

(2) Incorporated by reference from the First Farmers and Merchants Corporation Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on March 15, 2011 (File Number 000-10972).

SIGNATURES

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

FIRST FARMERS AND MERCHANTS CORPORATION

(Registrant)

Date November 5, 2012

/s/ T. Randy Stevens

T. Randy Stevens, Chief Executive Officer

Date November 5, 2012

/s/ Patricia P. Bearden

Patricia P. Bearden, Treasurer (principal financial officer and principal accounting officer)

EXHIBIT

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