KENTUCKY BANCSHARES INC /KY/
Form 10-Q
November 13, 2012
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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, 2012

or

o **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 o

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 (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

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. (Check one):

Large accelerated filer o	Accelerated filer o
Non-accelerated filer x (Do not check if a smaller reporting company)	Smaller reporting company o

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

Number of shares of Common Stock outstanding as of October 31, 2012: 2,719,682.

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Item 1 - Financial Statements

KENTUCKY BANCSHARES, INC.

CONSOLIDATED BALANCE SHEETS (unaudited)

(in thousands)

	9/30/2012	12/31/2011
Assets		
Cash and due from banks	$ 13,606	$ 17,129
Federal funds sold	178	528
Cash and cash equivalents	13,784	17,657
Securities available for sale	182,976	180,419
Mortgage loans held for sale	246	624
Loans	426,517	411,867
Allowance for loan losses	(6,017)	(5,842)
Net loans	420,500	406,025
Federal Home Loan Bank stock	6,731	6,731
Real estate owned, net	6,983	8,296
Bank premises and equipment, net	16,628	16,702
Interest receivable	4,034	4,052
Mortgage servicing rights	1,009	835
Goodwill	13,117	13,117
Other intangible assets	590	765
Other assets	5,838	4,230
Total assets	$ 672,436	$ 659,453
Liabilities and Stockholders Equity		
Deposits		
Non-interest bearing	$ 139,934	$ 130,999
Time deposits, $100,000 and over	85,669	93,127
Other interest bearing	314,978	318,798
Total deposits	540,581	542,924
Repurchase agreements and other borrowings	4,044	4,523
Federal Funds Purchased	1,942	
Federal Home Loan Bank advances	32,918	30,326
Subordinated debentures	7,217	7,217
Interest payable	721	963
Other liabilities	11,310	4,547
Total liabilities	598,733	590,500
Stockholders equity		
Preferred stock, 300,000 shares authorized and unissued		
Common stock, no par value; 10,000,000 shares authorized; 2,719,674 and 2,716,805 shares issued and outstanding on September 30, 2012 and December 31, 2011	12,505	12,448
Retained earnings	55,909	52,735
Accumulated other comprehensive income	5,289	3,770
Total stockholders equity	73,703	68,953

Total liabilities & stockholders equity	$	672,436	$	659,453

See Accompanying Notes

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KENTUCKY BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (unaudited)

(in thousands, except per share amounts)

	Nine Months Ending	
	9/30/2012	9/30/2011
INTEREST INCOME:		
Loans, including fees	$ 17,648	$ 17,959
Securities		
Taxable	1,260	2,105
Tax exempt	2,271	2,313
Other	242	228
Total interest income	21,421	22,605
INTEREST EXPENSE:		
Deposits	1,913	3,145
Repurchase agreements and other borrowings	28	62
Federal Home Loan Bank advances	738	1,020
Subordinated debentures	195	177
Total interest expense	2,874	4,404
Net interest income	18,547	18,201
Loan loss provision	1,600	1,900
Net interest income after provision	16,947	16,301
NON-INTEREST INCOME:		
Service charges	3,481	3,396
Loan service fee income, net	29	70
Trust department income	503	497
Securities available for sale gains	887	490
Gain on sale of mortgage loans	1,473	533
Brokerage Income	169	114
Debit Card Interchange Income	1,394	1,239
Other	130	152
Total other income	8,066	6,491
NON-INTEREST EXPENSE:		
Salaries and employee benefits	9,267	8,914
Occupancy expenses	2,229	2,270
Repossession expenses (net)	1,020	656
FDIC Insurance	433	521
Legal and professional fees	499	601
Data processing	887	752
Debit Card Expenses	658	535
Amortization	175	184
Advertising and marketing	529	538
Taxes other than payroll, property and income	643	583
Telephone	237	346
Postage	225	224
Loan fees	376	123
Other	1,605	1,307
Total other expenses	18,783	17,554
Income before taxes	6,230	5,238

Income taxes		1,136		781
Net income	$	5,094	$	4,457
Other Comprehensive Income, net of tax:				
Change in Unrealized Gains on Securities		1,519		4,711
Comprehensive Income	$	6,613	$	9,168
Earnings per share				
Basic	$	1.88	$	1.65
Diluted		1.88		1.65
Dividends per share		0.69		0.66

See Accompanying Notes

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KENTUCKY BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (unaudited)

(in thousands, except per share amounts)

	Three Months Ending	
	9/30/2012	9/30/2011
INTEREST INCOME:		
Loans, including fees	$ 5,789	$ 6,015
Securities		
Taxable	336	597
Tax exempt	735	784
Other	78	70
Total interest income	6,938	7,466
INTEREST EXPENSE:		
Deposits	591	898
Repurchase agreements and other borrowings	3	19
Federal Home Loan Bank advances	194	324
Subordinated debentures	72	60
Total interest expense	860	1,301
Net interest income	6,078	6,165
Loan loss provision	600	450
Net interest income after provision	5,478	5,715
NON-INTEREST INCOME:		
Service charges	1,198	1,241
Loan service fee income	(54)	(16)
Trust department income	159	146
Securities available for sale gains	616	266
Gain on sale of mortgage loans	625	250
Brokerage Income	48	42
Debit Card Interchange Income	467	420
Other	29	41
Total other income	3,088	2,390
NON-INTEREST EXPENSE:		
Salaries and employee benefits	3,114	3,038
Occupancy expenses	743	759
Repossession expenses (net)	500	362
FDIC Insurance	147	68
Legal and professional fees	127	234
Data processing	277	270
Debit Card Expenses	237	186
Amortization	58	60
Advertising and marketing	177	233
Taxes other than payroll, property and income	215	212
Telephone	79	75
Postage	77	75
Loan fees	165	63
Other	574	358
Total other expenses	6,490	5,993
Income before taxes	2,076	2,112

Income taxes		378		338
Net income	$	1,698	$	1,774
Other Comprehensive Income, net of tax:				
Change in Unrealized Gains on Securities		243		1,610
Comprehensive Income	$	1,941	$	3,384
Earnings per share				
Basic	$	0.63	$	0.67
Diluted		0.63		0.67
Dividends per share		0.23		0.22

See Accompanying Notes

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KENTUCKY BANCSHARES, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY (unaudited)

(in thousands, except share information)

	Common Stock(1) Shares	Common Stock(1) Amount	Retained Earnings	Accumulated Other Comprehensive Income/(Loss)	Total Stockholders Equity
Balances, January 1, 2012	2,716,805	$ 12,448	$ 52,735	$ 3,770	$ 68,953
Common stock issued, including tax benefit, net	5,614	1			1
Stock based compensation expense		69			69
Common stock purchased and retired	(2,745)	(13)	(43)		(56)
Net change in unrealized gain (loss) on securities available for sale, net of tax and reclassifications				1,519	1,519
Net income			5,094		5,094
Dividends declared - $0.69 per share			(1,877)		(1,877)
Balances, September 30, 2012	2,719,674	$ 12,505	$ 55,909	$ 5,289	$ 73,703

(1)Common Stock has no par value; amount includes Additional Paid-in Capital

See Accompanying Notes

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KENTUCKY BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

(in thousands)

	Nine Months Ended	
	9/30/2012	**9/30/2011**
Cash Flows From Operating Activities		
Net Income	$ 5,094	$ 4,457
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,346	1,268
Securities amortization (accretion), net	1,110	142
Stock based compensation expense	69	64
Provision for loan losses	1,600	1,900
Securities gains, net	(887)	(490)
Originations of loans held for sale	(47,196)	(16,936)
Proceeds from sale of loans	49,047	16,507
Gains (losses) on sale of fixed assets	14	(54)
Losses (gains) on other real estate	153	47
Gain on sale of mortgage loans	(1,473)	(533)
Changes in:		
Interest receivable	18	445
Write-downs of other real estate, net	381	156
Other assets	(2,146)	781
Interest payable	(242)	(73)
Other liabilities	5,980	(35)
Net cash from operating activities	12,868	7,646
Cash Flows From Investing Activities		
Purchases of securities	(69,896)	(41,192)
Proceeds from principal payments, sales, maturities and calls of securities	69,418	67,476
Net change in loans	(18,244)	(2,834)
Purchases of bank premises and equipment	(852)	(598)
Proceeds from the sale of bank premises	17	200
Proceeds from the sale of other real estate	3,037	3,157
Net cash from investing activities	(16,520)	26,209
Cash Flows From Financing Activities:		
Net change in deposits	(2,343)	(29,324)
Net change in repurchase agreements and other borrowings	2,063	7,808
Advances from Federal Home Loan Bank	45,000	10,000
Payments on Federal Home Loan Bank advances	(42,408)	(22,374)
Payments on note payable	(600)	(600)
Proceeds from issuance of common stock	1	
Purchase of common stock	(56)	(366)
Dividends paid	(1,878)	(1,804)
Net cash from financing activities	(221)	(36,660)
Net change in cash and cash equivalents	(3,873)	(2,805)
Cash and cash equivalents at beginning of period	17,657	17,625
Cash and cash equivalents at end of period	$ 13,784	$ 14,820
Supplemental disclosures of cash flow information		

Cash paid during the year for:				
Interest expense	$	3,116	$	4,477
Income taxes		600		500
Supplemental disclosures of non-cash investing activities				
Real estate acquired through foreclosure	$	2,257	$	5,301

See Accompanying Notes

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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, 2011.

Basis of Presentation: The consolidated financial statements include the accounts of Kentucky Bancshares, Inc. (the Company , we , our or us), its wholly-owned subsidiary, Kentucky Bank (the Bank), and the Bank s wholly-owned subsidiary, KB Special Assets Unit, LLC. Intercompany transactions and balances have been eliminated in consolidation.

Nature of Operations: The Bank operates under a state bank charter and provides full banking services, including trust services, to customers located in Bourbon, Clark, Elliott, Harrison, Jessamine, Rowan, Scott, Woodford and adjoining counties in Kentucky. As a state bank, the Bank is subject to regulation by the Kentucky Department of Financial Institutions and the Federal Deposit Insurance Corporation (FDIC). The Company, a bank holding company, is regulated by the Federal Reserve.

Estimates in the Financial Statements: 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 at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The allowance for loan losses, mortgage servicing rights, real estate owned, goodwill and fair value of financial instruments are particularly subject to change.

Loss Contingencies: Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. The Company terminated its Defined Benefit Plan (the Plan) effective December 31, 2008. The termination was filed with the Pension Benefit Guaranty Corporation (PBGC) in April 2009. The 60-day PBGC comment period passed without comment from PBGC. Benefits were distributed according to the actuarial calculations in 2009. The Internal Revenue Service (IRS) issued a favorable determination as to the Plan termination in July 2010. Subsequent to termination and distribution, the Plan was selected for audit by the PBGC. The PBGC asserts a plan amendment was applied errantly resulting in lower benefits. A preliminary estimate provided by the Plan actuary indicates the potential exposure related to this matter is $1.3 million. The Company believes it has meritorious defenses and formally rebutted the PBGC assertion in June 2011 requesting a reconsideration of the PBGC conclusion and intends to continue to vigorously defend the position. As such, the Company does not believe a loss is probable and has not recorded a liability relating to the PBGC assertion.

Reclassifications: Some items in the prior year financial statements were reclassified to conform to the current presentation.

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2. SECURITIES AVAILABLE FOR SALE

INVESTMENT SECURITIES

Period-end securities are as follows:

(in thousands)

		Amortized Cost		Gross Unrealized Gains		Gross Unrealized Losses		Fair Value
Available for Sale								
September 30, 2012								
U.S. government agencies	$	22,712	$	67	$		$	22,779
States and political subdivisions		76,370		5,264		(15)		81,619
Mortgage-backed - residential		75,610		2,669		(10)		78,269
Equity securities		270		39				309
Total	$	174,962	$	8,039	$	(25)	$	182,976
December 31, 2011								
U.S. government agencies	$	23,363	$	10	$	(19)	$	23,354
States and political subdivisions		81,697		4,938		(28)		86,607
Mortgage-backed - residential		69,378		786		(9)		70,155
Equity securities		270		33				303
Total	$	174,708	$	5,767	$	(56)	$	180,419

The amortized cost and fair value of securities at September 30, 2012 by contractual maturity are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity are shown separately.

(in thousands)		**Amortized Cost**		**Fair Value**
Due in one year or less	$	4,615	$	4,616
Due after one year through five years		8,251		8,364
Due after five years through ten years		33,341		34,770
Due after ten years		52,875		56,648
		99,082		104,398
Mortgage-backed - residential		75,610		78,269
Equity		270		309
Total	$	174,962	$	182,976

Proceeds from sales of securities during the first nine months of 2012 and 2011 were $31.8 million and $26.1 million. Gross gains of $887 thousand and $490 thousand and gross losses of $0 and $0 thousand were realized on those sales, respectively. The tax provision related to these realized gains and losses was $302 thousand and $167 thousand, respectively.

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Proceeds from sales of securities during the three months ending September 30, 2012 and September 30, 2011 were $15.7 million and $4.9 million. Gross gains of $616 thousand and $266 thousand, respectively, and no gross losses were realized on those sales. The tax provision related to these realized gains was $209 thousand and $90 thousand, respectively.

Securities with unrealized losses at September 30, 2012 and at December 31, 2011 not recognized in income are as follows:

September 30, 2012

	Less than 12 Months		12 Months or More		Total	
Description of Securities	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**
U.S. Government agencies	$	$	$	$	$	$
States and municipals	2,401	(15)			2,401	(15)
Mortgage-backed - residential	4,780	(10)			4,780	(10)
Total temporarily impaired	$ 7,181	$ (25)	$	$	$ 7,181	$ (25)

December 31, 2011

	Less than 12 Months		12 Months or More		Total	
Description of Securities	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**
U.S. Government agencies	$ 10,984	$ (19)	$	$	$ 10,984	$ (19)
States and municipals	2,006	(27)	1,028	(1)	3,034	(28)
Mortgage-backed - residential	3,159	(9)			3,159	(9)
Total temporarily impaired	$ 16,149	$ (55)	$ 1,028	$ (1)	$ 17,177	$ (56)

The Company evaluates securities for other than temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. In analyzing an issuer s financial condition, we may consider many factors including, (1) whether the securities are issued by the federal government or its agencies, (2) whether downgrades by bond rating agencies have occurred, (3) the results of reviews of the issuer s financial condition and near-term prospects, (4) the length of time and the extent to which the fair value has been less than cost, and (5) whether we intend to sell the investment security or more likely than not will be required to sell the investment security before its anticipated recovery.

Unrealized losses on securities included in the tables above have not been recognized into income because (1) all rated securities are investment grade and are of high credit quality, (2) management does not intend to sell and it is more likely than not that management would not be required to sell the securities prior to their anticipated recovery, (3) management believes the decline in fair value is largely due to changes in interest rates and (4) management believes the declines in fair value are temporary. The Company believes the fair value is expected to recover as the securities approach maturity.

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3. LOANS

Loans at period-end are as follows:

(in thousands)

	9/30/12	12/31/11
Commercial	$ 31,627	$ 28,892
Real estate construction	10,370	13,261
Real estate mortgage:		
1-4 family residential	169,477	160,645
Multi-family residential	11,268	13,305
Non-farm & non-residential	112,820	100,047
Agricultural	72,875	77,820
Consumer	17,848	17,572
Other	232	325
Total	$ 426,517	$ 411,867

Activity in the allowance for loan losses for the nine and three month periods indicated was as follows:

	Nine Months Ended September 30, 2012 (in thousands)				
	Beginning Balance	Charge-offs	Recoveries	Provision	Ending Balance
Commercial	$ 192	$	$ 24	$ (60)	$ 156
Real estate Construction	1,008	73	14	(178)	771
Real estate mortgage:					
1-4 family residential	2,257	907	14	871	2,235
Multi-family residential	336	52	1	63	348
Non-farm & non-residential	410	64		278	624
Agricultural	721	15	5	142	853
Consumer	524	296	33	281	542
Other	50	356	247	107	48
Unallocated	344			96	440
	$ 5,842	$ 1,763	$ 338	$ 1,600	$ 6,017

	Three Months Ended September 30, 2012 (in thousands)				
	Beginning Balance	Charge-offs	Recoveries	Provision	Ending Balance
Commercial	$ 198	$	$ 24	$ (66)	$ 156
Real estate Construction	764		14	(7)	771
Real estate mortgage:					
1-4 family residential	2,099	295	6	425	2,235

Multi-family residential	274			74	348
Non-farm & non-residential	698			(74)	624
Agricultural	791		1	61	853
Consumer	535	83	8	82	542
Other	37	102	55	58	48
Unallocated	393			47	440
	$ 5,789	$ 480	$ 108	$ 600	$ 6,017

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Activity in the allowance for loan losses for the nine and three month periods indicated was as follows:

	Nine Months Ended September 30, 2011 (in thousands)				
	Beginning Balance	Charge-offs	Recoveries	Provision	Ending Balance
Commercial	$ 235	$ 36	$ 74	$ (74)	$ 199
Real estate Construction	721	143		171	749
Real estate mortgage:					
1-4 family residential	1,827	442	11	920	2,316
Multi-family residential	148	178	144	149	263
Non-farm & non-residential	889	333	14	70	640
Agricultural	265		14	425	704
Consumer	582	146	17	142	595
Other	58	555	398	173	74
Unallocated	200			(76)	124
	$ 4,925	$ 1,833	$ 672	$ 1,900	$ 5,664

	Three Months Ended September 30, 2011 (in thousands)				
	Beginning Balance	Charge-offs	Recoveries	Provision	Ending Balance
Commercial	$ 205	$ 2	$	$ (4)	$ 199
Real estate Construction	674	19		94	749
Real estate mortgage:					
1-4 family residential	2,303	231	6	238	2,316
Multi-family residential	334	84		13	263
Non-farm & non-residential	696	4		(52)	640
Agricultural	683		2	19	704
Consumer	569	27	6	47	595
Other	26	194	119	123	74
Unallocated	152			(28)	124
	$ 5,642	$ 561	$ 133	$ 450	$ 5,664

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The following tables present the balance in the allowance for loan losses and the recorded investment (excluding accrued interest receivable amounting to $2.9 million as of September 30, 2012 and $2.9 million at December 31, 2011) in loans by portfolio segment and based on impairment method as of September 30, 2012 and December 31 2011:

As of September 30, 2012

(in thousands)

	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Total
Allowance for Loan Losses:			
Commercial	$	$ 156	$ 156
Real estate construction	499	272	771
Real estate mortgage:			
1-4 family residential	112	2,123	2,235
Multi-family residential	102	246	348
Non-farm & non-residential	156	468	624
Agricultural	559	294	853
Consumer		542	542
Other		48	48
Unallocated		440	440
	$ 1,428	$ 4,589	$ 6,017
Loans:			
Commercial	$	$ 31,627	$ 31,627
Real estate construction	3,035	7,335	10,370
Real estate mortgage:			
1-4 family residential	3,917	165,560	169,477
Multi-family residential	471	10,797	11,268
Non-farm & non-residential	4,225	108,595	112,820
Agricultural	6,389	66,486	72,875
Consumer		17,848	17,848
Other		232	232
	$ 18,037	$ 408,480	$ 426,517

As of December 31, 2011

(in thousands)

	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Total
Allowance for Loan Losses:			
Commercial	$	$ 192	$ 192
Real estate construction	703	305	1,008

Real estate mortgage:						
1-4 family residential		325		1,932		2,257
Multi-family residential		52		284		336
Non-farm & non-residential		119		291		410
Agricultural		427		294		721
Consumer				524		524
Other				50		50
Unallocated				344		344
	$	1,626	$	4,216	$	5,842
Loans:						
Commercial	$		$	28,892	$	28,892
Real estate construction		3,975		9,286		13,261
Real estate mortgage:						
1-4 family residential		1,873		158,772		160,645
Multi-family residential		207		13,098		13,305
Non-farm & non-residential		2,667		97,380		100,047
Agricultural		6,416		71,404		77,820
Consumer				17,572		17,572
Other				325		325
	$	15,138	$	396,729	$	411,867

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The following table presents individually impaired average loan balances by class for the nine months periods ended September 30, 2012 and September 30, 2011:

(in thousands)		September 30, 2012 Nine Month Average		September 30, 2011 Nine Month Average
Commercial	$		$	
Real Estate construction		3,325		5,265
Real estate mortgage:				
1-4 family residential		2,950		3,493
Multi-family residential		372		1,488
Non-farm & non-residential		3,691		5,477
Agricultural		6,406		4,565
Consumer				
Other				
Total	$	16,744	$	20,288

The following table presents individually impaired average loan balances by class for the three months periods ended September 30, 2012 and September 30, 2011:

(in thousands)		September 30, 2012 Three Month Average		September 30, 2011 Three Month Average
Commercial	$		$	
Real Estate construction		3,144		4,047
Real estate mortgage:				
1-4 family residential		3,005		2,717
Multi-family residential		406		945
Non-farm & non-residential		3,936		4,846
Agricultural		6,410		5,596
Consumer				
Other				
Total	$	16,901	$	18,151

Interest income and cash-basis interest income recognized during impairment for the nine and three months ending September 30, 2012 and September 30, 2011 is shown below.

(in thousands)		Nine Months Ended September 30, 2012		Three Months Ended September 30, 2012
Commercial	$		$	
Real estate construction		40		
Real estate mortgage:				
1-4 family residential		136		5
Multi-family residential		12		
Non-farm & non-residential		68		23
Agricultural		106		42
Consumer				
Other				
Total	$	362	$	70

	Nine Months Ended September 30, 2011	Three Months Ended September 30, 2011
Commercial	$ 1	$ 1
Real estate construction	93	93
Real estate mortgage:		
1-4 family residential	32	9
Multi-family residential		
Non-farm & non-residential		
Agricultural	111	7
Consumer	4	3
Other		
Total	$ 241	$ 113

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The following table presents loans individually evaluated for impairment by class of loans as of September 30, 2012 (in thousands):

[redacted]

With no related allowance recorded:						
Commercial	$	$	$	$	$	$
Real estate construction				800	40	40
Real estate mortgage:						
1-4 family residential	3,034	3,014		1,844	35	35
Multi-family residential				51	12	12
Non-farm & non-residential	2,759	2,038		2,191	21	21
Agricultural	975	975		1,370	73	73
Consumer						
Other						
With an allowance recorded:						
Commercial						
Real estate construction	3,035	3,035	499	2,525		
Real estate mortgage:						
1-4 family residential	904	904	112	1,106	101	101
Multi-family residential	523	471	102	321		
Non-farm & non-residential	2,186	2,186	156	1,500	47	47
Agricultural	5,414	5,414	559	5,036	33	33
Consumer						
Other						
Total	$ 18,830	$ 18,037	$ 1,428	$ 16,744	$ 362	$ 362

The recorded investment in loans excludes accrued interest receivable and loan origination fees, net due to immateriality. For purposes of this disclosure, the unpaid principal balance is not adjusted for net charge-offs.

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The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2011 (in thousands):

	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Average Recorded Investment	Interest Income Recognized	Cash Basis Interest Recognized
With no related allowance recorded:						
Commercial	$	$	$	$	$ 1	$ 1
Real estate construction	1,600	940		1,732	113	113
Real estate mortgage:						
1-4 family residential	595	595		1,003	39	39
Multi-family residential				493		
Non-farm & non-residential	1,578	1,578		3,908		
Agricultural	1,474	1,474		1,931	123	123
Consumer					5	5
Other						
With an allowance recorded:						
Commercial						
Real estate construction	3,035	3,035	703	3,274		
Real estate mortgage:						
1-4 family residential	1,298	1,278	325	2,167		
Multi-family residential	207	207	52	739		
Non-farm & non-residential	1,089	1,089	119	1,007		
Agricultural	4,942	4,942	427	3,004		
Consumer						
Other						
Total	$ 15,818	$ 15,138	$ 1,626	$ 19,258	$ 281	$ 281

The recorded investment in loans excludes accrued interest receivable and loan origination fees, net due to immateriality. For purposes of this disclosure, the unpaid principal balance is not adjusted for net charge-offs.

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The following tables present the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of September 30, 2012 and December 31, 2011:

As of September 30, 2012

(in thousands)

	Nonaccrual	Loans Past Due Over 90 Days Still Accruing	Troubled Debt Restructurings
Commercial	$ 46	$	$
Real estate construction	3,035		
Real estate mortgage:			
1-4 family residential	1,003	235	508
Multi-family residential	471		
Non-farm & non-residential	1,130		1,936
Agricultural	973	650	4,829
Consumer	32	22	
Total	$ 6,690	$ 907	$ 7,273

As of December 31, 2011

(in thousands)

	Nonaccrual	Loans Past Due Over 90 Days Still Accruing	Troubled Debt Restructurings
Commercial	$	$	$
Real estate construction	1,138		
Real estate mortgage:			
1-4 family residential	2,573	372	519
Multi-family residential	207		
Non-farm & non-residential	1,421		
Agricultural	610		585
Consumer	68	26	
Total	$ 6,017	$ 398	$ 1,104

Nonaccrual loans secured by real estate make up 99.0% of the total nonaccruals at September 30, 2012.

Nonaccrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

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A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. All amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement. Nonaccrual loans are loans for which payments in full of principal or interest is not expected or which principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection. Impaired loans may be loans showing signs of weakness or interruptions in cash flow, but ultimately are current or less than 90 days past due with respect to principal and interest and for which we anticipate full payment of principal and interest.

Additional factors considered by management in determining impairment and non-accrual status include payment status, collateral value, availability of current financial information, and the probability of collecting all contractual principal and interest payments.

During the first nine months of 2012, $2.3 million of impaired loans were transferred to other real estate owned and $1.8 million recorded in charge offs.

The following tables present the aging of the recorded investment in past due and non-accrual loans as of September 30, 2012 and December 31, 2011 by class of loans:

As of September 30, 2012

(in thousands)

	30 59 Days Past Due	60 89 Days Past Due	Loans Past Due Over 90 Days Still Accruing	Non-accrual	Total Past Due & Non-accrual	Loans Not Past Due
Commercial	$ 1,053	$	$	$ 46	$ 1,099	$ 30,528
Real estate construction				3,035	3,035	7,335
Real estate mortgage:						
1-4 family residential	3,011	396	235	1,003	4,645	164,832
Multi-family residential				471	471	10,797
Non-farm & non-residential	1,185	480		1,130	2,795	110,025
Agricultural	537	33	650	973	2,193	70,682
Consumer	235	12	22	32	301	17,547
Other						232
Total	$ 6,021	$ 921	$ 907	$ 6,690	$ 14,539	$ 411,978

As of December 31, 2011

(in thousands)

	30 59 Days Past Due	60 89 Days Past Due	Loans Past Due Over 90 Days Still Accruing	Non-accrual	Total Past Due & Non-accrual	Loans Not Past Due
Commercial	$ 71	$	$	$	$ 71	$ 28,821
Real estate construction				1,138	1,138	12,123
Real estate mortgage:						
1-4 family residential	1,859	232	372	2,573	5,036	155,609
Multi-family residential	164			207	371	12,934
Non-farm & non-residential	153			1,421	1,574	98,473
Agricultural	468	35		610	1,113	76,707
Consumer	130	38	26	68	262	17,310
Other						324
Total	$ 2,845	$ 305	$ 398	$ 6,017	$ 9,565	$ 402,301

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Troubled Debt Restructurings:

The Company has allocated $689 thousand in specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of September 30, 2012. No specific reserves were allocated to customers whose loan terms had been modified in troubled debt restructuring as of December 31, 2011. The Company has not committed to lend additional amounts as of September 30, 2012 and December 31, 2011 to customers with outstanding loans that are classified as troubled debt restructurings.

Two loans were modified as troubled debt restructurings during the nine months and three months ending September 30, 2012 and two additional notes were modified prior to January 1, 2012. The modification of the terms of such loans were to interest only payments for a 1 year term and lower interest rates.

The following table presents loans by class modified as troubled debt restructurings outstanding as of September 30, 2012:

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings:			
Real estate mortgage:			
1-4 family residential	1	$ 474	$ 508
Agricultural	1	4,847	4,829
Non-Farm & non-residential	1	1,926	1,936
Total	3	$ 7,247	$ 7,273

The troubled debt restructurings described above increased the allowance for loan losses by $270 thousand and resulted in charge offs of $0 during the nine month period ending September 30, 2012. The post-modification balances increased primarily for amounts advanced to pay interest and taxes. Loans past due 60 days are normally considered in default. No loans modified in the last 12 months are in default.

No other loans were modified during the nine months and three months ending September 30, 2012 that did not meet the definition of a troubled debt restructuring.

Credit Quality Indicators:

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. This analysis is performed on a quarterly basis. The Company uses the following definitions for risk ratings:

Special Mention. Loans classified as special mention have a potential weakness that deserves management s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution s credit position at some future date.

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Substandard. Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

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

As of September 30, 2012 and December 31, 2011, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

As of September 30, 2012

(in thousands)

	Pass	Special Mention	Substandard	Doubtful
Commercial	$ 29,852	$ 1,414	$ 360	$
Real estate construction	4,409	2,485	3,477	
Real estate mortgage:				
1-4 family residential	150,280	9,620	9,551	26
Multi-family residential	9,020	1,690	560	
Non-farm & non-residential	98,935	9,098	4,786	
Agricultural	60,881	4,016	7,975	2
Total	$ 353,377	$ 28,323	$ 26,709	$ 28

As of December 31, 2011

(in thousands)

	Pass	Special Mention	Substandard	Doubtful
Commercial	$ 27,294	$ 1,342	$ 256	$
Real estate construction	6,957	2,017	4,287	
Real estate mortgage:				
1-4 family residential	141,403	9,603	9,613	26
Multi-family residential	9,871	2,965	469	
Non-farm & non-residential	91,957	5,317	2,773	
Agricultural	63,391	6,663	7,751	15

Total	$ 340,873	$ 27,907	$ 25,149	$ 41

For consumer loans, the Company evaluates the credit quality based on the aging of the recorded investment in loans, which was previously presented. Non-performing consumer loans are loans which are greater than 90 days past due or on non-accrual status, and total $54 thousand at September 30, 2012 and $94 thousand at December 31, 2011.

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4. REAL ESTATE OWNED

Activity in real estate owned was as follows:

	Nine Months Ended 2012	2011
	(in thousands)	
Beginning of year	$ 8,296	$ 8,424
Additions	2,257	5,301
Sales	(3,565)	(3,815)
Additions to valuation allowance, net	(381)	(156)
Recovery from sale in valuation allowance	376	514
End of period	$ 6,983	$ 10,268

Activity in the valuation allowance was as follows:

	Nine Months Ended 2012	2011
	(in thousands)	
Beginning of year	$ 1,332	$ 799
Additions charged to expense, net	381	156
Recovery from sale	(376)	(514)
End of period	$ 1,337	$ 441

Expenses related to foreclosed assets include:

	Nine Months Ended 2012	2011
	(in thousands)	
Net loss (gain) on sales	$ 153	$ 47
Provision for unrealized losses, net	381	156
Operating expenses (receipts), net of rental income	639	500
End of period	$ 1,173	$ 703

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5. 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 (in thousands) 2012		2011	
Basic Earnings Per Share				
Net Income	$	5,094	$	4,457
Weighted average common shares outstanding		2,706		2,709
Basic earnings per share	$	1.88	$	1.65
Diluted Earnings Per Share				
Net Income	$	5,094	$	4,457
Weighted average common shares outstanding		2,706		2,709
Add dilutive effects of assumed vesting of stock grants		1		1
Weighted average common and dilutive potential common shares outstanding		2,707		2,710
Diluted earnings per share	$	1.88	$	1.65

	Three Months Ended September 30 (in thousands) 2012		2011	
Basic Earnings Per Share				
Net Income	$	1,698	$	1,774
Weighted average common shares outstanding		2,706		2,709
Basic earnings per share	$	0.63	$	0.67
Diluted Earnings Per Share				
Net Income	$	1,698	$	1,774
Weighted average common shares outstanding		2,706		2,709
Add dilutive effects of assumed vesting of stock grants		1		1
Weighted average common and dilutive potential common shares outstanding		2,707		2,710
Diluted earnings per share	$	0.63	$	0.67

Stock options for 29,160 shares of common stock for the nine and three months ended September 30, 2012 and 30,660 shares of common stock for the nine and three months ended September 30, 2011 were excluded from diluted earnings per share because their impact was antidilutive. Restricted stock grants of 14,154 shares of common stock for the nine and three months ended September 30, 2012 and 23,610 shares of common stock for the nine and three months ended September 30, 2011 were excluded from diluted earnings per share because their impact was antidilutive.

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6. STOCK COMPENSATION

We have four share based compensation plans as described below.

Two Stock Option Plans

Under our now expired 1999 Employee Stock Option Plan (the 1999 Plan), we granted certain officers and key employees stock option awards which vest and become fully exercisable at the end of five years and provide for issuance of up to 100,000 options. Under the now expired 1993 Non-Employee Directors Stock Ownership Incentive Plan (together with the 1999 Plan, the Stock Option Plans), we also granted certain directors stock option awards which vest and become fully exercisable immediately and provide for issuance of up to 20,000 options. For each Stock Option Plan, the exercise price of each option, which has a ten year life, was equal to the market price of our stock on the date of grant.

The combined summary of activity for 2012 in the expired Stock Option Plans follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding, beginning of year	30,660	$ 29.68		
Granted				
Forfeited or expired	(1,500)	26.47		
Exercised				
Outstanding, end of period	29,160	$ 29.86	20.1 months	$
Vested and expected to vest	29,160	$ 29.86	20.1 months	$
Exercisable, end of period	29,160	$ 29.86	20.1 months	$

As of September 30, 2012, there was $0 of total unrecognized compensation cost related to nonvested stock options granted under either Stock Option Plan. Since both Stock Option Plans have expired, as of September 30, 2012 no additional options can be granted under either of these plans.

2005 Restricted Stock Grant Plan

On May 10, 2005, our stockholders approved a restricted stock grant plan. Total shares issuable under the plan are 50,000. There were 5,615 shares issued during 2012 and 5,955 shares issued during 2011. There were 30 shares forfeited during the first nine months of 2012 and 295 shares forfeited during the first nine months of 2011. As of September 30, 2012, the restricted stock grant plan allows for additional restricted stock share awards of up to 18,310 shares.

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A summary of changes in the Company s nonvested shares for the year follows:

Nonvested Shares	Shares		Weighted-Average Grant-Date Fair Value		Fair Value Per Share
Nonvested at January 1, 2012	13,434	$	253,366	$	18.86
Granted	5,615		106,741		19.01
Vested	(4,280)		(91,879)		21.47
Forfeited	(30)		(570)		19.00
Nonvested at September 30, 2012	14,739	$	267,658	$	18.16

As of September 30, 2012, there was $222,312 of total unrecognized compensation cost related to nonvested shares granted under the restricted stock grant plan. The cost is expected to be recognized over a weighted-average period of 5 years.

2009 Stock Award Plan

On May 13, 2009, our stockholders approved a stock award plan that provides for the granting of both incentive and nonqualified stock options and other share based awards. Total shares issuable under the plan are 150,000. As of September 30, 2012 no awards have been granted under the plan and 150,000 shares are still available.

7. OTHER BORROWINGS

Promissory note payable of $700,000 at September 30, 2012 and $1,300,000 at December 31, 2011, matures July 28, 2013, and has principal due at maturity and interest payable quarterly at prime, and is secured by 100% of the common stock of the bank.

8. FAIR VALUE MEASUREMENTS

ASC Topic 820, *Fair Value Measurements and Disclosures* , defines fair value, establishes a framework for measuring fair value, and sets forth disclosures about fair value measurements. ASC Topic 825, *Financial Instruments* , allows entities to choose to measure certain financial assets and liabilities at fair value. The Company has not elected the fair value option for any financial assets or liabilities.

ASC Topic 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. This Topic describes three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2 Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

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Level 3 Significant unobservable inputs that reflect a company s own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Company used the following methods and significant assumptions to estimate the fair value:

Investment Securities: The fair values for available for sale investment securities are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3).

Impaired Loans: The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent third party real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Other Real Estate Owned: The fair value of certain commercial and residential real estate properties classified as other real estate owned (OREO) are generally based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

Mortgage Servicing Rights: Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively based on a valuation model that calculates the present value of estimated future net servicing income, resulting in a Level 3 classification.

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Assets and Liabilities Measured on a Recurring Basis

Available for sale investment securities are the Company s only balance sheet item that meet the disclosure requirements for instruments measured at fair value on a recurring basis. Disclosures are as follows in the tables below.

			Fair Value Measurements at September 30, 2012 Using:					
(In thousands) Description		Fair Value		Quoted Prices In Active Markets for Identical Assets (Level 1)		Significant Other Observable Inputs (Level 2)		Significant Unobservable Inputs (Level 3)
U. S. government agencies	$	22,779	$		$	22,779	$	
States and municipals		81,619				81,619		
Mortgage-backed - residential		78,269				78,269		
Equity securities		309		309				
Total	$	182,976	$	309	$	182,667	$	

			Fair Value Measurements at December 31, 2011 Using:					
(In thousands) Description		Fair Value		Quoted Prices In Active Markets for Identical Assets (Level 1)		Significant Other Observable Inputs (Level 2)		Significant Unobservable Inputs (Level 3)
U. S. government agencies	$	23,354	$		$	23,354	$	
States and municipals		86,607				86,607		
Mortgage-backed - residential		70,155				70,155		
Equity securities		303		303				
Total	$	180,419	$	303	$	180,116	$	

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Assets measured at fair value on a non-recurring basis are summarized below:

(In thousands) Description	Fair Value	Fair Value Measurements at September 30, 2012 Using: Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Other Significant Unobservable Inputs (Level 3)
Impaired loans:				
Real estate construction	$ 2,535	$	$	$ 2,535
Real Estate Mortgage:				
1-4 family residential	792			792
Multi-family residential	369			369
Non-farm & non-residential	2,031			2,031
Agricultural	4,855			4,855
Other real estate owned:				
Residential	4,630			4,630
Loan servicing rights	517			517

(In thousands) Description	Fair Value	Fair Value Measurements at December 31, 2011 Using: Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Other Significant Unobservable Inputs (Level 3)
Impaired loans:				
Real estate construction	$ 2,332	$	$	$ 2,332
Real Estate Mortgage:				
1-4 family residential	953			953
Multi-family residential	155			155
Non-farm & non-residential	970			970
Agricultural	4,515			4,515
Other real estate owned:				
Residential	5,542			5,542
Commercial real estate	42			42
Loan servicing rights	380			380

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Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of $10.6 million, which includes a valuation allowance of $1.4 million at September 30, 2012. The allowance for specific impaired loans decreased $198 thousand for the nine months ending September 30, 2012 and increased $28 thousand for the three months ending September 30, 2012. The loan loss provision for the nine months ending September 30, 2012 is $1.6 million and $600 thousand for the three months ending September 30, 2012. The loan loss provision for the nine months ending September 30, 2011 was $1.9 million and $450 thousand for the three months ending September 30, 2011.

Other real estate owned which is measured at fair value less costs to sell, had a net carrying amount of $4.6 million, which is made up of the outstanding balance of $5.9 million, net of a valuation allowance of $1.3 million at September 30, 2012. The net write-downs of Other Real Estate Owned properties totaled $381 thousand for the nine months ending September 30, 2012. The net write-down consists of $442 thousand in write downs and $61 thousand in the recovery of a prior write-down. Write-downs of Other Real Estate Owned properties totaled $362 thousand for the three months ending September 30, 2012. The write-down of Other Real Estate Owned properties totaled $156 thousand for the nine months ending September 30, 2011 and $88 thousand for the three months ending September 30, 2011.

Loan servicing rights, which are carried at lower of cost or fair value, were carried at their fair value of $517 thousand, which is made up of the outstanding balance of $795 thousand, net of a valuation allowance of $278 thousand at September 30, 2012, resulting in a net write-down of $29 thousand for the nine months ending September 30, 2012 and a write-down of $69 thousand for the three months ending September 30, 2012. The valuation adjustment to the loan servicing rights was a recovery of $8 thousand for the nine months ending September 30, 2011 and a write-down of $33 thousand for the three months ending September 30, 2011. At December 31, 2011, loan servicing rights were carried at their fair value of $380 thousand, which is made up of the outstanding balance of $630 thousand, net of a valuation allowance of $250 thousand at December 31, 2011.

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The following table presents quantitative information about level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at September 30, 2012:

(In thousands)		Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted Average)
Impaired loans					
Real estate construction	$	2,535	sales comparison	adjustment for differences between the comparable sales	23%-30% (27%)
Real estate mortgage:					
1-4 family residential		349	sales comparison	adjustment for differences between the comparable sales	0%-44% (10%)
Multi-family residential		369	sales comparison	adjustment for differences between the comparable sales	2%-23% (14%)
Non-farm & non-residential		243	sales comparison	adjustment for differences between the comparable sales	7%-11% (9%)
Other real estate owned:					
Residential		4,630	sales comparison	adjustment for differences between the comparable sales	1%-70% (10%)
			income approach	capitalization rate	8%-10% (8%)
Loan Servicing Rights		517	discounted cash flow	constant prepayment rates	3%-41% (20%)

Fair Value of Financial Instruments

The carrying amounts and estimated fair values of financial instruments, at September 30, 2012 and December 31, 2011 are as follows:

Fair Value Measurements at

September 30, 2012 Using:

(in thousands)		Carrying Value		Level 1		Level 2		Level 3		Total
Financial assets										
Cash and cash equivalents	$	13,784	$	13,784	$		$		$	13,784
Securities		182,976		309		182,667				182,976
Mortgage loans held for sale		246				246				246
Loans, net		420,500						419,161		419,161

FHLB Stock	6,731				N/A
Interest receivable	4,034		1,158	2,876	4,034
Financial liabilities					
Deposits	$ 540,581	$ 355,487	$ 188,176	$	$ 543,663
Securities sold under agreements to repurchase and other borrowings	4,044		4,046		4,046
Federal Funds Purchased	1,942	1,942			1,942
FHLB advances	32,918		34,340		34,340
Subordinated Debentures	7,217			7,626	7,626
Interest payable	721		704	17	721

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December 31, 2011:

	December 31, 2011	
	Carrying Amount	Fair Value
Financial assets		
Cash and cash equivalents	$ 17,657	$ 17,657
Securities	180,419	180,419
Mortgage loans held for sale	624	624
Loans, net	406,025	407,872
FHLB stock	6,731	N/A
Interest receivable	4,052	4,052
Financial liabilities		
Deposits	$ 542,924	$ 545,467
Securities sold under agreements to repurchase and other borrowings	4,523	4,523
FHLB advances	30,326	32,227
Subordinated debentures	7,217	6,339
Interest payable	963	963

The methods and assumptions, not previously presented, used to estimate fair values are described as follows:

Cash and Cash Equivalents - The carrying amounts of cash and short-term instruments approximate fair values and are classified as Level 1.

FHLB Stock - It is not practical to determine the fair value of FHLB stock due to restrictions placed on its transferability.

Loans - Fair values of loans, excluding loans held for sale, are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

The fair value of loans held for sale is estimated based upon binding contracts and quotes from third party investors resulting in a Level 2 classification.

Deposits - The fair values disclosed for demand deposits (e.g., interest and non-interest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amount) resulting in a Level 1 classification. The carrying amounts of variable rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date resulting in a Level 1 classification. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

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Securities Sold Under Agreements to Repurchase and Other Borrowings - The carrying amounts of borrowings under repurchase agreements approximate their fair values resulting in a Level 2 classification.

The carrying amount of the Company s variable rate borrowings approximate their fair values resulting in a Level 2 classification.

Federal Funds Purchased - The carrying amounts of federal funds purchased approximate fair values and are classified as Level 1.

FHLB Advances and Subordinated Debentures - The fair values of the Company s FHLB advances are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 2 classification.

The fair values of the Company s Subordinated Debentures are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 3 classification.

Accrued Interest Receivable/Payable - The carrying amounts of accrued interest approximate fair value resulting in a Level 2 or Level 3 classification based on the level of the related asset/liability.

Off-balance Sheet Instruments - Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties credit standing. The fair value of off-balance sheet instruments is not material.

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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. These statements are not historical facts, but rather statements based on our current expectations regarding our business strategies and their intended results and our future performance. Forward-looking statements are preceded by terms such as expects, believes, anticipates, intends and similar expressions.

Although we believe 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 (both generally and more specifically in the markets, including the tobacco market and the thoroughbred horse industry, in which we and our bank operate); competition for our subsidiary s customers from other providers of financial and mortgage services; government legislation, regulation and monetary policy (which changes from time to time and over which we have 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 our subsidiary s customers; adequacy of the allowance for losses on loans and the level of future provisions for losses on loans; and other risks detailed in our filings with the Securities and Exchange Commission, all of which are difficult to predict and many of which are beyond our control.

You are cautioned not to place undue reliance on any forward-looking statements made by us or on our behalf. We undertake no obligation to republish revised forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Summary

The Company recorded net income of $5.1 million, or $1.88 basic earnings and diluted earnings per share for the first nine months ending September 30, 2012 compared to $4.5 million or $1.65 basic earnings and diluted earnings per share for the nine month period ending September 30, 2011. The first nine months earnings reflects an increase of 14.3% compared to the same time period in 2011, due primarily to an increase in the gain on sold mortgage loans of $940 thousand, an increase of $397 thousand in gains on sold securities, an increase in net interest income of $346 thousand and a decrease of $300 thousand in the provision for loan losses. These positive changes to net income during 2012 were partially offset by an increase of $353 thousand in employee salaries and benefits, an increase of $364 thousand in repossession expenses and an increase of $253 thousand in loan fees. The earnings for the three months ending September 30, 2012 were $1.7 million, or $0.63 basic and diluted earnings per share compared to $1.8 million or $0.67 basic and diluted earnings per share for the three month period ending September 30, 2011. The earnings for the three month period in 2012 reflect a 4.3% decrease compared to the same time period in 2011.

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Return on average assets was 1.00% for the nine months ended September 30, 2012 and 0.91% for the nine month period ended September 30, 2011. Return on average assets was 1.00% for the three months ended September 30, 2012 and 1.09% for the three months ended September 30, 2011. Return on average equity was 9.5% for the nine month period ended September 30, 2012 and 9.3% for the same period in 2011. Return on average equity was 9.3% for the three months ended September 30, 2012 and 10.7% for the same time period in 2011. Gross Loans increased $14.6 million from $411.9 million on December 31, 2011 to $426.5 million on September 30, 2012. The overall increase is attributed mostly to an increase of $12.8 million in non-farm and non-residential real estate loans, an increase of $8.8 million in 1-4 family residential real estate loans and an increase of $2.7 million in commercial loans. Decreases in the loan portfolio from December 31, 2011 to September 30, 2012 included a decrease of $4.9 million in agricultural loans, a decrease of $2.9 million in real estate construction loans and a decrease of $2.0 million in multi-family residential real estate loans.

Total deposits decreased from $542.9 million on December 31, 2011 to $540.6 million on September 30, 2012, a decrease of $2.3 million. Non-interest bearing demand deposit accounts increased $8.9 million from December 31, 2011 to September 30, 2012. This increase is not all attributable to additional deposits being placed with the bank. Part of the increase is from deposit accounts changing from time deposits to non-interest bearing demand deposit accounts. Time deposits $100 thousand and over decreased $7.5 million and other interest bearing deposit accounts decreased $3.8 million.

Net Interest Income

Net interest income is the difference between interest income earned on interest-earning assets and the interest expense paid on interest-bearing liabilities.

Net interest income was $18.5 million for the nine months ended September 30, 2012 compared to $18.2 million for the nine months ended September 30, 2011, an increase of 1.9%. The interest spread of 3.97% for the first nine months of 2012 is down from 4.06% reported for the same period in 2011, a decrease of 9 basis points. Rates have remained fairly low in the past year. For the first nine months ending September 30, 2012, the cost of total deposits was 0.46% compared to 0.79% for the same time period in 2011. Increasing non-interest bearing deposit accounts and lower rates on certificates of deposit accounts have helped to lower the cost of deposits. Net interest income was $6.1 million for the three months ending September 30, 2012 compared to $6.2 million for the three months ending September 30, 2011, a decrease of 1.4%. The interest spread was 3.91% for the three month period ending September 30, 2012 compared to 4.15% for the three month period in 2011, a decrease of 24 basis points.

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For the first nine months, the yield on assets decreased from 5.06% in 2011 to 4.60% in 2012. The yield on loans decreased 23 basis points in the first nine months of 2012 compared to 2011 from 5.87% to 5.64%. The yield on securities decreased 78 basis points in the first nine months of 2012 compared to 2011 from 3.46% in 2011 to 2.68% in 2012. The cost of liabilities decreased from 1.00% in 2011 to 0.62% in 2012. Year to date average loans increased $7.8 million, or 1.9% from September 30, 2011 to September 30, 2012. Loan interest income decreased $311 thousand for the first nine months of 2012 compared to the first nine months of 2011. Year to date average deposits increased from September 30, 2011 to September 30, 2012, up $23.4 million or 4.4%. The increase is largely attributed to an increase in public funds. Year to date average interest bearing deposits increased $10.3 million, or 2.5%, from September 30, 2011 to September 30, 2012. Deposit interest expense has decreased $1.2 million for the first nine months of 2012 compared to the same period in 2011. Year to date average borrowings decreased $9.1 million, or 17.4% from September 30, 2011 to September 30, 2012. The decrease is mostly attributed to paying off FHLB advances as they mature. Interest expense on borrowed funds has decreased $298 thousand for the first nine months of 2012 compared to the same period in 2011.

The volume rate analysis for the nine months ending September 30, 2012 that follows indicates that $1.8 million of the decrease in interest income is attributable to a decrease in interest rates, while the change in volume contributed to an increase of $636 thousand in interest income. Even more affected by volume and rate changes was the liability side of the balance sheet. The average rate of the Company s total outstanding deposits and borrowing liabilities decreased from 1.00% in 2011 to 0.62% in 2012. Based on the volume rate analysis that follows, the lower level of interest rates contributed to a decrease of $1.2 million in interest expense, while the change in volume was responsible for a $327 thousand decrease in interest expense. As a result, the increase in net interest income for the first nine months in 2012 is mostly attributed to increases in volume in the loan and security portfolios and reduced rates on deposits.

The accompanying analysis of changes in net interest income in the following table shows the relationships of the volume and rate portions of these changes in 2012. Changes in interest income and expenses due to both rate and volume are allocated on a pro rata basis.

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Changes in Interest Income and Expense

(in thousands)	Nine Months Ending 2012 vs. 2011 Increase (Decrease) Due to Change in Volume	Rate	Net Change
INTEREST INCOME			
Loans	$ 486	$ (797)	$ (311)
Investment Securities	131	(1,022)	(891)
Other	19	(1)	18
Total Interest Income	636	(1,820)	(1,184)
INTEREST EXPENSE			
Deposits			
Demand	141	(347)	(206)
Savings	13	(14)	(1)
Negotiable Certificates of Deposit and Other Time Deposits	(261)	(764)	(1,025)
Securities sold under agreements to repurchase and other borrowings	(47)	31	(16)
Federal Home Loan			
Bank advances	(173)	(109)	(282)
Total Interest Expense	(327)	(1,203)	(1,530)
Net Interest Income	$ 963	$ (617)	$ 346

Non-Interest Income

Non-interest income increased $1.6 million for the nine months ended September 30, 2012, compared to the same period in 2011, to $8.1 million. The increase was due primarily to an increase of $940 thousand in gains recognized on sold mortgage loans, an increase of $397 thousand in gains recognized on sold securities and an increase of $155 thousand in debit card interchange income. Increases to non-interest income for the first nine months of 2012 compared to the first nine months of 2011 also included an increase of $85 thousand in service charges and an increase of $55 thousand in brokerage fee income. Non-interest income increased $698 thousand for the three months ended September 30, 2012 compared to the three months ended September 30, 2011. The increase was mostly the result of an increase of $375 thousand in gains recognized on the sale of mortgage loans and an increase of $350 thousand in gains recognized on sold securities. Increases to non-interest income for the three month period ending September 30, 2012 compared to the three months ending September 30, 2011 also included an increase of $47 thousand in debit card interchange income, a decrease of $43 thousand in service charges and a decrease of $38 thousand in loan service fee income.

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The gain on the sale of mortgage loans increased from $533 thousand in the first nine months of 2011 to $1.5 million during the first nine months of 2012, an increase of $940 thousand. For the three months ending September 30, 2012 compared to the same time period in 2011, the gain on the sale of mortgage loans increased $375 thousand. The volume of loans originated to sell during the first nine months of 2012 increased $30.3 million compared to the same time period in 2011. 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. Loan service fee income, net of amortization expense, was $29 thousand for the nine months ending September 30, 2012 compared to $70 thousand for the nine months ending September 30, 2011, a decrease of $41 thousand. For the three month period ending September 30, 2012, loan service fee income, net of amortization expense, was a loss of $54 thousand compared to a loss of $16 thousand for the same time period one year ago. During the first nine months of 2012, the carrying value of the mortgage servicing right was written down a net amount of $29 thousand, as the fair value of this asset decreased. Of this, a positive adjustment of $63 thousand was recorded in the first quarter of 2012, a write-down of $23 thousand was recorded during the second quarter of 2012 and a write-down in the amount of $69 thousand was recorded during the third quarter of 2012. For the nine months ending September 30, 2011, the carrying value of the mortgage servicing right had a positive valuation adjustment in the amount of $8 thousand. Of this, a positive adjustment of $20 thousand was recorded in the first quarter of 2011, a positive adjustment of $21 thousand was recorded in the second quarter of 2011 and a write-down of $33 thousand was recorded during the third quarter of 2011.

Non-Interest Expense

Total non-interest expenses increased $1.2 million for the nine month period ended September 30, 2012 compared to the same period in 2011. For the three month period ended September 30, 2012 compared to the three months ending September 30, 2011, total non-interest expense increased $497 thousand.

For the comparable nine month periods, salaries and benefits increased $353 thousand, an increase of 4.0%. The increase is attributed largely to additional employees being hired throughout 2011 and 2012 and normal pay increases at the beginning of 2012. The number of full time equivalent employees at September 30, 2012 was 202 compared to 193 one year ago and 184 at December 31, 2011. Salaries and employee benefits increased $76 thousand for the three month period ending September 30, 2012 compared to the same time period in 2011.

Occupancy expenses decreased $41 thousand to $2.2 million for the first nine months of 2012 compared to the same time period in 2011. Occupancy expenses decreased $16 thousand for the three month period ended September 30, 2012 compared to the same time period in 2011.

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Legal and professional fees decreased $102 thousand for the first nine months ended September 30, 2012 compared to the same time period in 2011. Legal and professional fees decreased $107 thousand for the three month period ending September 30, 2012 compared to the same time period in 2011. Repossession expenses increased $364 thousand for the first nine months ending September 30, 2012 compared to the same time period in 2011 and increased $138 thousand for the three months period ending September 30, 2012 compared to the same period one year ago. Repossession expenses are reported net of rental income earned on the repossessed properties. Repossession expenses were higher during the first nine months of 2012 when compared to the same time period in 2011 due to maintaining additional other real estate owned properties in 2012. In addition, the rents earned on other real estate properties, including new property added, decreased $153 thousand to $262 thousand for the nine months ending September 30, 2012 compared to the same period last year. FDIC insurance expense decreased $88 thousand for the nine months ending September 30, 2012 and $79 thousand for the three months ending September 30, 2012, compared to the same time period in 2011. The decrease is mostly attributed to a change in the calculation the FDIC uses to assess insurance premiums.

Income Taxes

The effective tax rate for the nine months ended September 30, 2012 was 18.2% compared to 14.9% in 2011. The effective tax rate for the three months ended September 30, 2012 was 18.2% compared to 16.0% for the three months ended September 30, 2011. These rates are less than the statutory rate as a result of the tax-free securities and loans and tax credits generated by certain investments held by the Company. The rates for 2012 are higher due to the higher level of income for 2012. Tax-exempt interest income decreased $61 thousand for the first nine months of 2012 compared to the first nine months of 2011.

As part of normal business, the Bank typically makes tax free loans to select municipalities in our market and invests in selected tax free securities, primarily in the Commonwealth of Kentucky. In making these investments, the Company considers the overall impact to managing our net interest margin, credit worthiness of the underlying issuer and the favorable impact on our tax position. For the nine months ended September 30, 2012, the Company averaged $77.7 million in tax free securities and $17.0 million in tax free loans. As of September 30, 2012, the weighted average remaining maturity for the tax free securities is 137 months, while the weighted average remaining maturity for the tax free loans is 146 months.

Liquidity and Funding

Liquidity is the ability to meet current and future financial obligations. The Company s primary sources of funds consist of deposit inflows, loan repayments, maturities and sales of investment securities and FHLB borrowings.

Liquidity risk is the possibility that we may not be able to meet our 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 $13.8 million as of September 30, 2012 compared to $17.7 million at December 31, 2011. The decrease in cash and cash equivalents is attributed to a decrease of $3.5 million in cash and due from banks and a decrease of $350 thousand in federal funds sold. In addition to cash and cash equivalents, the securities portfolio provides an important source of liquidity. Securities available for sale totaled $183.0 million at September 30, 2012 compared to $180.4 million at December 31, 2011. The available for sale securities are available to meet liquidity needs on a continuing basis. However, we expect our customers deposits to be adequate to meet our funding demands.

Generally, we rely upon net cash inflows from financing activities, supplemented by net cash inflows from operating activities, to provide cash used in our 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. Our primary investing activities include purchasing investment securities and loan originations.

For the first nine months of 2012, deposits decreased $2.3 million. The Company s investment portfolio increased $2.6 million and the Company s loan portfolio increased $14.7 million. The borrowed funds the Company have with the FHLB increased $2.6 million. The Company paid down FHLB advances by $42.4 million during the first nine months of 2012 but replaced some of those maturing advances with new short-term borrowings. Federal Funds purchased increased $1.9 million from $0 at December 31, 2011 to $1.9 million at September 30, 2012.

The Company has a promissory note payable that matures July 28, 2013, and has principal due at maturity and interest payable quarterly at prime, and is secured by 100% of the common stock of the Bank. The loan agreement contains certain covenants and performance terms. The Bank was in compliance with the non-performing asset covenant at September 30, 2012.

Management is aware of the challenge of funding sustained loan growth. Therefore, in addition to deposits, other sources of funds, such as FHLB advances, may be used. We rely 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, 2012, we have sufficient collateral to borrow an additional $58 million from the FHLB. In addition, as of September 30, 2012, $22 million is available in overnight borrowing through various correspondent banks and the Company has access to $229 million in brokered deposits. In light of this, management believes there is sufficient liquidity to meet all reasonable borrower, depositor and creditor needs in the present economic environment.

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Capital Requirements

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company s financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company s and the Bank s assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company and Bank capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the following table) of Total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital to average assets (as defined). Management believes, as of September 30, 2012 and December 31, 2011, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

The most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum Total risk-based, Tier I risk-based and Tier I leverage ratios as set forth in the following table. There are no conditions or events since that notification that management believes have changed the institution s category.

The Company s and the Bank s actual amounts and ratios are presented in the table below:

[redacted]

September 30, 2012									
Consolidated									
Total Capital (to Risk-Weighted Assets)	$	67,329	14.5%	$	37,086	8%	$	N/A	N/A
Tier I Capital (to Risk-Weighted Assets)		61,512	13.3		18,543	4		N/A	N/A
Tier I Capital (to Average Assets)		61,513	9.4		26,311	4		N/A	N/A
Bank Only									
Total Capital (to Risk-Weighted Assets)	$	67,216	14.5%	$	37,084	8%	$	46,356	10%
Tier I Capital (to Risk-Weighted Assets)		61,400	13.3		18,542	4		27,813	6
Tier I Capital (to Average Assets)		61,400	9.3		26,301	4		32,877	5
December 31, 2011									
Consolidated									
Total Capital (to Risk-Weighted Assets)	$	64,279	14.0%	$	36,718	8%		N/A	N/A
Tier I Capital (to Risk-Weighted Assets)		58,525	12.8		18,359	4		N/A	N/A

Tier I Capital (to Average Assets)		58,525	9.2		25,414	4		N/A	N/A
Bank Only									
Total Capital (to Risk-Weighted Assets)	$	65,229	14.2%	$	36,705	8%	$	45,882	10%
Tier I Capital (to Risk-Weighted Assets)		59,476	13.0		18,353	4		27,529	6
Tier I Capital (to Average Assets)		59,476	9.4		25,405	4		31,756	5

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Non-Performing Assets

As of September 30, 2012, our non-performing assets totaled $21.9 million or 3.25% of assets compared to $15.8 million or 2.35% of assets at December 31, 2011 (See table below.) The Company experienced an increase of $673 thousand in non-accrual loans from December 31, 2011 to September 30, 2012. As of September 30, 2012, non-accrual loans include $3.0 million in loans secured by real estate construction, $973 thousand in loans secured by farmland, $1.0 million in loans secured by 1-4 family residential properties, $1.1 million in loans secured by non-farm & non-residential real estate and $471 thousand in loans secured by multi-family residential real estate. Real estate loans composed 99.0% of the non-performing loans as of September 30, 2012 and 99.3% as of December 31, 2011. Forgone interest income on non-accrual loans totaled $273 thousand for the first nine months of 2012 compared to forgone interest of $558 thousand for the same time period in 2011. Accruing loans that are contractually 90 days or more past due as of September 30, 2012 totaled $907 thousand compared to $398 thousand at December 31, 2011, an increase of $509 thousand. The total nonperforming and restructured loans increased $7.4 million from December 31, 2011 to September 30, 2012, resulting in an increase in the ratio of nonperforming loans to loans of 166 basis points to 3.49%. In addition, the amount the Company has booked as Other Real Estate has decreased $1.3 million from December 31, 2011 to September 30, 2012. As of September 30, 2012, the amount recorded as Other Real Estate totaled $7.0 million compared to $8.3 million at December 31, 2011. The overall decrease in total Other Real Estate properties is mostly attributed to sales of Other Real Estate properties exceeding new additions. During the first nine months of 2012, $2.3 million was added to Other Real Estate properties while $3.2 million in Other Real Estate properties was sold. In addition, write-downs of $381 thousand also contributed to the decrease. The allowance as a percentage of non-performing and restructured loans and Other Real Estate Owned decreased from 37% at December 31, 2011 to 28% at September 30, 2012.

Nonperforming Assets

		9/30/12		12/31/11
		(in thousands)		
Non-accrual Loans	$	6,690	$	6,017
Accruing Loans which are Contractually past due 90 days or more		907		398
Troubled Debt Restructurings		7,273		1,104
Total Nonperforming Loans		14,870		7,519
Other Real Estate		6,983		8,296
Total Nonperforming Loans and Other Real Estate	$	21,853	$	15,815
Nonperforming Loans as a Percentage of Loans		3.49%		1.83%
Nonperforming Loans and Other Real Estate as a Percentage of Total Assets		3.25%		2.35%
Allowance as a Percentage of Period-end Loans		1.41%		1.42%
Allowance as a Percentage of Non-performing Loans and Other Real Estate		28%		37%

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We maintain a watch list of agricultural, commercial, real estate mortgage, and real estate construction loans and review those loans on a regular basis. Generally, assets are designated as watch list loans to ensure more frequent monitoring. If we determine that there is serious doubt as to performance in accordance with original terms of the contract, then the loan is generally downgraded and often placed on non-accrual status.

We review and evaluate nonaccrual loans, past due loans, and loans graded substandard or worse on a regular basis to determine if specific allocations are needed.

Provision for Loan Losses

The loan loss provision for the first nine months was $1.6 million for 2012 and $1.9 million for 2011. Management evaluates the loan portfolio by reviewing the historical loss rate for each respective loan type and assigns risk multiples to certain categories to account for qualitative factors including current economic conditions. The average loss rates are reviewed for trends in the analysis, as well as comparisons to peer group loss rates. Management makes allocations within the allowance for loan losses for specifically classified loans regardless of loan amount, collateral or loan type. Loan categories are evaluated utilizing subjective factors in addition to the historical loss calculations to determine a loss allocation for each of those types. As this analysis, or any similar analysis, is an imprecise measure of loss, the allowance is subject to ongoing adjustments. Therefore, management will often take into account other significant factors that may be necessary or prudent in order to reflect probable incurred losses in the total loan portfolio.

Nonperforming loans and restructured loans increased $7.4 million since December 31, 2011 to $14.9 million as of September 30, 2012. Other real estate decreased $1.3 million over this same time period. Additions to Other real estate totaled $3.6 million while sales totaled $2.3 million.

The September 30, 2012 unallocated allowance of $440 thousand increased from the December 31, 2011 balance of $344 thousand.

Net charge-offs for the nine month period ended September 30, 2012 were $1.4 million compared to net charge-offs of $1.2 million for the same period in 2011. Future levels of charge-offs will be determined by the particular facts and circumstances surrounding individual loans. Based on the above information, management believes the current loan loss allowance is sufficient to meet probable incurred loan losses.

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Loan Losses

	Nine Months Ended September 30 (in thousands) 2012	2011
Balance at Beginning of Period	$ 5,842	$ 4,925
Amounts Charged-off:		
Commercial		36
Real Estate Construction	73	143
1-4 family residential	907	442
Multi-family residential	52	178
Non-farm & non-residential	64	333
Agricultural	15	
Consumer and other	652	701
Total Charged-off Loans	1,763	1,833
Recoveries on Amounts Previously Charged-off:		
Commercial	24	74
Real Estate Construction	14	
1-4 family residential	14	11
Multi-family residential	1	144
Non-farm & non-residential		14
Agricultural	5	14
Consumer and other	280	415
Total Recoveries	338	672
Net Charge-offs	1,425	1,161
Provision for Loan Losses	1,600	1,900
Balance at End of Period	6,017	5,664
Loans		
Average	417,053	408,922
At September 30	426,517	408,202
As a Percentage of Average Loans:		
Net Charge-offs for the period	0.34%	0.28%
Provision for Loan Losses for the period	0.38%	0.46%
Allowance as a Multiple of Net Charge-offs (annualized)	3.2	3.7

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Loan Losses

	Three Months Ended September 30 (in thousands) 2012	2011
Balance at Beginning of Period	$ 5,789	$ 5,642
Amounts Charged-off:		
Commercial		2
Real estate construction		19
1-4 family residential	295	231
Multi-family residential		84
Non-farm & non-residential		4
Real estate mortgage		
Agricultural		
Consumer and other	185	221
Total Charged-off Loans	480	561
Recoveries on Amounts Previously Charged-off:		
Commercial	24	
Real estate construction	14	
1-4 family residential	6	6
Multi-family residential		
Non-farm & non-residential		
Real estate mortgage		
Agricultural	1	2
Consumer and other	63	125
Total Recoveries	108	133
Net Charge-offs	372	428
Provision for Loan Losses	600	450
Balance at End of Period	$ 6,017	$ 5,664
Loans		
Average	$ 422,989	$ 409,178
At September 30	426,517	408,202
As a Percentage of Average Loans:		
Net Charge-offs for the period	0.09%	0.10%
Provision for Loan Losses for the period	0.14%	0.11%
Allowance as a Multiple of Net Charge-offs (annualized)	4.0	3.3

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. Our 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.

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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. We have 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 re pricing opportunities for new, maturing and adjustable rate amounts. As of September 30, 2012, the projected percentage changes are within limits approved by our Board of Directors (Board). Although management does analyze and monitor the projected percentage change in a declining interest rate environment, due to the current rate environment many of the current deposit rates cannot decline an additional 100 basis points. Therefore, management places more emphasis in the rising rate environment scenarios. This period s volatility is slightly higher in each rate shock simulation when compared to the same period a year ago. The projected net interest income report summarizing our interest rate sensitivity as of September 30, 2012 is as follows:

PROJECTED NET INTEREST INCOME

(dollars in thousands)

Change in basis points:	**- 300**	**- 100**	**Level Rates**	**+ 100**	**+ 300**
Year One (10/12 - 9/13)					
Net interest income	$ 23,193	$ 24,136	$ 24,813	$ 25,003	$ 25,218
Net interest income dollar change	(1,499)	(677)	N/A	190	405
Net interest income percentage change	-6.1%	-2.7%	N/A	0.76%	1.63%
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, 2011 is as follows:

PROJECTED NET INTEREST INCOME

(dollars in thousands)

Change in basis points:	**- 300**	**- 100**	**Level Rates**	**+ 100**	**+ 300**
Year One (10/11 - 9/12)					
Net interest income	$ 24,485	$ 25,213	$ 25,796	$ 25,708	$ 25,740
Net interest income dollar change	(1,311)	(583)	N/A	(88)	(56)
Net interest income percentage change	-5.1%	-2.3%	N/A	-0.3%	-0.2%
Board approved limit	>-10.0%	>-4.0%	N/A	>-4.0%	>-10.0%

Projections from September 30, 2012, year one reflected a decline in net interest income of 2.7% with a 100 basis point decline compared to the 2.3% decline in 2011. The 100 basis point increase in rates reflected a 0.8% increase in net interest income in 2012 compared to a decrease of 0.3% in 2011.

EVE applies discounting techniques to future cash flows to determine the present value of assets, liabilities, and therefore equity. Based upon applying these techniques to the September 30, 2012 balance sheet, a 100 basis point increase in rates results in a 3.0% decrease in EVE. A 100 basis point decrease in rates results in a 7.4% decrease in EVE. These are within the Board approved limits.

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Item 4 CONTROLS AND PROCEDURES

As of the end of the period covered by this report, our management, including the Chief Executive Officer and the Chief Financial Officer, carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures. Based on the foregoing, our 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.

We 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, our internal control over financial reporting. Based on this evaluation, there has been no such change during the quarter covered by this report.

Our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives.

Part II - Other Information

Item 1. Legal Proceedings

We are not a party to any material legal proceedings.

Item 1A. Risk Factors

Enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), and the promulgation of regulations thereunder could significantly increase our compliance and operating costs or otherwise have a material and adverse effect on the Company s financial position, results of operations, or cash flows. The Dodd-Frank Act represents a comprehensive overhaul of the financial services industry within the United States, establishes the new federal Bureau of Consumer Financial Protection (the BCFP), and will require the BCFP and other federal agencies to implement many new rules. At this time, it is difficult to predict the extent to which the Dodd-Frank Act or the resulting regulations will impact the Company s business. However, compliance with these new laws and regulations will result in additional costs, which may adversely impact the Company s results of operations, financial condition or liquidity, any of which may impact the market price of the Company s common stock.

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Our results of operations and financial condition may be negatively affected if we are unable to meet a debt covenant and, correspondingly, unable to obtain a waiver regarding the debt covenant from the lender. From time to time we may obtain financing from other lenders. The loan documents reflecting the financing often require us to meet various debt covenants. If we are unable to meet one or more of our debt covenants, then we will typically attempt to obtain a waiver from the lender. For example, the Company has a promissory note payable that matured July 28, 2012 and was renewed for an additional one year term on similar terms. The Bank was not in compliance with the non-performing asset covenant in the subject loan agreement at June 30, 2012 but the lender waived the noncompliance. If a lender were not to agree to a waiver in such an instance, then we would be in default under our borrowing obligation. This default could affect our ability to fund various strategies that we may have implemented resulting in a negative impact in our results of operations and financial condition. The Bank was in compliance with the non-performing asset covenant at September 30, 2012.

Other than the additional risk factors mentioned above, there are no material changes from the risk factors set forth under Part I, Item 1A Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2011, which you are encouraged to carefully consider.

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 or Programs**
7/1/12 7/31/12		$		96,742 shares
8/1/12 8/31/12				96,742 shares
9/1/12 9/30/12				96,742 shares
Total				96,742 shares

On October 25, 2000, we announced that our Board approved a stock repurchase program and authorized the Company to purchase up to 100,000 shares of its outstanding common stock. On November 11, 2002, the Board approved and authorized the Company s repurchase of an additional 100,000 shares. On May 20, 2008, the Board of Directors approved and authorized the Company to purchase an additional 100,000 shares. On May 17, 2011, the Board 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, 2012, 303,258 shares have been purchased.

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Item 6. Exhibits

2.1 Agreement and Plan of Merger with Peoples Bancorp of Sandy Hook is incorporated by reference to Exhibit 2.1 of the Registrant s Current Report of Form 8-K dated and filed February 24, 2006.

3.1 Amended and Restated Articles of Incorporation of the Registrant are incorporated by reference to Exhibit 3.1 of the Registrant s Quarterly Report on Form 10-Q for the quarterly period ending March 31, 2000 and filed May 15, 2000.

3.2 Bylaws of the Registrant are incorporated by reference to Exhibit 3.1 of the Registrant s Quarterly Report of Form 10-Q for the quarterly period ending June 30, 2000 and filed August 14, 2000.

3.3 Articles of Amendment to Amended and Restated Articles of Incorporation of the Registrant are incorporated by reference to Exhibit 3.3 of the Registrant s Annual Report of Form 10-K for the period ending December 31, 2005 and filed March 29, 2006.

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.

101* The following financial information from Kentucky Bancshares, Inc. Quarterly Report on Form 10-Q for the period ended September 30, 2012, filed with the SEC on November 14, 2011, formatted in Extensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets at September 30, 2012 and December 31, 2011, (ii) Consolidated Statements of Income and Comprehensive Income for the three and nine months ended September 30, 2012 and September 30, 2011, (iii) Consolidated Statement of Stockholders Equity for the nine months ended September 30, 2012, (iv) Consolidated Statements of Cash Flows for the nine months ended September 30, 2012 and September 30, 2011 and (v) Notes to Consolidated Financial Statements.

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*Pursuant to Rule 406T of Regulation S-T, the XBRL related information in Exhibit 101 to this Quarterly Report on Form 10-Q shall not be deemed to be filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Exchange Act of 1934, or otherwise subject to the liability of those sections, and shall not be deemed part of a registration statement, prospectus or other document filed under the Securities Act of 1933 or the Exchange Act of 1934, except as shall be expressly set forth by specific reference in such filings.

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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 11/13/12	/s/Louis Prichard Louis Prichard, President and C.E.O.
Date 11/13/12	/s/Gregory J. Dawson Gregory J. Dawson, Chief Financial Officer