

FIRST FARMERS & MERCHANTS CORP  
Form 10-Q  
May 09, 2013

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 **March 31, 2013**.

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

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(Exact name of registrant as specified in its charter)

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 May 5, 2013, the registrant had 5,135,324 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 are included in this Report:

Condensed consolidated balance sheets - March 31, 2013 and December 31, 2012.

Condensed consolidated statements of income - For the three months ended March 31, 2013 and March 31, 2012.

Condensed consolidated statements of comprehensive income - For the three months ended March 31, 2013 and March 31, 2012.

Condensed consolidated statements of cash flows - For the three months ended March 31, 2013 and March 31, 2012.

Selected notes to condensed consolidated financial statements.



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

	March 31, 2013 (unaudited)	December 31, 2012 (1)
<i>(Dollars in Thousands, Except Per Share Data)</i>		
<b>ASSETS</b>		
Cash and due from banks	\$ 12,834	\$ 23,443
Interest-bearing due from banks	29,011	31,953
Federal funds sold	10,000	15,000
Total cash and cash equivalents	51,845	70,396
Securities		
Available-for-sale (amortized cost \$380,398 and \$339,971, respectively)	382,673	345,718
Held-to-maturity (fair market value \$32,454 and \$33,420, respectively)	30,983	31,755
Total securities	413,656	377,473
Loans, net of deferred fees	573,563	567,159
Allowance for loan and lease losses	(8,657)	(8,809)
Net loans	564,906	558,350
Bank premises and equipment, net	26,078	26,417
Other real estate owned	3,461	5,678
Bank owned life insurance	25,685	25,112
Goodwill	9,018	9,018
Other assets	20,284	17,919
<b>TOTAL ASSETS</b>	<b>\$ 1,114,933</b>	<b>\$ 1,090,363</b>
<b>LIABILITIES</b>		
Deposits		
Noninterest-bearing	\$ 172,141	\$ 169,136
Interest bearing	791,363	763,713
Total deposits	963,504	932,849
Securities sold under agreements to repurchase	18,766	17,068
Accounts payable and accrued liabilities	15,126	15,755
Federal Home Loan Bank advances	3,100	10,100
<b>TOTAL LIABILITIES</b>	<b>1,000,496</b>	<b>975,772</b>
<b>SHAREHOLDERS' EQUITY</b>		
Common stock - \$10 par value per share, 8,000,000 shares authorized; 5,135,324 and 5,180,000 shares issued and outstanding as of March 31, 2013 and December 31, 2012, respectively	51,353	51,800
Retained earnings	59,841	57,366
Accumulated other comprehensive income	3,148	5,330
	114,342	114,496

TOTAL SHAREHOLDERS' EQUITY BEFORE  
NONCONTROLLING INTEREST - PREFERRED STOCK  
OF SUBSIDIARY

Noncontrolling interest - preferred stock of subsidiary	95	95
TOTAL SHAREHOLDERS' EQUITY	114,437	114,591
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 1,114,933	\$ 1,090,363

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

(1) Derived from audited financial statements.

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

		Three Months Ended	
		March 31,	
<i>(Dollars in Thousands, Except Per Share Data)</i>		<b>2013</b>	<b>2012</b>
<b>INTEREST AND DIVIDEND INCOME</b>	Interest and fees on loans	\$ 6,962	\$ 6,980
	Income on investment securities		
	Taxable interest	1,437	1,184
	Exempt from federal income tax	746	809
	Other interest and dividend income	78	92
	Total interest income	9,223	9,065
<b>INTEREST EXPENSE</b>	Interest on deposits	735	904
	Interest on other borrowings	99	167
	Total interest expense	834	1,071
	Net interest income	8,389	7,994
	Provision for loan and lease losses	-	600
	Net interest income after provision	8,389	7,394
<b>NONINTEREST INCOME</b>	Gain on loans sold	179	119
	Trust department income	596	536
	Service fees on deposit accounts	1,565	1,648
	Brokerage fees	107	42
	Earnings on bank owned life insurance	87	120
	Gain on sale of securities	823	1,212
	Loss on foreclosed property	(139)	(414)
	Other non-interest income	111	116
	Total noninterest income	3,329	3,379
<b>NONINTEREST EXPENSE</b>	Salaries and employee benefits	4,472	4,273
	Net occupancy expense	523	468
	Depreciation expense	380	328
	Data processing expense	544	475
	Legal and professional fees	183	188
	Stationary and office supplies	74	49
	Advertising and promotions	253	294
	FDIC insurance premium expense	186	356
	Other real estate expense	21	111
	Other noninterest expense	1,469	1,212
	Total noninterest expenses	8,105	7,754
	Income before provision for income taxes	3,613	3,019
	Provision for income taxes	557	690



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Net income for common shareholders	\$	3,056	\$	2,329
Weighted average shares outstanding		5,178,759		5,330,000
Earnings per share	\$	0.59	\$	0.44

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

**FIRST FARMERS AND MERCHANTS CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (unaudited)***(Dollars in thousands)*

	Three Months Ended March 31,		
	2013	2012	
Net income	\$	3,056	\$ 2,329
Comprehensive income (loss)			
Unrealized depreciation on available-for-sale securities, net of taxes of \$1,020 and \$420 for 2013 and 2012, respectively		(1,629)	(671)
Less: reclassification adjustment for realized gains included in net income, net of taxes of \$317 and \$467, for 2013 and 2012, respectively		(506)	(745)
Change in unfunded portion of postretirement benefit obligations, net of tax of \$0 for 2013 and 2012		(47)	-
Other comprehensive loss		(2,182)	(1,416)
Comprehensive income		874	913
Less: comprehensive income attributable to the noncontrolling interest		-	-
Total comprehensive income	\$	874	\$ 913

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



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

<i>(unaudited)</i>		<b>Three months ended March 31,</b>	
		<b>2013</b>	<b>2012</b>
		\$	\$
<b>OPERATING</b>	Net income available for common shareholders	3,056	2,329
<b>ACTIVITIES</b>	Adjustments to reconcile net income to net cash provided by (used in) operating activities		
	Provision for loan losses	-	600
	Provision for depreciation and amortization of premises and equipment	380	329
	Deferred tax expense	(212)	59
	Net securities gains	(823)	(1,233)
	Gains on loans sold	(179)	(119)
	Proceeds from sale of mortgage loans held for sale	10,156	6,888
	Funding of mortgage loans held for sale	(10,301)	(5,783)
	Loss on foreclosed property	139	414
	Gain on sale of assets	16	-
	Amortization of investment security premiums, net of accretion of discounts	339	1,084
	Increase in cash surrender value of life insurance contracts	(87)	(131)
	Increase in		
	Other assets	(492)	(957)
	Increase (decrease) in		
	Other liabilities	(676)	590
	Total adjustments	(1,740)	1,741
	Net cash provided by operating activities	1,316	4,070
<b>INVESTING</b>	Proceeds from sales of available-for-sale securities	72,447	134,018
<b>ACTIVITIES</b>	Proceeds from maturities and calls of available-for-sale securities	16,629	19,144
	Proceeds from maturities and calls of held-to-maturity securities	765	1,390
	Purchases of investment securities		
	available-for-sale	(129,012)	(214,836)
	Net (increase) decrease in loans	(4,765)	10,915
	Proceeds from sale of other real estate owned	287	923
	Purchase of life insurance policies	(486)	-
	Purchases of premises and equipment	(57)	(206)
	Net cash used in investing activities	(44,192)	(48,652)
<b>FINANCING</b>	Net increase in deposits	30,655	43,592
<b>ACTIVITIES</b>	Net increase in securities sold under agreements to repurchase	1,698	943
	Payments to FHLB borrowings	(7,000)	(7,000)
	Repurchase of common stock	(1,028)	-
	Cash dividends paid on common stock	-	(1,972)

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Net cash provided by financing activities	24,325	35,563
Decrease in cash and cash equivalents	(18,551)	(9,019)
Cash and cash equivalents at beginning of period	70,396	73,021
Cash and cash equivalents at end of period	\$ 51,845	\$ 64,002
Supplemental disclosures of cash flow information		
Cash paid (received) during the period for expenses		
Interest on deposits and borrowed funds	\$ 780	\$ 1,001
Income Taxes	(201)	1,563
Loans to facilitate sale	1,760	141
Real estate acquired in settlement of taxes	42	-

*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, 2012 for further information in this regard. The condensed consolidated balance sheet of the Corporation as of December 31, 2012 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 ACCUMULATED OTHER COMPREHENSIVE INCOME ( AOCI ) BY COMPONENT**

Amounts reclassified from AOCI and the affected line items in the statements of income during the periods ended March 31, 2013 and 2012, were as follows (dollars in thousands):

	<b>Amounts Reclassified from AOCI</b>		<b>Affected Line Item in the Statements of Income</b>
	March 31, 2013	March 31, 2012	
<b>Unrealized gains on available-for-sale securities</b>			

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	\$	823	\$	1,212	Realized gain on sale of securities
		823		1,212	Total reclassified amount before tax
		(317)		(467)	Tax expense
	\$	506	\$	745	Net reclassified amount
<b>Amortization of defined benefit pension items</b>					
Actuarial losses	\$	(47)	\$	-	
		(47)		-	Total reclassified -amount before tax
		-		-	-Tax benefit
	\$	(47)	\$	-	Net reclassified -amount
Total reclassifications out of AOCI	\$	459	\$	745	

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The components of accumulated other comprehensive income, included in shareholder's equity, are as follows:

	<b>March 31, 2013</b>	<b>December 31, 2012</b>
Net unrealized gains on available-for-sale securities	\$ 2,275	\$ 5,747
Net actuarial loss on unfunded portion of postretirement benefit obligation		
	2,873	\$2,920
	5,148	8,667
Tax effect	2,000	3,337
Accumulated other comprehensive income	\$ 3,148	\$ 5,330

### **NOTE 3 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.



- *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 March 31, 2013 and December 31, 2012, 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 March 31, 2013**

<b>Available-For-Sale Securities</b>	Level 1	Level 2	Level 3	Total
U.S. Government agencies	\$ -	\$ 157,676	\$ -	\$ 157,676
U.S. Government sponsored agency mortgage backed securities	-	151,940	-	151,940
States and political subdivisions	-	52,234	-	52,234
Corporate bonds	-	20,823	-	20,823
<b>Total assets at fair value</b>	\$ -	\$ 382,673	\$ -	\$ 382,673

**Assets measured at fair value on a recurring basis as of December 31, 2012**

<b>Available-For-Sale Securities</b>	Level 1	Level 2	Level 3	Total
U.S. Government agencies	\$ -	\$ 144,017	\$ -	\$ 144,017
U.S. Government sponsored agency mortgage backed securities	-	133,718	-	133,718
States and political subdivisions	-	50,579	-	50,579
Corporate bonds	-	17,404	-	17,404
<b>Total assets at fair value</b>	\$ -	\$ 345,718	\$ -	\$ 345,718

Below 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 were no significant changes in the valuation techniques during the three months ended March 31, 2013.

***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 March 31, 2013 and December 31, 2012, by the level within the fair value hierarchy utilized to measure fair value (dollars in thousands):

**March 31, 2013**

	Level 1	Level 2	Level 3	Total
Impaired loans (collateral dependent)	\$ -	\$ -	\$ 2,455	\$ 2,455
Other real estate owned	-	-	1,499	1,499

**December 31, 2012**

	Level 1	Level 2	Level 3	Total
Impaired loans (collateral dependent)	\$ -	\$ -	\$ 4,840	\$ 4,840
Other real estate owned	-	-	3,385	3,385

***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 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 collateral-dependent impaired loans for each of the three months ended March 31, 2013 and 2012 were approximately \$48,000 and \$571,000, respectively, and \$3.3 million for the year ended December 31, 2012.

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 Corporation 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 OREO for the three months ended March 31, 2013 and 2012 were approximately \$250,000 and \$213,000, respectively, and \$1.2 million for the year ended December 31, 2012.

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

**Unobservable (Level 3) Inputs**

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

	Fair Value at March 31, 2013	Valuation Technique(s)	Unobservable Input	Range (Weighted Average)
Impaired loans (collateral-dependent)	\$ 2,455	Market comparable properties	Marketability discount	5.0% - 10.0% (6%)
Other real estate owned	\$ 1,499	Market comparable properties	Marketability discount	5.0% - 10.0% (6%)

	Fair Value at December 31, 2012	Valuation Technique(s)	Unobservable Input	Range (Weighted Average)
Impaired loans (collateral-dependent)	\$ 4,840	Market comparable properties	Marketability discount	5.0% - 10.0% (7%)
Other real estate/assets owned	\$ 3,385	Market comparable properties	Marketability discount	5.0% - 10.0% (7%)

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

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it was 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 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.

*Federal funds sold* The carrying amount approximates fair value.

*Securities available for sale* 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 and leases 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.

*Accrued interest receivable* The carrying amount approximates fair value.

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

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

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

*Accrued interest payable* The carrying amount approximates fair value.

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

The following table presents estimated fair values of the Corporation's financial instruments as of March 31, 2013 and December 31, 2012, and indicates the level within the fair value hierarchy of the valuation techniques (dollars in thousands):

	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Financial assets</b>				
Cash and due from banks	\$12,834	\$12,834	\$-	\$-
Interest-bearing deposits in other banks	29,011	29,011	-	-
Federal funds sold	10,000	10,000	-	-
Federal Home Loan Bank and Federal Reserve Bank stock	3,879	3,879	-	-
Securities available-for-sale	382,673	-	382,673	-
Securities held-to-maturity	30,983	-	32,454	-
Loans held for sale	2,780	2,780	-	-
Loans, net	564,906	-	-	575,602
Accrued interest receivable	4,846	-	4,846	-
<b>Financial liabilities</b>				
Non-interest bearing deposits	172,141	172,141	-	-
Interest bearing deposits	791,363	-	793,024	-





**NOTE 4 SECURITIES**

The amortized cost and estimated fair value of securities at March 31, 2013 and December 31, 2012 were as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Losses	Fair Value
<b>March 31, 2013</b>				
Available-for-sale securities				
U.S. Government agencies	\$ 158,228	\$ 108	\$ 660	\$ 157,676
U.S. Government sponsored agency mortgage backed securities	152,419	882	1,361	151,940
States and political subdivisions	49,376	2,873	15	52,234
Corporate bonds	20,375	466	18	20,823
Total	\$ 380,398	\$ 4,329	\$ 2,054	\$ 382,673
Held-to-maturity securities				
States and political subdivisions	\$ 30,983	\$ 1,471	\$ -	\$ 32,454
<b>December 31, 2012</b>				
Available-for-sale securities				
U.S. Government agencies	\$ 143,897	\$ 400	\$ 280	\$ 144,017
U.S. Government sponsored agency mortgage backed securities	131,917	1,856	55	133,718
States and political subdivisions	47,273	3,306	-	50,579
Corporate bonds	16,884	529	9	17,404
Total	\$ 339,971	\$ 6,091	\$ 344	\$ 345,718
Held-to-maturity securities				
States and political subdivisions	\$ 31,755	\$ 1,665	\$ -	\$ 33,420

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 March 31, 2013 and December 31, 2012 was approximately \$198.0 million and \$84.0 million, which was approximately 48% and 22%, 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 March 31, 2013 and December 31, 2012 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 March 31, 2013 and December 31, 2012 (dollars in thousands):



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March 31, 2013	Less than 12 months		12 months or Greater		Total	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
	Value	Losses	Value	Losses	Value	Losses
Type of Security						
U.S. Government agencies	\$ 117,944	\$ 660	\$ -	\$ -	\$ 117,944	\$ 660
U.S. Government sponsored agency mortgage backed securities	74,094	1,361	-	-	74,094	1,361
States and political subdivisions	897	15	-	-	897	15
Corporate bonds	5,161	18	-	-	5,161	18
Total	\$ 198,096	\$ 2,054	\$ -	\$ -	\$ 198,096	\$ 2,054

  

December 31, 2012	Less than 12 months		12 months or Greater		Total	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
	Value	Losses	Value	Losses	Value	Losses
Type of Security						
U.S. Government agencies	\$ 68,979	\$ 280	\$ -	\$ -	\$ 68,979	\$ 280
U.S. Government sponsored agency mortgage backed securities	12,881	55	-	-	12,881	55
Corporate bonds	1,719	9	-	-	1,719	9
Total	\$ 83,579	\$ 344	\$ -	\$ -	\$ 83,579	\$ 344

The amortized cost and fair value of available-for-sale securities and held-to-maturity securities at March 31, 2013, 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.

March 31, 2013	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Within one year	\$ 7,243	\$ 7,343	\$ 3,790	\$ 3,831
One to five years	20,758	21,474	6,616	6,938
Five to ten years	177,536	177,968	13,616	14,330
After ten years	22,442	23,948	6,961	7,355
Mortgage-backed securities	152,419	151,940	-	-
Total	\$ 380,398	\$ 382,673	\$ 30,983	\$ 32,454

The carrying value of securities pledged as collateral to secure public deposits and for other purposes was \$212.4 million at March 31, 2013 and \$210.8 million at December 31, 2012.

The book value of securities sold under agreements to repurchase amounted to \$26.5 million at March 31, 2013 and December 31, 2012.

Gross gains of approximately \$823,000 and \$1.2 million, resulting from sales of available-for-sale securities were realized for the three month periods ended March 31, 2013 and 2012, respectively.

**NOTE 5 LOANS**

The following table presents the Corporation's loans by class as of March 31, 2013 and December 31, 2012 (dollars in thousands):

	March 31, 2013	December 31, 2012
<b><u>Commercial</u></b>		
Commercial and industrial	\$ 85,805	\$ 83,631
Non-farm, nonresidential real estate	171,535	167,565
Construction and development	39,306	36,323
Commercial loans secured by real estate	23,864	23,983
Other commercial	23,258	24,423
Total commercial	343,768	335,925
<b><u>Residential</u></b>		
Consumer loans	10,909	11,621
Single family residential	194,185	196,349
Other retail	24,701	23,264
Total residential and consumer	229,795	231,234
<b>Total</b>	\$ 573,563	\$ 567,159

The amount of capitalized fees and costs under ASC 310-20, included in the above loan totals were \$700,407 and \$626,061 at March 31, 2013 and December 31, 2012.

*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 March 31, 2013, 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 because of their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

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

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

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

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

All closed-end consumer loans (excluding conventional 1-4 family residential loans and installment and revolving loans secured by real estate) are charged off no later than 120 days (five monthly payments) delinquent. If a loan is considered uncollectable, it is charged off earlier than 120 days delinquent. For conventional 1-4 family



residential loans and installment and revolving loans secured by real estate, when a loan is 90 days past due, a current assessment of the value of the real estate is made. If the balance of the loan exceeds the fair value of the property, the loan is placed on nonaccrual and foreclosure proceedings are initiated. When the foreclosed property has been legally assigned to the Corporation, a charge-off is taken with the remaining balance reflecting the fair value less estimated costs to sell, transferred to other real estate owned.

*Non-Accrual and Past Due Loans.* Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on non-accrual status when (i) principal or interest has been in default for a period of 90 days or more or (ii) full payment of principal and interest is not expected. Loans may be placed on non-accrual status regardless of whether or not such loans are considered past due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income on non-accrual loans is recognized only to the extent that cash payments are received in excess of principal due. A loan may be returned to accrual status when all the principal and interest amounts contractually due are brought current and future principal and interest amounts contractually due are reasonably assured, which is typically evidenced by a sustained period (three to six months) of repayment performance by the borrower. The Corporation had one single family residential loan of approximately \$24,000 that was 90 days or more past due that was not included in nonaccrual loans as of March 31, 2013.

The following tables provide details regarding the aging of the Corporation's loan portfolio as of March 31, 2013 and December 31, 2012 (dollars in thousands):

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March 31, 2013	30 - 89 Days Past Due	90 Days and Greater Past Due	Total Past Due	Current	Total Loans
<b><u>Retail</u></b>					
Consumer	\$ 170	\$ 4	\$ 174	\$ 10,735	\$ 10,909
Single family residential	2,425	529	2,954	191,231	194,185
Other retail	-	-	-	24,701	24,701
Retail total	2,595	533	3,128	226,667	229,795
<b><u>Commercial</u></b>					
Commercial and industrial	1,333	1,423	2,756	83,049	85,805
Non-farm, non-residential real estate	348	250	598	170,937	171,535
Construction and development	-	160	160	39,146	39,306
Commercial loans secured by real estate	67	193	260	23,604	23,864
Other commercial	722	1,379	2,101	21,157	23,258
Commercial total	2,470	3,405	5,875	337,893	343,768
Total	\$ 5,065	\$ 3,938	\$ 9,003	\$ 564,560	\$ 573,563
December 31, 2012	30 - 89 Days Past Due	90 Days and Greater Past Due	Total Past Due	Current	Total Loans
<b><u>Retail</u></b>					
Consumer loans	\$ 112	\$ 7	\$ 119	\$ 11,502	\$ 11,621
Single family residential	3,543	387	3,930	192,419	196,349
Other retail	193	-	193	23,071	23,264
Retail total	3,848	394	4,242	226,992	231,234
<b><u>Commercial</u></b>					
Commercial and industrial	618	1,457	2,075	81,556	83,631
Non-farm, non-residential real estate	666	448	1,114	166,451	167,565
Construction and development	160	-	160	36,163	36,323
Commercial loans secured by real estate	22	193	215	23,768	23,983
Other commercial	741	1,379	2,120	22,303	24,423
Commercial total	2,207	3,477	5,684	330,241	335,925
Total	\$ 6,055	\$ 3,871	\$ 9,926	\$ 557,233	\$ 567,159

The following table summarizes the nonaccrual loans by loan type as of March 31, 2013 and December 31, 2012 (dollars in thousands):

	March 31, 2013	December 31, 2012
<b><u>Retail</u></b>		

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Consumer	\$	7	\$	11
Single family residential		2,659		3,541
Retail total		2,666		3,552
<u>Commercial</u>				
Commercial and industrial	\$	1,842	\$	1,595
Nonfarm, non-residential real estate		1,254		1,372
Construction and development		160		50
Commercial loans secured by real estate		-		126
Other commercial		2,837		1,379
Commercial total		6,093		4,522
Total	\$	8,759	\$	8,074

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The following tables summarize the impaired loans by loan type as of March 31, 2013, December 31, 2012 and March 31, 2012 (dollars in thousands):

	Unpaid Contractual Principal Balance	Recorded Investment with no Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Paid
<b>March 31, 2013</b>							
<b><u>Commercial</u></b>							
Commercial and industrial	\$ 2,311	\$ 416	\$ 1,305	\$ 1,721	\$ 120	\$ 1,727	\$ 6
Non-farm, non-residential real estate	2,804	2,348	-	2,348	-	2,393	32
Construction and development	842	188	653	841	147	841	9
Other commercial	3,845	3,846	-	3,846	-	3,856	37
Commercial total	9,802	6,798	1,958	8,756	267	8,817	84
<b><u>Retail</u></b>							
Single family residential	2,111	826	918	1,744	227	1,768	29
Retail total	2,111	826	918	1,744	227	1,768	29
<b>Total</b>	<b>\$ 11,913</b>	<b>\$ 7,624</b>	<b>\$ 2,876</b>	<b>\$ 10,500</b>	<b>\$ 494</b>	<b>\$ 10,585</b>	<b>\$ 113</b>
<b>December 31, 2012</b>							
<b><u>Commercial</u></b>							
Commercial and industrial	\$ 2,036	\$ 1,076	\$ 328	\$ 1,404	\$ 103	\$ 3,483	\$ 74
Non-farm, non-residential real estate	3,613	2,417	-	2,417	-	1,606	83
Construction and development	682	-	682	682	118	682	35
Other commercial	3,124	3,124	-	3,124	-	3,099	126
Commercial total	9,455	6,617	1,010	7,627	221	8,870	318
<b><u>Retail</u></b>							
Single family residential	1,237	402	613	1,015	82	1,059	39
Retail total	1,237	402	613	1,015	82	1,059	39
<b>Total</b>	<b>\$ 10,692</b>	<b>\$ 7,019</b>	<b>\$ 1,623</b>	<b>\$ 8,642</b>	<b>\$ 303</b>	<b>\$ 9,929</b>	<b>\$ 357</b>
<b>March 31, 2012</b>							
<b><u>Commercial</u></b>							
Commercial and industrial	\$ 5,123	\$ -	\$ 4,389	\$ 4,389	\$ 590	\$ 4,627	\$ 8
Non-farm, non-residential real estate	4,106	2,852	-	2,852	-	2,531	17
Construction and development	819	-	819	\$ 819	86	837	9
Other commercial	3,753	880	2,210	3,090	66	3,107	32
Commercial total	13,801	3,732	7,418	11,150	742	11,102	66
<b><u>Retail</u></b>							
Single family residential	1,579	228	1,081	1,309	117	1,330	33
<b>Total</b>	<b>\$ 15,380</b>	<b>\$ 3,960</b>	<b>\$ 8,499</b>	<b>\$ 12,459</b>	<b>\$ 859</b>	<b>\$ 12,432</b>	<b>\$ 99</b>



*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.

*Troubled Debt Restructurings.* Included in certain 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 or interest payments, regardless of the period of the modification. All of the loans identified as troubled debt restructuring were modified as a result of 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 determines 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.

During the three months ended March 31, 2013, 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. There were no troubled debt restructuring loans that subsequently defaulted during the three months ending March 31, 2013, 2012 and year ending December 31, 2012. Presented

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below, segregated by class of loans, are troubled debt restructurings that occurred during the three months ended March 31, 2013, 2012 and year ended December 31, 2012 (dollars in thousands):

<i>(dollars in thousands)</i>	<b>Three Months Ended March 31, 2013</b>			
	<b>Number of</b>	<b>Post-</b>		
	<b>Loans</b>	<b>Modifications</b>	<b>Outstanding</b>	<b>Net Charge-offs</b>
		<b>Outstanding</b>	<b>Balance</b>	<b>Resulting from</b>
				<b>Modifications</b>
Retail:				
Single family residential	1		130	-
<b>Total trouble debt restructurings</b>	<b>1</b>	<b>\$</b>	<b>130</b>	<b>\$</b>
				-

<i>(dollars in thousands)</i>	Year Ended December 31, 2012		
	Number of Loans	Post- Modification Outstanding Balance	Net Charge-offs Resulting from Modifications
Commercial:			
Commercial and industrial	1	\$ 8	\$ -
Nonfarm nonresidential	1	361	-
Retail:			
Consumer	1	3	-
Single family residential	3	237	-
<b>Total trouble debt restructurings</b>	<b>6</b>	<b>\$ 609</b>	<b>\$ -</b>

<i>(dollars in thousands)</i>	Three Months Ended March 31, 2012		
	Number of Loans	Post- Modifications Outstanding Balance	Net Charge-offs Resulting from Modifications
Commercial:			
Commercial and industrial	5	\$ 1,068	\$ 197
Nonfarm nonresidential	1	\$ 1,203	\$ 222
Retail:			
Single family residential	-	-	-
<b>Total trouble debt restructurings</b>	<b>6</b>	<b>\$ 2,271</b>	<b>\$ 419</b>

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 and lease losses ( ALLL ) 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 status.

*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's, or other qualified rating agency that is grade A or higher.
- A cash secured loan with the cash on deposit in the Corporation or a guaranty from the federal government also warrants this risk rating.

**Risk Rating 2      Modest Risk**

General Characteristics:

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

**Risk Rating 3      Average Risk**

General Characteristics:

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

- Borrower may be an individual with a sound financial condition and liquidity with proven historical income to repay the debt as scheduled.
- Credit extensions are generally secured by acceptable collateral.

**Risk Rating 4**      **Acceptable Risk**

General Characteristics:

- Credit is to a borrower with smaller margins of debt service coverage and with some elements of reduced financial strength.
- Borrower is generally in a lower average market position in its industry.
- Borrower shows satisfactory asset quality and liquidity, good debt capacity and coverage, and good management in critical positions.
- Borrower's management is of unquestioned character but management succession may be questionable.
- Borrower can obtain similar financing from other financial institutions.
- Interim losses or moderately declining earnings trends may occur, but the borrower has sufficient strength and financial flexibility to offset these issues.

- Credit may be to individuals with a moderately leveraged financial condition but with satisfactory liquidity and income to cover debt repayment requirements.
- Business borrowers may have moderate leverage, but must have historically consistent cash flow to cover debt service and other operating needs.
- Business borrowers may also have erratic or cyclical operating performances but should demonstrate strong equity positions to support these profitability swings.
- Asset-based loans that have stabilized and proven performance with the financial capacity to provide for annual clean up may qualify for this rating.
- Borrower has no access to capital markets but would be financeable by another financial institution or finance company.
- Credit extensions are generally secured by acceptable collateral.

**Risk Rating 5      Pass / Watch**

General Characteristics:

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

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

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

- Borrower may exhibit declining earnings, strained cash flow, increasing leverage, or weakening market positions that indicate a trend toward an unacceptable risk.
- Borrower's liquidity, leverage, and earnings performance is below or trending below industry norms.

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

**Risk Rating 6**      **Special Mention**

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

General Characteristics:

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

**Risk Rating 7**      **Substandard**

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

General Characteristics:

- The primary source of borrower's repayment no longer provides satisfactory support and repayment is dependent on secondary sources.
- A substandard loan is inadequately protected by the current sound worth and paying capacity of the obligor or by the collateral pledged, if any.
- Normal repayment from the borrower is impaired although no loss of principal is envisioned.
- A partial loss of interest or principal will occur if the borrower's deficiencies are not corrected.
- Borrower's cash flow is generally not sufficient to fund anticipated cash needs.
- Borrower's financeable assets may not be sufficient to protect the Corporation's position.

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- 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**

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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 March 31, 2013 and December 31, 2012 (dollars in thousands):

**March 31, 2013**

Commercial Loan Portfolio: Credit risk profile by internally assigned grade	Commercial and Industrial	Non-Farm, Non-Residential Real Estate Loans	Construction and Development	Commercial Loans		Commercial Loan Totals
				Secured by Residential Real Estate	Other Commercial Loans	
Pass	\$ 83,533	\$ 168,628	\$ 38,448	\$ 22,831	\$ 20,439	\$ 333,879
Special Mention	259	797	-	392	-	1,448
Substandard	937	2,110	858	641	1,440	5,986
Doubtful	1,076	-	-	-	1,379	2,455
<b>TOTALS</b>	<b>\$ 85,805</b>	<b>\$ 171,535</b>	<b>\$ 39,306</b>	<b>\$ 23,864</b>	<b>\$ 23,258</b>	<b>\$ 343,768</b>
Retail Loan Portfolio: Credit risk profiles based on delinquency status classification	Consumer	Single-Family Residential**	All Other Retail Loans	Retail Loan Totals		



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Performing	\$ 10,890	\$ 191,017	\$ 24,576	\$ 226,483
Non-performing*	19	3,168	125	3,312
<b>TOTALS</b>	<b>\$ 10,909</b>	<b>\$ 194,185</b>	<b>\$ 24,701</b>	<b>\$ 229,795</b>

\*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.

**December 31, 2012**

Commercial Loan Portfolio: Credit risk profile by internally assigned grade	Non-Farm, Commercial and Industrial Loans		Non-Residential Real Estate Loans		Construction and Development		Residential Real Estate Loans		Commercial Loans Secured by Other Commercial		Commercial Loan Totals
Pass	\$ 81,560	164,890	35,543	21,660	22,857	25,910					
Special Mention	269	815	98	398	-	1,580					
Substandard	726	2,460	682	1,925	187	5,980					
Doubtful	1,076	-	-	-	1,379	2,455					
<b>TOTALS</b>	<b>\$ 83,631</b>	<b>167,565</b>	<b>36,323</b>	<b>23,983</b>	<b>24,423</b>	<b>35,925</b>					

  

Retail Loan Portfolio: Credit risk profiles based on delinquency status classification	Single-Family Residential** Consumer Loans		Retail Loans		All Other Retail Loan Totals	
Performing	\$ 11,610	192,808	23,131	227,549		
Non-performing*	11	3,541	133	3,685		
<b>TOTALS</b>	<b>\$ 11,621</b>	<b>196,349</b>	<b>23,264</b>	<b>231,234</b>		

\*Loans are classified as non-performing loans and are automatically placed on non-accrual status once they reach 90 days past due. For the purposes of this calculation,

all loans rated at or below Substandard (RR7) are classified as non-performing.

\*\*Single-family residential loans includes first mortgages, closed-end second mortgages, residential construction loans, and home equity lines of credit.

*Allowance for Loan and Lease Losses.* The ALLL 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 ALLL 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 ALLL 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 ALLL 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 ALLL 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 ALLL 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 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 ALLL is maintained at a level considered adequate to provide for the losses that can be reasonably anticipated. Management's periodic evaluation of the adequacy of the allowance is based on the Corporation's past loan loss experience, know and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to change.

The following tables summarize the allocation in the ALLL by loan segment for the three months ended March 31, 2013 and March 31, 2012 and the year ended December 31, 2012 (dollars in thousands):

	Commercial	Residential Real Estate	Consumer & Other Retail	Total
Beginning ALLL balance - 12/31/12	\$ 7,528	\$ 1,109	\$ 172	\$ 8,809
Less: Charge-offs	(144)	(12)	(14)	(170)
Add: Recoveries	10	-	8	18
Add: Provisions	(54)	46	8	-
Ending ALLL balance - 3/31/13	\$ 7,340	\$ 1,143	\$ 174	\$ 8,657

	Commercial	Residential Real Estate	Consumer & Other Retail	Total
Beginning ALLL balance -12/31/11	\$ 6,895	\$ 2,113	\$ 192	\$ 9,200
Less: Charge-offs	(1,016)	(106)	(5)	(1,127)
Add: Recoveries	23	1	2	26
Add: Provisions	1,106	(487)	(19)	600
Ending ALLL balance - 3/31/12	\$ 7,008	\$ 1,521	\$ 170	\$ 8,699

	Commercial	Residential Real Estate	Consumer & Other Retail	Total
Beginning ALLL balance - 1/1/12	\$ 6,895	\$ 2,113	\$ 192	\$ 9,200
Less: Charge-offs	(1,690)	(176)	(19)	(1,885)
Add: Recoveries	364	2	8	374
Add: Provisions	1,959	(830)	(9)	1,120
Ending ALLL balance - 12/31/12	\$ 7,528	\$ 1,109	\$ 172	\$ 8,809

The following tables detail the amount of the ALLL allocated to each portfolio segment as of March 31, 2013, December 31, 2012 and March 31, 2012, disaggregated on the basis of the Corporation's impairment methodology (dollars in thousands):

March 31, 2013	Commercial	Residential Real Estate	Consumer & Other Retail	Totals
Loans individually evaluated for impairment	\$ 267	\$ 227	\$ -	\$ 494
Loans collectively evaluated for impairment	7,073	916	174	8,163
Total	\$ 7,340	\$ 1,143	\$ 174	\$ 8,657
December 31, 2012	Commercial	Residential Real Estate	Consumer & Other Retail	Total
Loans individually evaluated for impairment	\$ 221	\$ 82	\$ -	\$ 303
Loans collectively evaluated for impairment	7,307	1,027	172	8,506
Total	\$ 7,528	\$ 1,109	\$ 172	\$ 8,809
March 31, 2012	Commercial	Residential Real Estate	Consumer & Other Retail	Total
Loans individually evaluated for impairment	\$ 742	\$ 117	\$ -	\$ 859
Loans collectively evaluated for impairment	6,266	1,404	170	7,840
Total	\$ 7,008	\$ 1,521	\$ 170	\$ 8,699

The following tables show loans related to each balance in the ALLL by portfolio segment and disaggregated on the basis of the Corporation's impairment methodology (dollars in thousands):

March 31, 2013	Commercial	Residential Real Estate	Consumer & Other Retail	Total
Loans individually evaluated for impairment	\$ 8,756	\$ 1,744	\$ -	\$ 10,500
Loans collectively evaluated for impairment	335,012	212,907	15,144	563,063
Ending Balance	\$ 343,768	\$ 214,651	\$ 15,144	\$ 573,563
December 31, 2012	Commercial	Residential Real Estate	Consumer & Other Retail	Total

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Loans individually evaluated for impairment	\$ 7,627	\$ 1,015	\$ -	\$ 8,642
Loans collectively evaluated for impairment	328,298	195,334	34,885	558,517
Ending Balance	\$ 335,925	\$ 196,349	\$ 34,885	\$ 567,159
		Residential	Consumer &	
March 31, 2012	Commercial	Real Estate	Other Retail	Total
Loans individually evaluated for impairment	\$ 11,150	\$ 1,309	\$ -	\$ 12,459
Loans collectively evaluated for impairment	268,592	211,286	13,308	493,186
Ending Balance	\$ 279,742	\$ 212,595	\$ 13,308	\$ 505,645

**NOTE 6 BORROWED FUNDS**

The Corporation is a party to the Blanket Agreement for Advances and Security Agreement, dated June 20, 2006 (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. The advances mature at varying dates throughout 2013 at interest rates ranging from 2.61% to 3.76%.

The Corporation also has a Cash Management Advance Line of Credit Agreement (the CMA), dated June 21, 2010, with the FHLB. 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 March 31, 2013 or December 31, 2012.

**NOTE 7 POST-RETIREMENT BENEFIT PLAN**

(dollars in thousands)	Three months ended	
	March 31, 2013	March 31, 2012
Service cost	\$ 35	\$ 23
Interest cost	73	92
Amortization of net loss	47	-
Net periodic pension cost	\$ 155	\$ 115

The Corporation amended the plan subsequent to March 31, 2013. Effective July 1, 2013, employees retiring after that date will no longer be eligible to receive post-retirement medical insurance coverage. The Corporation will pay qualifying employees a retirement bonus equal to \$20,000 to employees (i) who were hired prior to March 20, 2007; (ii) who retire on or after July 1, 2013; (iii) who are at least age 59 ½ at the time of retirement; and (iv) who have at least twenty-five years of service. The bonus will be paid in a lump sum cash payment within sixty days after retirement.



Current retirees who retired prior to July 1, 2007 will retain their insurance coverage under the current plan structure as of March 31, 2013. For employees retiring between July 1, 2007 and June 30, 2013 the Corporation made changes to eligibility and the amounts of required premiums based on age and years of service at the time of retirement.

The Corporation contributed approximately \$107,000 and \$39,000 to the plan for the three month periods ending March 31, 2013 and 2012, respectively.

## **NOTE 8 RECENT ACCOUNTING PRONOUNCEMENTS**

ASU 2013-02, *Comprehensive Income (Topic 220) Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. ASU 2013-02 amends recent guidance related to the reporting of comprehensive income to enhance the reporting of reclassifications out of accumulated other comprehensive income. ASU 2013-02 became effective for the Corporation on January 1, 2013 and did not have a significant impact on the Corporation's financial statements. See Note 2 Other Comprehensive Income (Loss).

## **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, 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 ALLL, 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, the sufficiency of our ALLL, economic conditions in the communities in the States of Tennessee and Alabama 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, recent legislation and regulations impacting service fees, the Corporation's ability to pay dividends, the availability of additional capital on favorable terms, the Corporation's ability to adapt its products and services to evolving industry standards and consumer preferences, security breaches and other disruptions 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 March 31, 2013, the consolidated total assets of the Corporation were \$1.1 billion, its consolidated net loans were \$564.9 million, its total deposits were \$963.5 million and its total shareholders' equity was \$114.4 million. The

Corporation's loan portfolio at March 31, 2013 reflected an increase of \$6.4 million, or 1.1%, compared to December 31, 2012. Total deposits increased \$30.7 million, or 3.3%, and shareholders' equity decreased by 0.1% during the first three months of 2012.

## **Financial Condition**

Average earning assets for the quarter ended March 31, 2013 increased 5.2%, or \$49.3 million, from average earning assets for the quarter ended December 31, 2012. Average overnight investments for the quarter ended March 31, 2013 decreased 2.4% compared to the quarter ended December 31, 2012. Average investment securities for the quarter ended March 31, 2013 increased 3.6% compared to the quarter ended December 31, 2012. Average total assets increased 4.6% or \$48.2 million, from \$1.054 billion for the quarter ended December 31, 2012 to \$1.103 billion for the quarter ended March 31, 2013.

## **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 March 31, 2013, the Corporation's investment securities portfolio had \$382.7 million of available-for-sale securities, which are valued at fair market value, and \$31.0 million of held-to-maturity securities, which are valued at cost on the balance sheet. These compare to \$345.7 million of available-for-sale securities and \$31.8 million of held-to-maturity securities as of December 31, 2012.

### **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 first quarter of 2013, with total loans increasing by \$6.4 million, or 1.1% during the three-month period. Commercial loans increased by \$7.8 million, or 2.3%, in the first quarter, and the retail portfolio decreased by approximately \$1.4 million, or 0.6%. At \$573.6 million, total loans outstanding increased by \$68.0 million, or 13.4%, at March 31, 2013 compared to March 31, 2012. Loan demand has shown an improvement during the three months ended March 31, 2013, 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 are promptly charged off. Furthermore, consumer loan accounts are charged off automatically based on regulatory requirements.

The ALLL 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 ALLL 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 risk pools and specific loss allocations, with adjustments for current events and conditions. The Corporation's process for determining the appropriate level of the ALLL 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 ALLL 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. See Note 5 - 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 ALLL.

*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 March 31, 2013, this process identified loans totaling \$1.4 million that were classified as other assets especially mentioned compared to loans totaling \$1.6 million at December 31, 2012. Loans totaling \$6.0 million were classified as substandard at March 31, 2013, compared to loans totaling \$5.9 million at December 31, 2012. Loans totaling \$2.5 million were classified as doubtful at March 31, 2013 and December 31, 2012.

Loans having average recorded investments of \$10.6 million and \$9.9 million at March 31, 2013 and December 31, 2012, respectively, have been identified as impaired. Nonaccrual loans amounting to \$8.8 million and \$8.1 million at March 31, 2013 and December 31, 2012, respectively, were not accruing interest. Interest received on nonaccrual loans during the first quarter of 2013 was approximately \$113,000, compared to approximately \$99,000 over the same period in 2012. 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 \$136,000, and \$226,000 for the three-month periods ended March 31, 2013 and March 31, 2012, respectively. The Corporation had one loan for approximately \$24,000 that was 90 days or more past due that was not included in nonaccrual loans as of March 31, 2013.

### **Deposits**

The Corporation does not have any foreign offices and all deposits are serviced in its 19 domestic offices. The Corporation's average deposits increased 5.7% during the first three months of 2013 compared to an increase of 7.7% in the first three months of 2012. Average total noninterest-bearing deposits were 17.6% of total deposits at March 31, 2013, contributing to the Corporation's low cost of deposits, compared to 17.5% at December 31, 2012.

### **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 ALLL.

As of March 31, 2013, the Bank's Tier 1 Risk-Based Capital Ratio, Total Risk-Based Capital Ratio and Tier 1 Leverage Capital Ratios were 14.1%, 15.4%, and 9.2%, respectively, compared to 14.2%, 15.5%, and 9.4% at December 31, 2012. At March 31, 2013, the Corporation's Tier 1 Risk-Based Capital Ratio, Total Risk-Based Capital Ratio and Tier 1 Leverage Capital Ratios were 14.5%, 15.7% and 9.4%, respectively, compared to 14.5%, 15.8%, and 9.7% at December 31, 2012. Management believes, as of March 31, 2013, 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 March 31, 2013, 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 and Lease 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 three months ended March 31, 2013 was \$9.2 million compared to \$9.1 million for the three months ended March 31, 2012. Interest and fees earned on loans and investments are the primary components of total interest income. Interest and fees earned on loans were \$7.0 million, a decrease of approximately \$18,000, or 0.3%, during the three months ended March 31, 2013 compared to the three months ended March 31, 2012. The lower interest rates for loans were the primary reason for the lower interest income. Interest earned on investment securities and other earning assets was approximately \$2.3 million, an increase of approximately \$176,000, or 8.4%, during the three months ended March 31, 2013 compared to the three months ended March 31, 2012.

Total interest expense in the three months ended March 31, 2013 was approximately \$834,000, a decrease of approximately \$237,000, or 22.2%, compared to the three months ended March 31, 2012. The lower interest rates for certificates of deposits and public funds during the first quarter of 2013 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 April 1, 2013 and ending March 31, 2015 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 9.0%, or a decrease in net interest income of \$3.0 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;
- (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 March 31, 2013, December, 31, 2012 and March 31, 2012, was 3.56%, 3.66% and 3.66%, respectively. The decline during the first three months of 2013 was due, in part, to lower yields on earnings assets.

No additions were made to the provision for loan losses in the first quarter of 2013, compared to additions of approximately \$600,000 in the first quarter of 2012. This decrease was primarily because of the net charge-off ratios trending down.

Noninterest income was \$3.3 million, a decrease of approximately \$50,000, or 1.5%, during the three months ended March 31, 2013 compared to the three months ended March 31, 2012. The gain on sales of securities for the three months ended March 31, 2013 and 2012 was \$823,000 and \$1.2 million, respectively, which accounted for most of the increase in noninterest income over the three-month period.

Noninterest expense, excluding the provision for loan losses, was \$8.1 million in the three months ended March 31, 2013, an increase of approximately \$351,000, or 4.5%, as compared to noninterest expense for the three months ended March 31, 2012. An increase in salary and benefits was the primary contributor to the higher noninterest expense.

Net income for the three months ended March 31, 2013 was \$3.1 million, compared to \$2.3 million for the three months ended March 31, 2012. The Corporation made no provision for loan losses in the first quarter 2013, compared to a provision expense of approximately \$600,000 during the three months ended March 31, 2012. The Corporation earned \$0.59 per share for the three months ended in March 31, 2013, compared to \$0.44 per share for the three months ended March 31, 2012.

## **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.

The total outstanding balance of loan commitments and stand-by letters of credit in the normal course of business at March 31, 2013 were \$119.6 million and \$7.4 million, respectively.

At March 31, 2013, 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 March 31, 2013, 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, 2012.

**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 and the identification of material weaknesses in the Corporation's internal control over financial reporting as described in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2012, the Corporation's Chief Executive Officer and Treasurer (principal financial officer) concluded that the Corporation's disclosure controls and procedures were not 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 first quarter of 2013 that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting, except for the remediation efforts that management commenced during the first quarter of 2013 related to the material weaknesses in internal control over financial reporting identified as of December 31, 2012 and reported on in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2012. Following management's determination of the material weaknesses, management promptly began taking the following remedial actions:

Expansion of the review process of certain accounting reconciliations to ensure that certain transactions are identified and recorded properly;

A committee consisting of all senior level accounting managers was charged with meeting quarterly to identify new accounting pronouncements and developments and determine the appropriate application to the Corporation's financial reporting; and

The committee commenced quarterly communications to executive management of the results of such meetings and any required changes in accounting policies or procedures.

Management anticipates that these remedial actions will strengthen the Corporation's internal control over financial reporting and will, over time, address the material weaknesses that were identified as of December 31, 2012. The Corporation cannot provide any assurance that these remediation efforts will be successful or that the Corporation's internal control over financial reporting will be effective as a result of these efforts.



**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, 2012.

**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:

<b>CORPORATION'S PURCHASES OF EQUITY SECURITIES</b>				
<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</b>	<b>Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs</b>
January 1 January 31, 2013				
February 1 February 28, 2013				
March 1 March 31, 2013	44,677*	\$23.00		
<b>Total</b>	<b>44,677*</b>	<b>\$23.00</b>		

\*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.

101.LAB XBRL Taxonomy Label Linkbase Document.

101.PRE XBRL Taxonomy Presentation Linkbase Document.

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(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 May 9, 2013

/s/ T. Randy Stevens  
T. Randy Stevens, Chief Executive Officer

Date May 9, 2013

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



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