FIRST FARMERS & MERCHANTS CORP
Form 10-Q
November 07, 2014

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, 2014.**

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

For the transition period from _______________ to _______________________

Commission File Numbers: 000-10972

First Farmers and Merchants Corporation

(Exact name of registrant as specified in its charter)

Tennessee	62-1148660
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
816 South Garden Street Columbia, Tennessee	38402-1148
(Address of principal executive offices)	(Zip Code)

931-388-3145

(Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

[X]Yes [ ] No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

[ ]Yes [X] No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer [ ]	Accelerated filer [X]
Non-accelerated filer [ ] (Do not check if a smaller reporting company)	Smaller reporting company [ ]

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

As of November 8, 2014, the registrant had 4,911,860 shares of common stock outstanding.

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 September 30, 2014 and December 31, 2013.

Condensed consolidated statements of income - For the three and nine months ended September 30, 2014 and September 30, 2013.

Condensed consolidated statements of comprehensive income (loss) - For the three and nine months ended September 30, 2014 and September 30, 2013.

Condensed consolidated statements of cash flows - For the nine months ended September 30, 2014 and September 30, 2013. Selected notes to condensed consolidated financial statements.

All dollar amounts are reported in thousands except share and per share data.

FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	(dollars in thousands)	**September 30, 2014**	**December 31, 2013**
		(unaudited)	(1)
ASSETS	Cash and due from banks	$ 21,001	$ 20,391
	Interest-bearing deposits	17,984	25,167
	Federal funds sold	-	9,850
	Total cash and cash equivalents	38,985	55,408
	Securities:		
	Available-for-sale (amortized cost $387,280 and $346,892 as of Sept. 30, 2014 and December 31, 2013, respectively)	378,332	329,714
	Held-to-maturity (fair market value $24,325 and $28,595 as of Sept. 30, 2014 and December 31, 2013, respectively)	23,859	27,839
	Total securities	402,191	357,553
	Loans, net of deferred fees	616,966	606,766
	Allowance for loan and lease losses	(8,257)	(8,595)
	Net loans	608,709	598,171
	Loans held for sale	2,311	327
	Bank premises and equipment, net	25,101	24,868
	Other real estate owned	514	1,438
	Bank owned life insurance	26,071	25,867
	Goodwill	9,018	9,018
	Deferred tax asset	7,543	10,905
	Other assets	12,552	10,605
	TOTAL ASSETS	$ 1,130,684	$ 1,093,833
LIABILITIES	Deposits		
	Noninterest-bearing	$ 189,154	$ 179,823
	Interest-bearing	787,035	777,514
	Total deposits	976,189	957,337
	Securities sold under agreements to repurchase	21,367	18,095
	Federal funds purchased	6,000	-
	Accounts payable and accrued liabilities	16,524	15,728
	TOTAL LIABILITIES	1,020,080	991,160
SHAREHOLDERS EQUITY	Common stock - $10 par value per share, 8,000,000 shares authorized; 4,911,860 and 5,021,012 shares issued and outstanding as of Sept. 30, 2014 and December 31, 2013, respectively	49,119	50,210
	Retained earnings	65,419	61,369
	Accumulated other comprehensive loss	(4,029)	(9,001)
	TOTAL SHAREHOLDERS EQUITY BEFORE		

NONCONTROLLING INTEREST - PREFERRED STOCK OF SUBSIDIARY		110,509		102,578
Noncontrolling interest - preferred stock of subsidiary		95		95
TOTAL SHAREHOLDERS EQUITY		110,604		102,673
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$	1,130,684	$	1,093,833

(1) Derived from audited financial statements.

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

All dollar amounts are reported in thousands except share and per share data.

FIRST FARMERS AND MERCHANTS CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(unaudited)

	(dollars in thousands, except per share data)	**Three months ended September 30, 2014**	**2013**	**Nine months ended September 30, 2014**	**2013**
INTEREST AND DIVIDEND INCOME	Interest and fees on loans	$ 7,248	$ 7,219	$ 21,190	$ 21,495
	Income on investment securities				
	Taxable interest	1,469	1,332	4,230	4,151
	Exempt from federal income tax	578	717	1,867	2,200
	Other interest and dividend income	56	60	209	228
	Total interest income	9,351	9,328	27,496	28,074
INTEREST EXPENSE	Interest on deposits	587	642	1,798	2,073
	Interest on other borrowings	18	37	50	191
	Total interest expense	605	679	1,848	2,264
	Net interest income	8,746	8,649	25,648	25,810
	Provision for loan and lease losses	-	-	-	-
	Net interest income after provision	8,746	8,649	25,648	25,810
NONINTEREST INCOME	Gain on loans sold	86	75	180	405
	Trust department income	633	550	1,886	1,710
	Service fees on deposit accounts	1,681	1,689	4,845	4,856
	Brokerage fees	103	72	325	271
	Earnings on bank owned life insurance	104	77	293	278
	(Loss) gain on sale of securities	(7)	-	540	829
	Gain (loss) on foreclosed property	475	(75)	471	(243)
	Other non-interest income	102	121	379	352
	Total non-interest income	3,177	2,509	8,919	8,458
NONINTEREST EXPENSE	Salaries and employee benefits	4,483	4,293	13,380	13,290
	Net occupancy expense	510	509	1,453	1,565
	Depreciation expense	349	373	1,060	1,138
	Data processing expense	573	579	1,734	1,729
	Legal and professional fees	219	302	647	790
	Stationary and office supplies	74	87	229	232
	Advertising and promotions	376	266	1,055	807
	FDIC insurance premium expense	172	336	461	573
	Other real estate expense	17	8	68	47
	Other noninterest expense	1,393	1,569	4,202	4,413
	Total noninterest expenses	8,166	8,322	24,289	24,584
	Income before provision for income taxes	3,757	2,836	10,278	9,684
	Provision for income taxes	1,031	779	2,685	2,178

Net income before noncontrolling interest - dividends on preferred stock of subsidiary	2,726	2,057	7,593	7,506
Noncontrolling interest-dividends on preferred stock subsidiary	-	-	8	8
Net income for common shareholders	$ 2,726	$ 2,057	$ 7,585	$ 7,498
Weighted average shares outstanding	4,934,895	5,086,469	4,977,091	5,132,422
Earnings per share	$ 0.55	$ 0.40	$ 1.52	$ 1.46

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

All dollar amounts are reported in thousands except share and per share data.

FIRST FARMERS AND MERCHANTS CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

	Three months ended		**Nine months ended**	
(dollars in thousands)	**September 30,**		**September 30,**	
(unaudited)	**2014**	**2013**	**2014**	**2013**
Net income	$ 2,726	$ 2,057	$ 7,585	$ 7,498
Comprehensive income (loss)				
Unrealized appreciation (depreciation) on available-for-sale securities, net of taxes of ($475) and ($759) for the three months ended September 30, 2014 and 2013, respectively and net of taxes of $3,376 and ($6,823) for the nine months ended September 30, 2014 and 2013, respectively	(759)	(1,213)	5,393	(10,899)
Reclassification adjustment for realized losses (gains) included in net income, net of taxes of $3 and ($0), for the three months ended September 30, 2014 and 2013, respectively and net of taxes of ($208) and ($319) for the nine months ended September 30, 2014 and 2013, respectively	4	-	(332)	(510)
Change in unfunded portion of postretirement benefit obligations, net of taxes of ($18), and ($53), for the three months ended September 30, 2014 and 2013, respectively and net of taxes of ($56) and $956 for the nine months ended September 30, 2014 and 2013, respectively	(30)	(84)	(89)	1,526
Other comprehensive income (loss)	(785)	(1,297)	4,972	(9,883)
Comprehensive income (loss)	1,941	760	12,557	(2,385)
Less: comprehensive income attributable to the noncontrolling interest	-	-	-	-
Total comprehensive income (loss)	$ 1,941	$ 760	$ 12,557	$ (2,385)

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

FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

			Nine months ended September 30,		
	(unaudited)		**2014**		**2013**
OPERATING ACTIVITIES	Net income available for common shareholders	$	7,585	$	7,498
	Adjustments to reconcile net income to net cash provided by (used in) operating activities				
	Provision for loan losses		-		-
	Provision for depreciation and amortization of premises and equipment		1,060		1,138
	Deferred tax expense		250		626
	Net securities gains		(540)		(829)
	Gains on loans sold		(180)		(405)
	Proceeds from sale of mortgage loans held for sale		7,913		19,112
	Funding of mortgage loans held for sale		(9,718)		(16,648)
	(Gain) loss on other real estate owned		(471)		243
	Loss on sale of assets		1		15
	Amortization of investment security premiums, net of accretion of discounts		818		1,039
	Increase in cash surrender value of life insurance contracts		(29)		(278)
	(Increase) decrease in other assets		38		1,148
	Increase (decrease) in other liabilities		2,997		661
	Total adjustments		2,139		5,822
	Net cash provided by operating activities		9,724		13,320
INVESTING ACTIVITIES	Proceeds from sales of available-for-sale securities		24,389		137,150
	Proceeds from maturities and calls of available-for-sale securities		21,878		38,989
	Proceeds from maturities and calls of held-to-maturity securities		3,970		2,925
	Purchases of investment securities available-for-sale		(86,924)		(188,925)
	Net decrease in loans		(10,543)		(23,164)
	Proceeds from sale of other real estate owned		912		902
	Purchases of premises and equipment		(1,294)		(570)
	Purchase of life insurance policy		(175)		(485)
	Net cash used in investing activities		(47,787)		(33,178)
FINANCING ACTIVITIES	Net increase in deposits		18,852		3,187
	Net increase in securities sold under				

agreements to repurchase		9,272		3,959
Payments to FHLB borrowings		-		(10,100)
Repurchase of common stock		(2,799)		(2,903)
Cash dividends paid on common stock		(3,685)		(1,883)
Net cash provided by (used in) financing activities		21,640		(7,740)
Decrease in cash and cash equivalents		(16,423)		(27,598)
Cash and cash equivalents at beginning of period		55,408		70,396
Cash and cash equivalents at end of period	$	38,985	$	42,798
Supplemental disclosures of cash flow information				
Interest paid	$	1,768	$	2,162
Income taxes paid	$	1,929	$	1,945
Loans to facilitate sale of other real estate owned	$	-	$	1,905
Real estate acquired in settlement of loans	$	5	$	312

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

All dollar amounts are reported in thousands except share and per share data.

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 management of First Farmers and Merchants Corporation (the Corporation), 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 Corporation s Annual Report on Form 10-K. Accordingly, the reader of this Quarterly Report on Form 10-Q should refer to the Corporation s Annual Report on Form 10-K for the year ended December 31, 2013 for further information in this regard. The condensed consolidated balance sheet of the Corporation as of December 31, 2013 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 September 30, 2014 and 2013 were as follows (dollars in thousands):

	Amounts reclassified from AOCI		
	Nine months ended		
	September 30, 2014	September 30, 2013	Affected line item in the Statements of Income
Unrealized gains on available-for-sale securities			
	$ 540	$ 829	Gain on sale of securities
	540	829	Total reclassified amount before tax and noncontrolling interest
	(208)	(319)	Tax expense
	332	510	Net reclassified amount

Amortization of defined benefit pension items			
Prior service costs	-	(65)	Components are included in the computation of net
Actuarial losses	(145)	(141)	periodic pension cost and presented in Note 7
	(145)	(206)	Total reclassified amount before tax
	56	79	Tax benefit
	(89)	(127)	Net reclassified amount
Total reclassifications out of AOCI	$ 243	$ 383	

All dollar amounts are reported in thousands except share and per share data.

	Amounts reclassified from AOCI		
	Three months ended		
	September 30, 2014	September 30, 2013	Affected line item in the Statements of Income
Unrealized losses on available-for-sale securities			
	$ (7)	$ -	Loss on sale of securities
	(7)	-	Total reclassified amount before tax and noncontrolling interest
	3	-	Tax benefit
	(4)	-	Net reclassified amount
Amortization of defined benefit pension items			
Prior service costs	-	(65)	Components are included in the computation of
Actuarial gains	(48)	(47)	net periodic pension cost and presented in Note 7
	(48)	(112)	Total reclassified amount before tax
	18	43	Tax expense
	(30)	(69)	Net reclassified amount
Total reclassifications out of AOCI	$ (34)	$ (69)	

The components of AOCI included in shareholder s equity are as follows (dollars in thousands):

	September 30, 2014	December 31, 2013
Net unrealized losses on available-for-sale securities	$ (8,949)	$ (17,178)
Net defined benefit pension plan deferred amounts	2,397	2,542
	(6,552)	(14,636)
Tax effect	2,523	5,635
Accumulated other comprehensive loss	$ (4,029)	$ (9,001)

NOTE 3 FAIR VALUE MEASUREMENTS

The fair value of an asset or liability is the price that would be received in a sale of 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.

All dollar amounts are reported in thousands except share and per share data.

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

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

Recurring Measurements

The following table summarizes financial assets measured at fair value on a recurring basis as of September 30, 2014 and December 31, 2013, and by the level within the fair value hierarchy utilized to measure fair value (dollars in thousands):

Assets measured at fair value on a recurring basis as of September 30, 2014								
Available-for-sale securities	Level 1			Level 2	Level 3			Total
U.S. government agencies	$	-	$	124,431	$	-	$	124,431
U.S. government sponsored agency mortgage backed securities		-		190,990		-		190,990
States and political subdivisions		-		44,088		-		44,088
Corporate bonds		-		18,823		-		18,823
Total assets at fair value	$	-	$	378,332	$	-	$	378,332
Assets measured at fair value on a recurring basis as of December 31, 2013								
Available-for-sale securities	Level 1			Level 2	Level 3			Total
U.S. government agencies	$	-	$	105,072	$	-	$	105,072
U.S. government sponsored agency mortgage backed securities		-		157,423		-		157,423
States and political subdivisions		-		46,337		-		46,337
Corporate bonds		-		20,882		-		20,882
Total assets at fair value	$	-	$	329,714	$	-	$	329,714

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 nine months ended September 30, 2014.

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 securities terms and conditions, among other factors. U.S. government agencies, state and political subdivisions, U.S. government sponsored agency mortgage-backed securities and corporate bonds are classified as Level 2 inputs.

Nonrecurring Measurements

The following table summarizes financial assets measured at fair value on a nonrecurring basis as of September 30, 2014 and December 31, 2013, by the level within the fair value hierarchy utilized to measure fair value (dollars in thousands):

September 30, 2014	Level 1		Level 2		Level 3		Total	
Impaired loans (collateral-dependent)	$	-	$	-	$	699	$	699
December 31, 2013	Level 1		Level 2		Level 3		Total	
Impaired loans (collateral-dependent)	$	-	$	-	$	2,214	$	2,214
Other real estate owned	$	-	$	-	$	208	$	208

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 nine months ended September 30, 2014 and 2013 were $270 and $72, respectively, and $79 for the year ended December 31, 2013.

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 write-downs that are based on the observable market price or current appraised value of the collateral or (2) changes in the specific reserve.

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. There were no fair value adjustments for OREO for the nine months ended September 30, 2014. Fair value adjustments for OREO for the nine months ended September 30, 2013 were $325 and $395 for the year ended December 31, 2013.

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

Unobservable (Level 3) Inputs

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

	Quantitative Information about Level 3 Fair Value Measurements			
	Fair value at September 30, 2014	Valuation technique(s)	Unobservable input	Range (weighted average)
Impaired loans (collateral-dependent)	$ 699	Market comparable properties	Marketability discount	5.0% - 37.0% (35%)

	Quantitative Information about Level 3 Fair Value Measurements			
	Fair value at December 31, 2013	Valuation technique(s)	Unobservable input	Range (weighted average)
Impaired loans (collateral-dependent)	$ 2,214	Market comparable properties	Marketability discount	5.0% - 10.0% (7%)
Other real estate owned	$ 208	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 September 30, 2014 and December 31, 2013, and indicates the level within the fair value hierarchy of the valuation techniques (dollars in thousands):

		Fair value measurements at September 30, 2014 using		
	Carrying	Quoted prices in active markets for identical assets	Significant other	Significant

September 30, 2014	amount	(Level 1)	observable inputs (Level 2)	unobservable inputs (Level 3)
Financial assets				
Cash and due from banks	$ 21,001	$ 21,001	$ -	$ -
Interest-bearing deposits in other banks	17,984	17,984	-	-
Federal funds sold	-	-	-	-
Federal Home Loan Bank and Federal Reserve Bank stock	3,897	-	3,897	-
Securities available-for-sale	378,332	-	378,332	-
Securities held-to-maturity	23,859	-	24,325	-
Loans held for sale	2,311	-	2,311	-
Loans, net	608,709	-	-	613,464
Accrued interest receivable	4,638	-	4,638	-
Financial liabilities				
Non-interest bearing deposits	189,154	189,154	-	-
Interest bearing deposits	787,035	-	761,445	-
Repurchase agreements	21,367	-	21,367	-
Federal funds purchased	6,000	6,000	-	-
Accrued interest payable	583	-	583	-
Off-balance sheet credit related instruments:				
Commitments to extend credit	-	-	-	-

All dollar amounts are reported in thousands except share and per share data.

		Fair value measurements at December 31, 2013 using		
December 31, 2013	Carrying amount	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Financial assets				
Cash and due from banks	$ 20,391	$ 20,391	$ -	$ -
Interest-bearing deposits in other banks	25,167	25,167	-	-
Federal funds sold	9,850	9,850	-	-
Federal Home Loan Bank and Federal Reserve Bank stock	3,897	-	3,897	-
Securities available-for-sale	329,714	-	329,714	-
Securities held-to-maturity	27,839	-	28,595	-
Loans held for sale	327	-	327	-
Loans, net	598,171	-	-	607,113
Accrued interest receivable	4,183	-	4,183	-
Financial liabilities				
Non-interest bearing deposits	179,823	179,823	-	-
Interest bearing deposits	777,514	-	778,682	-
Repurchase agreements	18,095	-	18,095	-
Accrued interest payable	663	-	663	-
Off-balance sheet credit related instruments:				
Commitments to extend credit	-	-	-	-

NOTE 4 SECURITIES

The amortized cost and estimated fair value of securities at September 30, 2014 and December 31, 2013 were as follows (dollars in thousands):

	Amortized	Gross unrealized		Fair
September 30, 2014	cost	Gains	Losses	value
Available-for-sale securities				
U.S. government agencies	$ 128,733	$ 12	$ 4,314	$ 124,431
U.S. government sponsored agency mortgage backed securities	197,323	4	6,337	$ 190,990
States and political subdivisions	42,507	1,638	57	44,088
Corporate bonds	18,717	159	53	18,823
	$ 387,280	$ 1,813	$ 10,761	$ 378,332
Held-to-maturity securities				
States and political subdivisions	$ 23,859	$ 466	$ -	$ 24,325
	Amortized	Gross unrealized		Fair
December 31, 2013	cost	Gains	Losses	value
Available-for-sale securities				

U.S. government agencies	$	112,863	$	-	$	7,791	$	105,072
U.S. government sponsored agency mortgage backed securities		168,045		27		10,649	$	157,423
States and political subdivisions		45,237		1,240		140		46,337
Corporate bonds		20,747		280		145		20,882
	$	346,892	$	1,547	$	18,725	$	329,714
Held-to-maturity securities								
States and political subdivisions	$	27,839	$	756	$	-	$	28,595

All dollar amounts are reported in thousands except share and per share data.

Certain investments in debt securities are reported in the financial statements at an amount less than their historical cost. Total fair value of these investments at September 30, 2014 and December 31, 2013 was $326,218 and $269,691, respectively, which was 81% and 75%, respectively, of the Corporation s aggregate available-for-sale and held-to-maturity investment portfolio. The Corporation evaluates its investment portfolio on a quarterly basis for impairment. The analysis performed as of September 30, 2014 and December 31, 2013 indicated that all impairment was considered temporary, market driven due primarily to fluctuations in market interest rates and not credit-related.

The following table shows the Corporation s investments gross unrealized losses and fair value of the Corporation s investments with unrealized losses that were not deemed to be other-than-temporarily impaired, aggregated by investment class and length of time that individual securities had been in a continuous unrealized loss position at September 30, 2014 and December 31, 2013 (dollars in thousands):

September 30, 2014	Less than 12 months		12 months or greater		Total	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
Type of security	value	losses	value	losses	value	losses
U.S. government agencies	$ 19,753	$ 80	$ 103,448	$ 4,234	$ 123,201	$ 4,314
U.S. government sponsored agency mortgage						
backed securities	49,915	336	138,648	6,001	188,563	6,337
States and political subdivisions	4,077	38	1,922	19	5,999	57
Corporate bonds	4,956	13	3,499	40	8,455	53
	$ 78,701	$ 467	$ 247,517	$ 10,294	$ 326,218	$ 10,761
December 31, 2013	Less than 12 months		12 months or greater		Total	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
Type of security	value	losses	value	losses	value	losses
U.S. government agencies	$ 100,533	$ 7,330	$ 4,539	$ 461	$ 105,072	$ 7,791
U.S. government sponsored agency mortgage						
backed securities	144,134	10,073	8,698	576	152,832	10,649
States and political subdivisions	2,615	140	-	-	2,615	140
Corporate bonds	8,590	121	582	24	9,172	145
	$ 255,872	$ 17,664	$ 13,819	$ 1,061	$ 269,691	$ 18,725

As shown in the tables above, at September 30, 2014, the Corporation had approximately $10.7 million in unrealized losses on $326 million of securities. The unrealized losses associated with these investment securities are driven by changes in interest rates and the unrealized loss is recorded as a component of equity. These securities will continue to be monitored as a part of our ongoing impairment analysis, but are expected to perform even if the rating agencies reduce the credit rating of the bond issuers. Management evaluates the financial performance of the issuers on a quarterly basis to determine if it is probable that the issuers can make all contractual principal and interest payments. If a shortfall in future cash flows is identified, a credit loss will be deemed to have occurred and will be recognized as a change to earnings and a new cost basis for the security will be established.

The amortized cost and fair value of available-for-sale securities and held-to-maturity securities at September 30, 2014, by contractual maturity, are shown below (dollars in thousands). Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Available-for-sale		Held-to-maturity	
September 30, 2014	Amortized cost	Estimated fair value	Amortized cost	Estimated fair value
Within one year	$ 4,052	$ 4,078	$ 5,136	$ 5,230
One to five years	48,532	48,330	4,459	4,559
Five to ten years	116,692	113,490	14,264	14,536
After ten years	20,681	21,444	-	-
Mortgage-backed securities	197,323	190,990	-	-
Total	$ 387,280	$ 378,332	$ 23,859	$ 24,325

The carrying value of securities pledged as collateral to secure public deposits and for other purposes was $221,246 at September 30, 2014 and $210,494 at December 31, 2013.

The book value of securities sold under agreements to repurchase amounted to $34,973 at September 30, 2014 and $34,978 at December 31, 2013.

The Corporation realized gross gains of $21 and $0 for the three months ending September 30, 2014 and 2013, respectively, and gross gains of $626 and $1,025 for the nine months ending September 30, 2014 and 2013, respectively, resulting from sales of available-for-sale securities. Gross losses of $28 were included in the three months ended September 30, 2014 and $86 were included in the nine months ended September 30, 2014. There were no gross losses in the three month period ended September 30, 2013, however, losses of $196 were included in the nine-month period ended September 30, 2013.

All dollar amounts are reported in thousands except share and per share data.

NOTE 5 LOANS

The following table presents the Corporation s loans by class as of September 30, 2014 and December 31, 2013 (dollars in thousands):

	September 30, 2014	December 31, 2013
Commercial:		
Commercial and industrial	$ 94,537	$ 94,702
Non-farm, nonresidential real estate	165,344	176,213
Construction and development	41,467	29,938
Commercial loans secured by real estate	28,961	26,940
Other commercial	20,400	26,582
Total commercial	350,709	354,375
Residential and Consumer:		
Consumer loans	9,602	10,957
Single family residential	226,994	213,763
Other retail	29,661	27,671
Total residential and consumer	266,257	252,391
	616,966	606,766
Less:		
Allowance for possible loan losses	(8,257)	(8,595)
Total net loans	$ 608,709	$ 598,171

The amount of capitalized fees and costs calculated in accordance with ASC 310-20 included in the above loan totals were $900 and $831 at September 30, 2014 and December 31, 2013, respectively.

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

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

Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. As a general rule, the Corporation avoids financing single-purpose projects unless other underwriting factors are present to help mitigate risk. The Corporation also utilizes third-party experts to provide insight and guidance about economic conditions and trends affecting market areas it serves. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans. At September 30, 2014, approximately sixty-one percent 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.

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 market 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 market 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 upon. When the foreclosed property has been legally assigned to the Corporation, a charge-off is taken with the remaining balance, which reflects 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.

Nonaccrual 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 nonaccrual 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 nonaccrual 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 nonaccrual loans is recognized only to the extent that cash payments are received in excess of principal due. A loan may be returned to accrual status when all the principal and interest amounts contractually due are brought current and future principal and interest amounts contractually due are reasonably assured, which is typically evidenced by a sustained period (three to six months) of repayment performance by the borrower. The Corporation had one loan that was 90 days or more past due that was not included in nonaccrual loans as of September 30, 2014. The amount of this loan at September 30, 2014 was $26. The Corporation had no loans that were 90 days or more past due that were not included in nonaccrual loans as of December 31, 2013.

The following tables provide details regarding the aging of the Corporation s loan portfolio as of September 30, 2014 and December 31, 2013 (dollars in thousands):