KENTUCKY BANCSHARES INC /KY/
Form 10-Q
November 13, 2007

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

(Mark One)
[ X ] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2007
or
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ____________________ to ___________________

Commission File Number: 000-52598

KENTUCKY BANCSHARES, INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Kentucky | 61-0993464 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| P.O. Box 157, Paris, Kentucky | 40362-0157 |
| (Address of principal executive offices) | (Zip Code) |

Registrant's telephone number, including area code: (859)987-1795

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 X No _____

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.
Large accelerated filer _ Accelerated filer _ Non-accelerated filer X

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

Number of shares of Common Stock outstanding as of November 9, 2007: 2,850,889.

KENTUCKY BANCSHARES, INC.

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Item 1 - Financial Statements

KENTUCKY BANCSHARES, INC.

CONSOLIDATED BALANCE SHEETS (unaudited)

| (thousands) | 9/30/2007 | 12/31/2006 |
|---|---|---|
| Assets | | |
| Cash and due from banks | $ 13,420 | $ 14,905 |
| Federal funds sold | 9,188 | 4,106 |
| Cash and cash equivalents | 22,608 | 19,011 |
| Securities available for sale | 125,596 | 127,891 |
| Mortgage loans held for sale | 255 | - |
| Loans | 423,130 | 444,150 |
| Allowance for loan losses | (4,781) | (4,991) |
| Net loans | 418,349 | 439,159 |
| Federal Home Loan Bank stock | 6,468 | 6,468 |
| Bank premises and equipment, net | 16,035 | 14,327 |
| Interest receivable | 5,706 | 5,654 |
| Goodwill | 13,117 | 13,117 |
| Other intangible assets | 1,855 | 2,058 |
| Mortgage servicing rights | 691 | 746 |
| Other assets | 1,310 | 1,111 |
| Total assets | $ 611,990 | $ 629,542 |
| Liabilities and Stockholders' Equity | | |
| Deposits | | |
| Non-interest bearing | $ 87,409 | $ 87,503 |

| | | |
|---|---|---|
| Time deposits, $100,000 and over | 81,251 | 67,255 |
| Other interest bearing | 294,116 | 314,050 |
| Total deposits | 462,776 | 468,808 |
| Repurchase agreements and other borrowings | 13,042 | 11,327 |
| Federal Home Loan Bank advances | 64,306 | 80,030 |
| Subordinated debentures | 7,217 | 7,217 |
| Interest payable | 4,351 | 3,683 |
| Other liabilities | 2,807 | 3,196 |
| Total liabilities | 554,499 | 574,261 |
| | | |
| Stockholders' equity | | |
| Common stock | 12,440 | 12,474 |
| Additional paid-in capital | 134 | 59 |
| Retained earnings | 46,362 | 44,062 |
| Accumulated other comprehensive income (loss) | (1,445) | (1,314) |
| Total stockholders' equity | 57,491 | 55,281 |
| Total liabilities & stockholders' equity | $ 611,990 | $ 629,542 |

See Accompanying Notes

KENTUCKY BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (unaudited)

| (thousands, except per share amounts) | Nine Months Ending | |
|---|---|---|
| | 9/30/2007 | 9/30/2006 |
| INTEREST INCOME: | | |
| Loans, including fees | $ 24,106 | $ 20,911 |
| Securities available for sale | 4,774 | 4,779 |
| Other | 761 | 99 |
| Total interest income | 29,641 | 25,789 |
| INTEREST EXPENSE: | | |
| Deposits | 11,373 | 8,593 |
| Other | 3,001 | 3,359 |
| Total interest expense | 14,374 | 11,952 |
| Net interest income | 15,267 | 13,837 |
| Loan loss provision | 650 | 334 |
| Net interest income after provision | 14,617 | 13,503 |
| NON-INTEREST INCOME: | | |
| Service charges | 4,194 | 3,767 |
| Loan service fee income | 46 | 28 |
| Trust department income | 395 | 455 |
| Securities available for sale gains (losses), net | 33 | 41 |
| Gain on sale of mortgage loans | 312 | 178 |
| Other | 1,002 | 758 |
| Total other income | 5,982 | 5,227 |
| NON-INTEREST EXPENSE: | | |
| Salaries and employee benefits | 8,051 | 6,985 |
| Occupancy expenses | 1,864 | 1,705 |
| Amortization | 204 | 116 |
| Advertising and marketing | 405 | 363 |
| Taxes other than payroll, property and income | 513 | 439 |
| Other | 2,503 | 2,550 |
| Total other expenses | 13,540 | 12,158 |
| Income before taxes | 7,059 | 6,572 |
| Income taxes | 1,909 | 1,849 |
| Net income | $ 5,150 | $ 4,723 |

Other Comprehensive Income, net of tax:

| | | |
|---|---|---|
| Change in Unrealized Gains on Securities | (112) | 494 |
| Comprehensive Income | $ 5,038 | $ 5,217 |
| Earnings per share | | |
| Basic | $ 1.80 | $ 1.73 |
| Diluted | 1.79 | 1.72 |

See Accompanying Notes

KENTUCKY BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (unaudited)

| (thousands, except per share amounts) | Three Months Ending | |
|---|---|---|
| | 9/30/2007 | 9/30/2006 |
| INTEREST INCOME: | | |
| Loans, including fees | $ 8,012 | $ 7,726 |
| Securities available for sale | 1,590 | 1,751 |
| Other | 199 | 16 |
| Total interest income | 9,801 | 9,493 |
| INTEREST EXPENSE: | | |
| Deposits | 3,663 | 3,274 |
| Other | 990 | 1,369 |
| Total interest expense | 4,653 | 4,643 |
| Net interest income | 5,148 | 4,850 |
| Loan loss provision | 330 | 94 |
| Net interest income after provision | 4,818 | 4,756 |
| NON-INTEREST INCOME: | | |
| Service charges | 1,421 | 1,474 |
| Loan service fee income | 14 | 8 |
| Trust department income | 121 | 138 |
| Securities available for sale gains (losses), net | 30 | 64 |
| Gain on sale of mortgage loans | 102 | 74 |
| Other | 357 | 281 |
| Total other income | 2,045 | 2,039 |
| NON-INTEREST EXPENSE: | | |
| Salaries and employee benefits | 2,669 | 2,536 |
| Occupancy expenses | 621 | 628 |
| Amortization | 68 | 68 |
| Advertising and marketing | 135 | 123 |
| Taxes other than payroll, property and income | 171 | 150 |
| Other | 928 | 939 |
| Total other expenses | 4,592 | 4,444 |
| Income before taxes | 2,271 | 2,351 |
| Income taxes | 601 | 637 |
| Net income | $ 1,670 | $ 1,714 |
| Other Comprehensive Income, net of tax: | | |
| Change in Unrealized Gains on Securities | 1,269 | 1,976 |
| Comprehensive Income | $ 2,939 | $ 3,690 |
| Earnings per share | | |
| Basic | $ 0.58 | $ 0.60 |
| Diluted | 0.58 | 0.60 |

See Accompanying Notes

KENTUCKY BANCSHARES, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY (unaudited)
(thousands, except share information)

| | ----Common Stock---- Shares | Amount | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income |
|---|---|---|---|---|---|
| Balances, December 31, 2006 | 2,864,586 | $ 12,474 | $ 59 | $ 44,062 | $ (1,314) |
| Common stock issued, including tax benefit, net (including stock grants of 5,605 shares and employee gifts of 93 shares) | 8,554 | 56 | - | - | - |
| Stock based compensation expense | - | - | 75 | - | - |
| Common stock purchased and retired | (20,469) | (90) | - | (531) | - |
| Net change in unrealized gain (loss) on securities available for sale, net of tax | - | - | - | - | (112) |
| Net change in SFAS No. 158, net of tax | - | - | - | - | (19) |
| Net income | - | - | - | 5,150 | - |
| Dividends declared - $0.81 per share | - | - | - | (2,319) | - |
| Balances, September 30, 2007 | 2,852,671 | $ 12,440 | $ 134 | $ 46,362 | $ (1,445) |

See Accompanying Notes

KENTUCKY BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)
(thousands)

| | Nine Months Ending 9/30/2007 | 9/30/2006 |
|---|---|---|
| Cash Flows From Operating Activities | | |
| Net Income | $ 5,150 | $ 4,723 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 772 | 709 |
| Amortization | 361 | 289 |
| Accretion of premium on debt | (20) | (56) |
| Securities amortization (accretion), net | (131) | 33 |
| Noncash compensation expense | 75 | 49 |
| Provision for loan losses | 650 | 334 |
| Securities (gains) losses, net | (33) | (41) |
| Originations of loans held for sale | (10,356) | (11,624) |

| | | |
|---|---|---|
| Proceeds from sale of loans | 10,413 | 11,802 |
| Federal Home Loan Bank stock dividends | - | (246) |
| Gain on sale of mortgage loans | (312) | (178) |
| Changes in: | | |
| Interest receivable | (52) | (2,093) |
| Other assets | (422) | 1,364 |
| Interest payable | 668 | 175 |
| Other liabilities | (230) | 724 |
| Net cash from operating activities | 6,533 | 5,964 |
| Cash Flows From Investing Activities | | |
| Purchases of securities available for sale | (70,496) | (3,215) |
| Proceeds from sales of securities available for sale | 19,324 | 17,486 |
| Proceeds from principal payments, maturities and calls of securities available for sale | 53,461 | 36,542 |
| Cash paid in bank acquisition | - | (6,411) |
| Net change in loans | 20,160 | (17,157) |
| Purchases of bank premises and equipment | (2,480) | (1,448) |
| Net cash from investing activities | 19,969 | 25,797 |
| Cash Flows From Financing Activities: | | |
| Net change in deposits | (6,032) | (48,851) |
| Net change in securities sold under agreements to repurchase, federal funds purchased and other borrowings | 2,215 | 15,097 |
| Advances from Federal Home Loan Bank | - | 80,000 |
| Payments on Federal Home Loan Bank advances | (15,704) | (78,118) |
| Proceeds from note payable | - | 8,000 |
| Payment on note payable | (500) | (7,000) |
| Proceeds from issuance of common stock | 56 | 33 |
| Purchase of common stock | (621) | (356) |
| Dividends paid | (2,319) | (2,052) |
| Net cash from financing activities | (22,905) | (33,247) |
| Net change in cash and cash equivalents | 3,597 | (1,486) |
| Cash and cash equivalents at beginning of period | 19,011 | 14,164 |
| Cash and cash equivalents at end of period | $ 22,608 | $ 12,678 |

See Accompanying Notes

KENTUCKY BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Estimates used in the preparation of the financial statements are based on various factors including the current interest rate environment and the general strength of the local economy. Changes in the overall interest rate environment can significantly affect the Company's net interest income and the value of its recorded assets and liabilities. Actual results could differ from those estimates used in the preparation of the financial statements.

The financial information presented as of any date other than December 31 has been prepared from the Company's books and records without audit. The accompanying consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Certain financial information that is normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America, but is not required for interim reporting purposes, has been condensed or omitted. In the opinion of management, all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of such financial statements, have been included. The results of operations for the interim periods are not necessarily indicative of the results to be expected for the full year.

For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

New accounting pronouncements -

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements". This Statement provides clarification of the definition of fair value, methods used to measure fair value, and additional disclosures about fair value measurements. This Standard is applicable in circumstances in which other Standards require or permit assets or liabilities to be measured at fair value. Therefore, this Standard does not require any new fair value measurements. This Standard is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is still evaluating the impact, if any, the adoption of this Statement on January 1, 2008 will have on its results of operations and consolidated financial condition.

On February 15, 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities". SFAS No. 159 allows companies to record certain financial assets and financial liabilities at full fair value if they so choose. SFAS No. 159 was issued to mitigate volatility in reported earnings caused by an accounting model utilizing multiple measurement attributes. The adoption of the fair value option is recorded as a cumulative-effect adjustment to the opening balance of retained earnings. Upon adoption, the difference between the carrying amount and the fair value of the items chosen is included in the cumulative-effect adjustment. Subsequent changes in fair value are recorded through the income statement. SFAS No. 159 is effective as of the beginning of the first fiscal year after November 15, 2007, which is January 1, 2008 for the Company. The Company does not expect the adoption of this Statement to have a material impact on its results of operations and consolidated financial condition.

The Company adopted FASB Interpretation 48, Accounting for Uncertainty in Income Taxes ("FIN 48"), as of January 1, 2007. A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. The adoption had no effect on the Company's financial statements, and the Company had no unrecognized tax benefits at January 1, 2007 or September 30, 2007.

The Company and its subsidiaries are subject to U.S. federal income tax. The Company is no longer subject to examination by taxing authorities for years before 2002. The Company does not expect the total amount of unrecognized tax benefits to significantly increase in the next twelve months.

The Company recognizes interest related to income tax matters as interest expense and penalties related to income tax matters as other expense. The Company did not have any amounts accrued for interest and penalties at January 1, 2007 or September 30, 2007.

## 2. INVESTMENT SECURITIES

INVESTMENT SECURITIES

Period-end securities are as follows:
(in thousands)

| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Available for Sale | | | | |
| September 30, 2007 | | | | |
| U.S. government agencies | $ 19,110 | $ 375 | $ - | $ 19,485 |
| States and political subdivisions | 55,657 | 422 | (658) | 55,421 |
| Mortgage-backed | 51,441 | 31 | (1,069) | 50,403 |
| Equity securities | 270 | 17 | - | 287 |
| Total | 126,478 | 845 | (1,727) | 125,596 |
| December 31, 2006 | | | | |
| U.S. government agencies | 31,524 | 93 | (125) | 31,492 |
| States and political subdivisions | 43,609 | 703 | (182) | 44,130 |
| Mortgage-backed | 53,200 | - | (1,218) | 51,982 |
| Equity securities | 270 | 17 | - | 287 |
| Total | 128,603 | 813 | (1,525) | 127,891 |

## 3. LOANS

Loans at period-end are as follows:
(in thousands)

| | 9/30/2007 | 12/31/2006 |
|---|---|---|
| Commercial | $ 21,967 | $ 29,335 |
| Real estate construction | 27,768 | 29,034 |
| Real estate mortgage | 276,827 | 290,068 |
| Agricultural | 80,723 | 79,627 |
| Consumer | 15,845 | 16,086 |
| Total | 423,130 | 444,150 |

## 4. EARNINGS PER SHARE

Basic earnings per common share is net income divided by the weighted average number of common shares outstanding during the period. Diluted earnings per common share includes the dilutive effect of additional potential common shares issuable under stock options.

The factors used in the earnings per share computation follow:

Nine Months Ended

September 30

| | 2007 | 2006 |
|---|---|---|

(in thousands, except per share information)

| | 2007 | 2006 |
|---|---|---|
| Basic Earnings Per Share | | |
| Net Income | $5,150 | $4,723 |
| Weighted average common shares outstanding | 2,855 | 2,730 |
| Basic earnings per share | $ 1.80 | $ 1.73 |
| | | |
| Diluted Earnings Per Share | | |
| Net Income | $5,150 | $4,723 |
| Weighted average common shares outstanding | 2,855 | 2,730 |
| Add dilutive effects of assumed exercise of stock options | 10 | 11 |
| Weighted average common and dilutive potential common shares outstanding | 2,865 | 2,741 |
| Diluted earnings per share | $ 1.79 | $ 1.72 |

| Three Months Ended | September 30 2007 | September 30 2006 |
|---|---|---|
| (in thousands, except per share information) | | |
| Basic Earnings Per Share | | |
| Net Income | $1,670 | $1,714 |
| Weighted average common shares outstanding | 2,845 | 2,854 |
| Basic earnings per share | $ 0.58 | $ 0.60 |
| | | |
| Diluted Earnings Per Share | | |
| Net Income | $1,670 | $1,714 |
| Weighted average common shares outstanding | 2,845 | 2,854 |
| Add dilutive effects of assumed exercise of stock options | 10 | 11 |
| Weighted average common and dilutive potential common shares outstanding | 2,855 | 2,865 |
| Diluted earnings per share | $ 0.58 | $ 0.60 |

Stock options for 10,407 shares of common stock for the nine months and three months ended September 30, 2007, and for 32,400 shares of common stock for the nine and three months ended September 30, 2006 were excluded from diluted earnings per share because their impact was antidilutive.

5. STOCK COMPENSATION

The Company grants certain officers and key employees stock option awards, which vest and become fully exercisable at the end of five years. The Company also grants certain directors stock option awards, which vest and become fully exercisable immediately. The exercise price of each option, which has a ten year life, was equal to the market price of the Company's stock on the date of grant. The Company also provides to certain officers and key employees restricted stock grants, which fully vest at the end of five years. The Company records employee expense ratably over the five year period, based on the market price of the common stock on the date of grant. Total shares issuable under the restricted stock grant plan are 50,000 shares. In January 2007, 5,095 shares were granted under the plan and in May 2007, 510 shares were granted under the plan.

The following table summarizes stock option activity:

Nine Months Ended
September 30, 2007
Weighted Average

| | Options | Exercise Price |
|---|---|---|
| Outstanding, beginning of year | 69,914 | $ 26.54 |
| Granted | 800 | 31.00 |
| Expired | (880) | 31.59 |
| Exercised | (2,960) | 20.17 |
| Outstanding, end of period | 66,874 | 26.81 |
| Options exercisable at period end | 49,984 | 25.68 |

The following details stock options outstanding:

| | September 30, 2007 | December 31, 2006 |
|---|---|---|
| Stock options vested and currently exercisable: | | |
| Number | 49,984 | 44,072 |
| Weighted average exercise price | $ 25.68 | $ 24.35 |
| Aggregate intrinsic value | $ 391,875 | $ 308,190 |
| Weighted average remaining contractual life | 51.5 months | 52.3 months |

The intrinsic value for stock options is calculated based on the exercise price of the underlying awards and the market price of our common stock as of the reporting date. The Company recorded $75 thousand in stock compensation expense during the nine months ended September 30, 2007 to salaries and employee benefits.

The weighted-average assumptions for options granted during the year and the resulting estimated weighted average fair values per share used in computing 2007 and 2006 recognized compensation expense follow:

| | 2007 | 2006 |
|---|---|---|
| Weighted-average fair value of options granted during the year | $4.22 | $3.14 |
| Risk-free interest rate | 4.51% | 4.59% |
| Expected option life | 8 years | 8 years |
| Expected stock price volatility | 12.69% | 7.99% |
| Expected dividend yield | 3.48% | 3.39% |

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes based stock option valuation model. This model requires the input of subjective assumptions that will usually have a significant impact on the fair value estimate. Expected volatilities are based on historical volatility of the Company's stock, and other factors. Expected dividends are based on dividend trends and the market price of the Company's stock price at grant. The Company uses historical data to estimate option exercises and employee terminations within the valuation model. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

6. DIVIDENDS

Dividends per share paid for the quarter ended September 30, 2007 were $0.27 compared to $0.25 for September 30, 2006. This is the same rate of dividend paid for the first two quarters of the respective years.

7. RETIREMENT PLAN

Components of Net Periodic Benefit Cost

| Pension Benefits | Nine months ended September 30 (in thousands) | |
|---|---|---|
| | 2007 | 2006 |
| Service cost | $ 355 | $ 354 |
| Interest cost | 304 | 273 |
| Expected return on plan assets | (328) | (298) |
| (Gain) loss amortization | 26 | 31 |
| Net Periodic Benefit Cost | $ 357 | $ 360 |

| Pension Benefits | Three months ended September 30 (in thousands) | |
|---|---|---|
| | 2007 | 2006 |
| Service cost | $ 128 | $ 118 |
| Interest cost | 102 | 91 |
| Expected return on plan assets | (111) | (99) |
| (Gain) loss amortization | 9 | 10 |
| Net Periodic Benefit Cost | $ 128 | $ 120 |

Employer Contributions

The Company contributed $503 thousand as its 2007 annual contribution to the Pension Plan in July 2007.

## Item 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### Forward-Looking Statements

This discussion contains forward-looking statements under the Private Securities Litigation Reform Act of 1995 that involve risks and uncertainties. Words such as "believes," "anticipates," "expects," "intends," "plans," "targeted," and similar expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements. Although the Company believes that the assumptions underlying the forward-looking statements contained herein are reasonable, any of the assumptions could be inaccurate, and therefore, there can be no assurance that the forward-looking statements included herein will prove to be accurate. Factors that could cause actual results to differ from the results discussed in the forward-looking statements include, but are not limited to: economic conditions (the Company and its bank operate in areas affected by various markets); competition for the Company's customers from other providers of financial and mortgage services; government legislation and regulation (which changes from time to time and over which the Company has no control); changes in interest rates (both generally and more specifically mortgage interest rates); material unforeseen changes in the liquidity, results of operations, or financial condition of the Company's customers; and other risks detailed in the Company's filings with the Securities and Exchange Commission, all of which are difficult to predict and many of which are beyond the control of the Company. The Company undertakes no obligation to update or revise forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

## Summary

Kentucky Bancshares, Inc. recorded net income of $5.2 million, or $1.80 basic earnings per share and $1.79 diluted earnings per share for the first nine months ended September 30, 2007 compared to $4.7 million, or $1.73 basic earnings per share and $1.72 diluted earnings per share for the nine month period ending September 30, 2006. The first nine months earnings reflects an increase of 9.0% compared to the same time period in 2006. The earnings for the three months ended September 30, 2007 were $1.7 million, or $0.58 basic and diluted earnings per share for the three month period ending September 30, 2007 compared to $1.7 million, or $0.60 basic and diluted earnings per share for the three month period ending September 30, 2006. This three months period earnings reflects a decrease of 2.6% compared to the same time period in 2006. The issuance of 198,836 shares of common stock, in connection with our merger with Peoples Bancorp, Inc. in July 2006, had a slightly dilutive effect on earnings per share.

Return on average assets was 1.08% for the nine months ended September 30, 2007 and for the nine month period ended September 30, 2006. Return on average equity was 12.2% for the nine month period ended September 30, 2007 and 12.9% for the same period in 2006. Return on average assets was 1.08% for the three months ended September 30, 2007 and 1.09% for the three month period September 30, 2006. Return on average equity was 12.0% for the three months ended September 30, 2007 and 13.0% for the same time period in 2006.

Loans decreased $21.0 million from $444.1 million on December 31, 2006 to $423.1 million on September 30, 2007. Increases in agricultural loans were offset by a decrease in commercial, real estate mortgage, real estate construction and consumer loans. Management attributes the decline in loans to the slow down in the real estate economy and to competitive pressures.

Total deposits decreased from $468.8 million on December 31, 2006 to $462.8 million on September 30, 2007, a decrease of $6.0 million. This decrease is primarily the result of an increase in certificates of deposit, reported in time deposits, $100,000 or greater, but offset by a decrease in other interest bearing deposits (the loss of public funds placed by competitive bid during the third quarter).

## Net Interest Income

Net interest income was $15.3 million for the nine months ended September 30, 2007 compared to $13.8 million for the nine months ended September 30, 2006, an increase of 10.3%. The interest spread was 3.35% for the first nine months of 2007 compared to 3.27% for the same period in 2006, an increase of 8 basis points. Net interest income was $5.1 million for the three months ended September 30, 2007 compared to $4.8 million for the three months ended September 30, 2006, an increase of 6.1%. The interest spread for the three month period ended September 30, 2007 was 3.44% compared to 3.22% for the same period in 2006, an increase of 22 basis points. Net interest margins have increased slightly in 2007 compared to 2006.

For the first nine months, the yield on assets increased from 6.27% in 2006 to 6.70% in 2007. The cost of liabilities increased from 3.00% in 2006 to 3.35% in 2007. Year to date average loans are up $38.3 million, or 9.6% from September 30, 2006 to September 30, 2007. Approximately $51 million in loans were acquired with the Peoples Bancorp, Inc. (Peoples) merger in July 2006. Loan interest income has increased $3.2 million for the first nine months of 2007 compared to the first nine months of 2006. Year to date average deposits increased from September 30, 2006 to September 30, 2007, up $53.4 million, or 12.4%. About $72 million in deposits were acquired in the Peoples merger in July 2006. The slight increase, excluding the Peoples merger, is a result of slower deposit growth, resulting from the loss of a large certificate of deposit customer and public funds placed by competitive bid. Deposit interest expense has increased $2.8 million for the first nine months of 2007 compared to the same period in 2006.

Non-Interest Income

Non-interest income increased $755 thousand for the nine months ended September 30, 2007 compared to the same period in 2006 to $6.0 million, due primarily to an increase in overdraft income of $414 thousand (primarily from the deposit relationships acquired with the Peoples merger in July 2006). There was a slight increase in non-interest income for the three months ended September 30, 2007 compared to the same time period in 2006.

Gain on sale of mortgage loans increased from $178 thousand in the first nine months of 2006 to $312 thousand during the first nine months of 2007. The increase was $28 thousand for the three month period ended September 30, 2007 compared to the same time period in 2006. A selected group of loans sold servicing released account for most of the increase. The volume of mortgage loan originations and sales is generally inverse to rate changes. A change in the mortgage loan rate environment can have a significant impact on the related gain on sale of mortgage loans.

Non-Interest Expense

Total non-interest expenses increased $1.4 million for the nine month period ended September 30, 2007 compared to the same period in 2006. For the three month period ended September 30, 2007 total non-interest expense increased $148 thousand.

For the comparable nine month periods, salaries and benefits increased $1.1 million, an increase of 15.3%. Salaries and incentives represented $804 thousand and employee benefits represented $263 thousand of the increase in salaries and employee benefits expense during these comparable periods. Salaries and benefits increased $133 thousand for the three month period ended September 30, 2007 compared to the same time period in 2006. These increases are primarily attributable to the Peoples merger completed in July 2006.

Occupancy expenses increased $159 thousand to $1.9 million for the first nine months of 2007 compared to the same time period in 2006. Occupancy expenses decreased $7 thousand for the three month period ended September 30, 2007 compared to the same time period in 2006. The increase in year to date 2007 is mainly attributable to two additional facilities acquired in the Peoples merger in July 2006. With the upcoming opening of additional facilities in Paris, Morehead and Nicholasville, occupancy expense is expected to increase starting in the fourth quarter of 2007.

The increases in amortization, advertising and marketing, and taxes are also primarily attributable to the Peoples merger completed in July 2006.

Other expenses decreased $47 thousand for the nine months ended September 30, 2007 compared to the same time period in 2006. For the three month period ended September 30, 2007 other expenses decreased $11 thousand compared to the three month period ended September 30, 2006. The year to date decrease is mainly a result of a one time credit of $80 thousand received in the first quarter of 2007 for debit card expenses. In addition, one-time costs (approximately $41 thousand in the first six months of 2006), related to the

Peoples Bank merger, incurred in 2006 inflated 2006 expenses.

In August 2007, the Company starting outsourcing its account processing to Fiserv, Inc. The Company does not expect this to have a material impact on its results of operations and consolidated financial condition.

Income Taxes

The effective tax rate for the nine months ended September 30, 2007 was 27% compared to 28% in 2006. The effective tax rate for the three months ended September 30, 2007 was 26% compared to 27% for the same time period in 2006. These rates are less than the statutory rate as a result of the tax-free securities and loans held by the Company.

Stock Repurchase Program

On October 25, 2000, the Company announced that its Board of Directors approved a stock repurchase program to purchase up to 100,000 shares of its outstanding common stock. On November 11, 2002, the Board of Directors approved and authorized the Company's repurchase of an additional 100,000 shares. Shares will be purchased from time to time in the open market depending on market prices and other considerations. Through September 30, 2007, 138,679 shares have been purchased under the program. The most recent share repurchase occurred on November 2, 2007. The repurchase program has had a positive effect on earnings per share calculations.

Liquidity and Funding

Liquidity risk is the possibility that the Company may not be able to meet its cash requirements. Management of liquidity risk includes maintenance of adequate cash and sources of cash to fund operations and to meet the needs of borrowers, depositors and creditors. Excess liquidity has a negative impact on earnings as a result of the lower yields on short-term assets.

Cash and cash equivalents were $22.6 million as of September 30, 2007 compared to $19.0 million at December 31, 2006. The increase in cash and cash equivalents is mainly attributable to an increase in federal funds sold resulting primarily from a decrease in loan demand. In addition to cash and cash equivalents, the securities portfolio provides an important source of liquidity. Total securities available for sale totaled $125.6 million at September 30, 2007. The available for sale securities are available to meet liquidity needs on a continuing basis. The Company expects the customers' deposits to be adequate to meet its funding demands.

Generally, the Company relies upon net cash inflows from financing activities, supplemented by net cash inflows from operating activities, to provide cash used in its investing activities. As is typical of many financial institutions, significant financing activities include deposit gathering, and the use of short-term borrowings, such as federal funds purchased and securities sold under repurchase agreements along with long-term debt. The Company's primary investing activities include purchasing investment securities and loan originations.

Management is aware of the challenge of funding sustained loan growth. Therefore, in addition to deposits, other sources of funds, such as Federal Home Loan Bank (FHLB) advances, may be used. The Company relies on FHLB advances for both liquidity and asset/liability management purposes. These advances are used primarily to fund long-term fixed rate residential mortgage loans. As of September 30, 2007, we have sufficient collateral to borrow an additional $41 million from the FHLB. In addition, as of September 30, 2007, over $48 million is available in overnight borrowing through various correspondent banks. In light of this, management believes there is sufficient liquidity to meet all reasonable borrower, depositor and creditor needs in the present economic environment.

Non-Performing Assets

As of September 30, 2007, the Company's non-performing loans totaled $4.4 million or 1.03% of loans compared to $2.6 million or 0.59% of loans at December 31, 2006. (See table below) The Company experienced an increase of $1.7 million in non-accrual loans secured by various real estate loans from December 31, 2006 to September 30, 2007. As of September 30, 2007, non-accrual loans include $2.6 million in loans secured by 1-4 property and $1.0 million in real estate construction. The Company believes these increases are attributable to the general softening of the real estate market, including the residential construction market. Real estate loans composed 94% of the non-performing loans as of September 30, 2007 and 91% as of December 31, 2006. Forgone interest income on the non-accrual loans for both 2007 and 2006 is immaterial.

Nonperforming Assets

| | 9/30/07 | 12/31/06 |
|---|---|---|
| | (in thousands) | |
| Non-accrual Loans | $ 4,276 | $ 2,379 |
| Accruing Loans which are Contractually past due 90 days or more | 102 | 253 |
| Total Nonperforming and Restructured | 4,378 | 2,632 |
| Other Real Estate | 705 | 411 |
| Total Nonperforming and Restructured Loans and Other Real Estate | $ 5,083 | $ 3,043 |
| Nonperforming and Restructured Loans as a Percentage of Loans | 1.03% | 0.59% |
| Nonperforming and Restructured Loans and Other Real Estate as a Percentage of Total Assets | 0.83% | 0.48% |
| Allowance as a Percentage of Period-end Loans | 1.13% | 1.12% |
| Allowance as a Percentage of Non-performing and Restructured Loans | 109% | 164% |

Provision for Loan Losses

The loan loss provision for the first nine months was $650 thousand for 2007 and $334 thousand for the same period in 2006. The loan loss provision for the three months ended September 30, 2007 was $330 thousand and $94 thousand for the same period in 2006. The current level of nonperforming loans has caused management to increase the 2007 provision in order to maintain an allowance for loan losses that is representative of the risk of loss based on the quality of loans currently in the portfolio. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Net charge-offs for the nine month period ended September 30, 2007 were $860 thousand compared to $278 thousand for the same period in 2006. Net charge-offs for the three month period ended September 30, 2007 were $505 thousand compared to $136 thousand for the same period in 2006. Future levels of charge-offs will be determined by the particular facts and circumstances surrounding individual loans. Management believes the current loan loss allowance is sufficient to meet probable incurred loan losses.

Loan Losses

| | Nine Months Ended September 30 (in thousands) | |
|---|---|---|
| | 2007 | 2006 |
| Balance at Beginning of Period | $ 4,991 | $ 4,310 |
| Amounts Charged-off: | | |
| Commercial | 127 | 15 |
| Real Estate Construction | 330 | 28 |
| Real Estate Mortgage | 167 | 135 |
| Agricultural | 25 | 3 |
| Consumer | 693 | 682 |
| Total Charged-off Loans | 1,342 | 863 |
| Recoveries on Amounts Previously Charged-off: | | |
| Commercial | 5 | 2 |
| Real Estate Construction | 14 | - |
| Real Estate Mortgage | 2 | 2 |
| Agricultural | 64 | 21 |
| Consumer | 397 | 560 |
| Total Recoveries | 482 | 585 |
| Net Charge-offs | 860 | 278 |
| Provision for Loan Losses | 650 | 334 |
| Peoples Bank Reserve Acquired | - | 776 |
| Balance at End of Period | 4,781 | 5,142 |
| Loans | | |
| Average | 435,797 | 397,492 |
| At September 30 | 423,130 | 439,492 |
| As a Percentage of Average Loans: | | |
| Net Charge-offs | 0.20% | 0.07% |
| Provision for Loan Losses | 0.15% | 0.08% |
| Allowance as a Multiple of Net Charge-offs | 4.2 | 13.9 |

Loan Losses

| | Quarter Ended September 30 (in thousands) | |
|---|---|---|
| | 2007 | 2006 |
| Balance at Beginning of Period | $ 4,956 | $ 4,408 |
| Amounts Charged-off: | | |
| Real Estate Construction | 330 | 28 |
| Real Estate Mortgage | 76 | 81 |
| Agricultural | 25 | - |
| Consumer | 211 | 158 |
| Total Charged-off Loans | 642 | 267 |
| Recoveries on Amounts Previously Charged-off: | | |
| Commercial | 4 | 1 |
| Real Estate Construction | 4 | - |
| Real Estate Mortgage | - | 2 |
| Agricultural | 35 | - |
| Consumer | 94 | 128 |
| Total Recoveries | 137 | 131 |
| Net Charge-offs | 505 | 136 |
| Provision for Loan Losses | 330 | 94 |
| Peoples Bank Reserve Acquired | - | 776 |
| Balance at End of Period | 4,781 | 5,142 |

| | | |
|---|---|---|
| Loans | | |
| Average | 428,273 | 432,132 |
| At September 30 | 423,130 | 439,492 |
| As a Percentage of Average Loans: | | |
| Net Charge-offs | 0.12% | 0.03% |
| Provision for Loan Losses | 0.08% | 0.02% |
| Allowance as a Multiple of Net Charge-offs | 2.4 | 9.5 |

Item 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Asset/Liability management control is designed to ensure safety and soundness, maintain liquidity and regulatory capital standards, and achieve acceptable net interest income. Management considers interest rate risk to be the most significant market risk. The Company's exposure to market risk is reviewed on a regular basis by the Asset/Liability Committee. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect on net interest income and to adjust the balance sheet to minimize the inherent risk while at the same time maximize income.

Management realizes certain risks are inherent and that the goal is to identify and minimize the risks. The primary tools used by management are interest rate shock and economic value of equity (EVE) simulations. The Bank has no market risk sensitive instruments held for trading purposes.

Using interest rate shock simulations, the following table depicts the change in net interest income resulting from 100 and 300 basis point changes in rates on the Company's interest earning assets and interest bearing liabilities. The projections are based on balance sheet growth assumptions and repricing opportunities for new, maturing and adjustable rate amounts. As of September 30, 2007 the projected percentage changes are within the Board approved limits. This period's volatility is similar to the same period a year ago. The projected net interest income report summarizing the Company's interest rate sensitivity as of September 30, 2007 is as follows:

(dollars in thousands)
PROJECTED NET INTEREST INCOME

| Change in basis points: | - 300 | - 100 | Level Rates | + 100 | + 300 |
|---|---|---|---|---|---|
| Year One (10/07 - 9/08) | | | | | |
| Net interest income | $21,742 | $22,020 | $22,373 | $22,520 | $22,675 |
| Net interest income dollar change | (631) | (353) | N/A | 147 | 302 |
| Net interest income percentage change | -2.8% | -1.6% | N/A | 0.7% | 1.3% |
| Board approved limit | >-10.0% | >-4.0% | N/A | >-4.0% | >-10.0% |

The projected net interest income report summarizing the Company's interest rate sensitivity as of September 30, 2006 is as follows:

(dollars in thousands)
PROJECTED NET INTEREST INCOME

| Change in basis points: | - 300 | - 100 | Level Rates | + 100 | + 300 |
|---|---|---|---|---|---|
| Year One (10/06 - 9/07) | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| Net interest income | $18,837 | $19,030 | $19,425 | $19,737 | $20,033 |
| Net interest income dollar change | (588) | (395) | N/A | 312 | 608 |
| Net interest income percentage change | -3.0% | -2.0% | N/A | 1.6% | 3.1% |
| Board approved limit | >-18.0% | >-6.0% | N/A | >-4.0% | >-10.0% |

These projected changes in net interest income as of September 30, 2007 are slightly different when compared to the projected changes in net interest income as of September 30, 2006 for the 100 and 300 basis point changes. Projections from September 30, 2007, year one reflected a decline in net interest income of 1.6% with a 100 basis point decline compared to the 2.0% decline in 2006. The 100 basis point increase in rates reflected a 0.7% increase in net interest income in 2007 compared to 1.6% in 2006.

EVE applies discounting techniques to future cash flows to determine the present value of assets, liabilities, and therefore equity. Based on applying these techniques to the September 30, 2007 balance sheet, a 300 basis point increase in rates results in a 21% decline in EVE. A 300 basis point decrease in rates results in a 10% increase in EVE. These are within the Board approved limits.

## Item 4 - CONTROLS AND PROCEDURES

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on the foregoing, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective, in all material respects, to ensure that information required to be disclosed in the reports the Company files and submits under the Exchange Act is recorded, processed, summarized and reported as and when required.

The Company also conducted an evaluation of internal control over financial reporting to determine whether any changes occurred during the quarter covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting. Based on this evaluation, there has been no such change during the quarter covered by this report.

# Part II - Other Information

## Item 1. Legal Proceedings

The Company is not a party to any material legal proceedings.

## Item 1A. Risk Factors

There have been no material changes in risk factors, as previously disclosed in the December 31, 2006 Form 10-K.

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

ISSUER PURCHASES OF EQUITY SECURITIES

| Period | (a) Total Number of Shares (or Units) Purchased | (b) Average Price Paid Per Share (or Unit) | (c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans Or Programs | (d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans of Programs |
|---|---|---|---|---|
| 7/1/07 - 7/31/07 | 4,774 | $30.86 | 4,774 | 64,403 shares |
| 8/1/07 - 8/31/07 | 2,882 | 31.07 | 2,882 | 61,521 shares |
| 9/1/07 - 9/30/07 | 200 | 32.43 | 200 | 61,321 shares |
| Total | 7,856 | | 7,856 | 61,321 shares |

On October 25, 2000, the Company announced that its Board of Directors approved a stock repurchase program. The Company is authorized to purchase up to 100,000 shares of its outstanding common stock. On November 11, 2002, the Board of Directors approved and authorized the Company's repurchase of an additional 100,000 shares. Shares will be purchased from time to time in the open market depending on market prices and other considerations. Through September 30, 2007, 138,679 shares have been purchased.

Item 3. Defaults upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 5. Other Information

None

Item 6. Exhibits

31.1 Certifications of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certifications of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32 Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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.

KENTUCKY BANCSHARES, INC.

Date _____11/13/07_______ __/s/Louis Prichard_____________
Louis Prichard, President and C.E.O.

Date ______11/13/07________ __/s/Gregory J. Dawson____________
Gregory J. Dawson, Chief Financial Officer

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