KENTUCKY BANCSHARES INC /KY/
Form 10-Q
November 13, 2017
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period September 30, 2017

or

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

For the transition period from to

Commission File Number: 000-52598

KENTUCKY BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

Kentucky (State or other jurisdiction of incorporation or organization)	61-0993464 (I.R.S. Employer Identification No.)

P.O. Box 157, Paris, Kentucky (Address of principal executive offices)	40362-0157 (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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (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 No

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Number of shares of Common Stock outstanding as of October 31, 2017: 2,971,611.

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Item 1 – Financial Statements

KENTUCKY BANCSHARES, INC.

CONSOLIDATED BALANCE SHEETS (unaudited)

(in thousands, except per share amounts)

	9/30/2017	12/31/2016
ASSETS		
Cash and due from banks	$ 18,426	$ 42,052
Federal funds sold	186	1,198
Cash and cash equivalents	18,612	43,250
Interest bearing time deposits	1,830	5,029
Securities available for sale	289,956	273,770
Trading Assets	5,714	5,592
Loans held for sale	1,316	724
Loans	648,965	656,007
Allowance for loan losses	(7,755)	(7,541)
Net loans	641,210	648,466
Federal Home Loan Bank stock	7,034	7,034
Real estate owned, net	2,669	1,824
Assets held for sale	—	969
Bank premises and equipment, net	16,265	14,781
Interest receivable	3,785	3,715
Mortgage servicing rights	1,485	1,321
Goodwill	14,001	14,001
Other intangible assets	405	529
Other assets	6,476	7,442
Total assets	$ 1,010,758	$ 1,028,447
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits		
Non-interest bearing	$ 220,518	$ 219,556
Time deposits, $250,000 and over	68,528	74,302
Other interest bearing	459,333	509,123
Total deposits	748,379	802,981
Repurchase agreements	24,070	20,873
Federal funds purchased	17,302	—
Short-term Federal Home Loan Bank advances	8,530	—
Long-term Federal Home Loan Bank advances	93,665	92,500
Note payable	3,762	4,090
Subordinated debentures	7,217	7,217
Interest payable	796	692
Other liabilities	6,768	7,122
Total liabilities	910,489	935,475
Stockholders' equity		

Preferred stock, 300,000 shares authorized and unissued	—	—
Common stock, no par value; 10,000,000 shares authorized; 2,971,611 and 2,973,232 shares issued and outstanding at September 30, 2017 and December 31, 2016	20,889	20,767
Retained earnings	78,515	73,161
Accumulated other comprehensive income (loss)	865	(956)
Total stockholders’ equity	100,269	92,972
Total liabilities and stockholders’ equity	$ 1,010,758	$ 1,028,447

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 Ended		Nine Months Ended	
	9/30/2017	9/30/2016	9/30/2017	9/30/2016
INTEREST INCOME:				
Loans, including fees	$ 7,779	$ 7,630	$ 22,985	$ 22,432
Securities				
Taxable	1,156	782	3,353	2,555
Tax exempt	625	649	1,801	1,967
Trading assets	27	44	86	117
Other	132	101	454	319
Total interest income	9,719	9,206	28,679	27,390
INTEREST EXPENSE:				
Deposits	668	555	1,997	1,667
Repurchase agreements and federal funds purchased	38	30	89	83
Federal Home Loan Bank advances	466	428	1,251	1,205
Note payable	48	57	147	177
Subordinated debentures	75	70	232	198
Total interest expense	1,295	1,140	3,716	3,330
Net interest income	8,424	8,066	24,963	24,060
Provision for loan losses	100	175	650	775
Net interest income after provision	8,324	7,891	24,313	23,285
NON-INTEREST INCOME:				
Service charges	1,281	1,401	3,806	3,782
Loan service fee income, net	60	(26)	234	23
Trust department income	304	272	879	796
Gain on sale of available for sale securities, net	60	40	103	317
Gain (loss) on trading assets	(15)	(52)	36	48
Gain on sale of loans	415	533	1,456	1,289
Brokerage income	215	168	589	602
Debit card interchange income	763	699	2,274	2,053
Gain on bank premises	—	—	1,200	4
Other	88	201	239	218
Total other income	3,171	3,236	10,816	9,132
NON-INTEREST EXPENSE:				
Salaries and employee benefits	4,592	4,540	13,545	13,472
Occupancy expenses	935	974	2,884	2,831
Repossession expenses, net	104	79	289	222
FDIC Insurance	86	106	274	444
Legal and professional fees	285	423	762	1,314
Data processing	409	396	1,309	1,249
Debit card expenses	486	391	1,304	1,078
Amortization expense of intangible assets, excluding mortgage servicing right	38	45	124	201

Advertising and marketing	212	225	636	675
Taxes other than payroll, property and income	304	282	904	836
Telephone	83	77	342	262
Postage	92	88	270	278
Loan fees	40	64	151	155
Other	669	1,064	2,276	2,536
Total other expenses	8,335	8,754	25,070	25,553
Income before taxes	3,160	2,373	10,059	6,864
Income taxes	568	8	1,920	580
Net income	$ 2,592	$ 2,365	$ 8,139	$ 6,284
Other comprehensive income, net of tax:				
Change in unrealized gains on securities, net of tax	(348)	(800)	1,821	3,243
Comprehensive Income	$ 2,244	$ 1,565	$ 9,960	$ 9,527
Earnings per share				
Basic	$ 0.87	$ 0.79	$ 2.74	$ 2.10
Diluted	0.87	0.79	2.74	2.10
Dividends per share	0.29	0.27	0.87	0.81

See Accompanying Notes

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KENTUCKY BANCSHARES, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY (unaudited)

(in thousands, except share information)

(Dollars in thousands)	Common Stock Shares	Amount	Retained Earnings	Accumulated Other Comprehensive Income	Total Stockholders' Equity
Balances, January 1, 2017	2,973,232	$ 20,767	$ 73,161	$ (956)	$ 92,972
Common stock issued (employee stock grants of 5,423 shares, net of 1,152 shares forfeited, director stock awards of 1,386 shares and director stock options exercised of 600 shares)	7,409	64	—	—	64
Stock compensation expense	—	121	—	—	121
Common stock purchased and retired	(9,030)	(63)	(200)	—	(263)
Other comprehensive income	—	—	—	1,821	1,821
Net income	—	—	8,139	—	8,139
Dividends declared - $0.87 per share	—	—	(2,585)	—	(2,585)
Balances, September 30, 2017	2,971,611	$ 20,889	$ 78,515	$ 865	$ 100,269

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

See Accompanying Notes

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KENTUCKY BANCSHARES, INC.

CONSOLIDATED STATEMENT OF CASH FLOWS (unaudited)

(in thousands, except share information)

	Nine Months Ended	
	9/30/2017	9/30/2016
Cash Flows From Operating Activities		
Net Income	$ 8,139	$ 6,284
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	514	985
Securities amortization (accretion), net	794	854
Stock based compensation expense	121	117
Provision for loan losses	650	775
Securities available for sale gains, net	(103)	(317)
Net change in trading assets	(122)	(165)
Originations of loans held for sale	(46,559)	(43,331)
Proceeds from sale of loans	47,423	42,345
Losses (gains) on sale of bank premises and equipment	(1,200)	(4)
Losses (gains) on other real estate	(11)	(163)
Gain on sale of loans	(1,456)	(1,289)
Write-downs of other real estate, net	141	131
Changes in:		
Interest receivable	(70)	(6)
Other assets	4	461
Interest payable	104	81
Deferred taxes	12	1,663
Other liabilities	(354)	(2,425)
Net cash from operating activities	8,027	5,996
Cash Flows From Investing Activities		
Net change in interest bearing time deposits	3,199	(155)
Purchases of securities available for sale	(59,235)	(61,876)
Proceeds from sales of securities available for sale	14,559	23,888
Proceeds from principal payments, maturities and calls securities available for sale	30,570	50,987
Net change in loans	5,048	(35,688)
Purchases of bank premises and equipment	(2,270)	(667)
Proceeds from the sale of bank premises and equipment	2,062	4
Proceeds from the sale of other real estate	922	734
Net cash used in investing activities	(5,145)	(22,773)
Cash Flows From Financing Activities:		
Net change in deposits	(54,602)	(24,783)
Net change in repurchase agreements	3,197	5,037
Net change in federal funds purchased	17,302	10,517
Net change in short-term Federal Home Loan Bank advances	8,530	10,000
Proceeds from long-term Federal Home Loan Bank advances	13,000	15,000
Repayment of long-term Federal Home Loan Bank advances	(11,835)	(6,660)
Repayment of note payable	(328)	(600)

Proceeds from issuance of common stock	64	49
Purchase of common stock	(263)	(296)
Dividends paid	(2,585)	(2,426)
Net cash (used in) from financing activities	(27,520)	5,838
Net change in cash and cash equivalents	(24,638)	(10,939)
Cash and cash equivalents at beginning of period	43,250	28,048
Cash and cash equivalents at end of period	$ 18,612	$ 17,109
Supplemental disclosures of cash flow information Cash paid during the year for:		
Interest expense	$ 3,612	$ 3,249
Income taxes	1,600	800
Supplemental disclosures of non-cash investing activities		
Real estate acquired through foreclosure	$ 1,897	$ 235

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. There have been no significant changes to the Company’s accounting and reporting policies as disclosed in the Company’s Annual Report on Form 10-K for the year ended December 31, 2016. 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, 2016.

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

Nature of Operations: 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.

KBI Insurance Company, Inc. is a subsidiary of Kentucky Bancshares, Inc. and is located in Las Vegas, Nevada. It is a captive insurance subsidiary which provides various liability and property damage insurance policies for Kentucky Bancshares, Inc. and its related subsidiaries. KBI Insurance Company, Inc. is regulated by the State of Nevada Division of Insurance.

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 and such differences could be material to the financial statements.

Trading Assets: The Company engages in trading activities for its own account. Securities that are held principally for resale in the near term are recorded at fair value with changes in fair value included in earnings. Interest and dividends are included in net interest income.

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.

Reclassifications: Some items in the prior year financial statements were reclassified to conform to the current presentation. Reclassifications had no effect on prior period net income or stockholders' equity.

Adoption of New Accounting Standards

ASU 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments." Issued in August 2016, ASU 2016-15 provides guidance to reduce the diversity in practice of how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments of ASU 2016-15 provide guidance on eight specific cash flow: (i) debt prepayment or debt extinguishment costs; (ii) settlement of zero-coupon bonds; (iii) contingent consideration payments made after a business combination; (iv) proceeds from the settlement of insurance claims; (v) proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; (vi) distributions received from equity method investees; (vii) beneficial interests in securitization transactions and (viii) separately identifiable cash flows and application of the predominance principle. The amendments of ASU 2016-15 are effective for interim and annual periods beginning after December 15, 2017. Management has evaluated the amendments of ASU 2016-15 and does not believe that adoption of this ASU will impact Kentucky Bancshares existing presentation of the applicable cash receipts and cash payments on its consolidated statement of cash flows.

ASU 2016-13, "Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." Issued in June 2016, ASU 2016-13 will add Financial Accounting Standards Board "FASB" ASC Topic 326, "Financial Instruments-Credit Losses" and finalizes amendments to FASB ASC Subtopic 825-15, "Financial Instruments-Credit Losses." The amendments of ASU 2016-13 are intended to provide financial statement users with more decision-useful information related to expected credit losses on financial instruments and other commitments to extend credit by replacing the current incurred loss impairment methodology with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to determine credit loss estimates. The amendments of ASU 2016-13 eliminate the probable initial recognition threshold and, in turn, reflect an entity's current estimate of all expected credit losses. ASU 2016-13 does not specify the method for measuring expected credit losses, and an entity is allowed to apply methods that reasonably reflect its expectations of the credit loss estimate. Additionally, the amendments of ASU 2016-13 require that credit losses on available for sale debt securities be presented as an allowance rather than as a writedown. The amendments of ASU 2016-13 are effective for interim and annual periods beginning after December 15, 2019. Earlier application is permitted for interim and annual periods beginning after December 15, 2018. Kentucky Bancshares plans to adopt the amendments of ASU 2016-13 during the first quarter of 2020. Kentucky Bancshares has established a steering committee which includes the appropriate members of management to evaluate the impact this ASU will have on the Company's financial position, results of operations and financial statement disclosures and determine the most appropriate method of implementing the amendments in this ASU as well as any resources needed to implement the amendments.

ASU 2016-09, "Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting." Issued in March 2016, ASU 2016-09 seeks to reduce complexity in accounting standards by simplifying several aspects of the accounting for share-based payment transactions. The amendments of ASU 2016-09 include: (i) requiring all excess tax benefits and tax deficiencies to be recognized as income tax expense or benefit in the income statement; (ii) requiring excess tax benefits to be classified along with other income tax cash flows as an operating activity on the statement of cash flow; (iii) allowing an entity to make an entity-wide accounting policy election to either estimate the number of awards that expect to vest or account for forfeitures when they occur; (iv) change the threshold to qualify for equity classification to permit withholding up to the maximum statutory tax rates in the applicable jurisdictions; and (v) requiring that cash paid by an employer when directly withholding shares for tax-withholding purposes to be classified as a financing activity on the statement of cash flows. The amendments of ASU 2016-09 became effective for Kentucky Bancshares on January 1, 2017 and did not have a material impact on Kentucky Bancshares consolidated financial statements. The Company has made an entity-wide accounting policy election to account for forfeitures of stock awards as they occur. Changes to Kentucky Bancshares consolidated statement of cash flows required by the amendments of ASU 2016-09 are incorporated into the presentation in the Quarterly Report on Form 10-Q for the three month and nine month periods ending September 30, 2017.

ASU 2016-02, "Leases (Topic 842)." Issued in February 2016, ASU 2016-02 was issued by the FASB to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and by disclosing key information about leasing arrangements. ASU 2016-02 will, among other things, require lessees to recognize a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. ASU 2016-02 does not significantly change lease accounting requirements applicable to lessors; however, the ASU contains some targeted improvements that are intended to align, where necessary, lessor accounting with the lessee accounting model and with the updated revenue recognition guidance issued in 2014. The amendments of ASU 2016-02 are effective for interim and annual periods beginning after December 15, 2018. Kentucky Bancshares plans to adopt the amendments of ASU 2016-02 beginning in the first quarter of 2019. At adoption, Kentucky Bancshares will recognize a lease asset and a corresponding lease liability on its consolidated balance sheet for its total lease obligation measured on a discounted basis. As of September 30, 2017, all leases in which Kentucky Bancshares was the lessee were classified as operating leases.

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Kentucky Bancshares does not anticipate any material impact to its consolidated statements of income, balance sheet or regulatory capital as a result of the adoption of this ASU as the Company has an immaterial amount of leases in which it is the lessee.

ASU 2016-01, "Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities (An Amendment of the FASB Accounting Standards Codification)." Issued in January 2016, ASU 2016-01 is intended to enhance the reporting model for financial instruments to provide users of financial statements with improved decision-making information. The amendments of ASU 2016-01 include: (i) requiring equity investments, except those accounted for under the equity method of accounting or those that result in the consolidation of an investee, to be measured at fair value with changes in fair value recognized in net income; (ii) requiring a qualitative assessment to identify impairment of equity investments without readily determinable fair values; (iii) eliminating the requirement to disclose the method and significant assumptions used to estimate the fair value for financial instruments measured at amortized cost on the balance sheet; (iv) requiring the use of the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (v) requiring an entity that has elected the fair value option to measure the fair value of a liability to present separately in other comprehensive income the portion of the change in the fair value resulting from a change in the instrument-specific credit risk; (vi) requiring separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (vii) clarifying that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available for sale securities in combination with the entity's other deferred tax assets. The amendments of ASU 2016-01 are effective for interim and annual periods beginning after December 15, 2017. Kentucky Bancshares plans to adopt the amendments of ASU 2016-01 during the first quarter of 2018. Management has evaluated the impact this ASU will have on the Company's consolidated financial statements and does not expect the adoption of this ASU to have a material impact on the Company's consolidated financials statements.

ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)." Issued in May 2014, ASU 2014-09 will add FASB ASC Topic 606, "Revenue from Contracts with Customers," and will supersede revenue recognition requirements in FASB ASC Topic 605, "Revenue Recognition," as well as certain cost guidance in FASB ASC Topic 605-35, "Revenue Recognition – Construction-Type and Production-Type Contracts." ASU 2014-09 provides a framework for revenue recognition that replaces the existing industry and transaction specific requirements under the existing standards. ASU 2014-09 requires an entity to apply a five-step model to determine when to recognize revenue and at what amount. The model specifies that revenue should be recognized when (or as) an entity transfers control of goods or services to a customer at the amount in which the entity expects to be entitled. Depending on whether certain criteria are met, revenue should be recognized either over time, in a manner that depicts the entity's performance, or at a point in time, when control of the goods or services are transferred to the customer. ASU 2014-09 provides that an entity should apply the following steps: (1) identify the contract(s) with a customer; (2) identify the performance obligations in the contract; (3) determine the transaction price; (4) allocate the transaction price to the performance obligations in the contract; and (5) recognize revenue when (or as) the entity satisfies a performance obligation. In addition, the existing requirements for the recognition of a gain or loss on the transfer of non-financial assets that are not in a contract with a customer are amended to be consistent with the guidance on recognition and measurement in ASU 2014-09.

The amendments of ASU 2014-09 may be applied either retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying ASU 2014-09 recognized at the date of initial application. If the transition method of application is elected, the entity should also provide the additional disclosures in reporting periods that include the date of initial application of (1) the amount by which each financial statement line item is affected in the current reporting period, as compared to the guidance that was in effect before the change, and (2) an explanation of the reasons for significant changes. ASU 2015-14, "Revenue from Contracts with Customers (Topic 606)-Deferral of the Effective Date," issued in August 2015, defers the effective date of ASU 2014-09 by one year. ASU 2015-14 provides that the amendments of ASU 2014-09 become effective for interim and annual periods beginning after December 15, 2017. All subsequently issued ASUs which provide additional guidance and clarifications to various aspects of FASB ASC Topic 606 will become effective when the amendments of ASU 2014-09 become effective. Kentucky Bancshares plans to adopt these amendments during the first quarter of 2018. Management is continuing to evaluate the impact ASU 2014-09 will have on Kentucky Bancshares consolidated financial statements as well as the most appropriate transition method of application. Based on this evaluation to date, Management has determined that the majority of the revenues earned by Kentucky Bancshares are not within the scope of ASU 2014-09. Management also believes that for most revenue streams within the scope of ASU 2014-09, the amendments will not change the timing of when the revenue is recognized.

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Management will continue to evaluate the impact the adoption of ASU 2014-09 will have on Kentucky Bancshares consolidated financial statements, focusing on noninterest income sources within the scope of ASU 2014-09 as well as new disclosures required by these amendments; however, the adoption of ASU 2014 09 is not expected to have a material impact on Kentucky Bancshares consolidated financial statements.

ASU 2017-04 - Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment: In January 2017, the FASB issued ASU 2017-04, Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment. This ASU eliminates Step 2 from the goodwill impairment test. Instead, under the new guidance, an entity is to perform its annual goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An impairment charge would be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value. The new guidance is effective for annual reporting periods, and interim reporting periods within those annual periods, beginning after December 15, 2019, which for Kentucky Bancshares will be effective for the fiscal year beginning January 1, 2020. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The adoption of this guidance is not expected to have an impact on the Company’s consolidated financial statements.

ASU 2017-08 - Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities: In March 2017, the FASB issued ASU 2017-08 - Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities. This ASU amends the amortization period for certain purchased callable debt securities held at a premium. It shortens the amortization period for the premium to the earliest call date. Under current U.S. GAAP, premiums on callable debt securities generally are amortized to the maturity date. The new guidance is effective for annual reporting periods, and interim reporting periods within those annual periods, beginning after December 15, 2018, which for Kentucky Bancshares will be the fiscal year beginning January 1, 2019. Early adoption is permitted for interim or annual periods. The adoption of this guidance is not expected to have a material impact on the Company’s consolidated financial statements.

ASU 2016-18 - Statement of Cash Flows (Topic 230): Restricted Cash (a consensus of the FASB Emerging Issues Task Force): Effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The adoption of this guidance is not expected to have a material impact on the Company’s consolidated financial statements.

Update 2017-01 - Business Combinations (Topic 805): Clarifying the Definition of a Business: The amendments in this ASU are intended to help companies and other organizations evaluate whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. Public business entities should apply the amendments in this Update to annual periods beginning after December 15, 2017, which for Kentucky Bancshares will be the fiscal year beginning January 1, 2018, including interim periods within those periods. All other entities should apply the amendments to annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019.

ASU 2017-09 - Compensation - Stock Compensation (Topic 718): Scope of Modification Accounting: In May 2017, the FASB issued ASU 2017-09 - Compensation - Stock Compensation (Topic 718): Scope of Modification Accounting. This ASU amends the guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting in Topic 718. The new guidance is effective for annual reporting periods, and interim reporting periods within those annual periods, beginning after December 15, 2017. Early adoption is permitted for interim or annual periods. The adoption of this guidance is not expected to have a material impact on Kentucky Bancshares consolidated financial statements.

ASU 2017-12, "Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities." Issued in August 2017, ASU 2017-12 aims to improve the financial reporting of hedging relationships to better portray the economic results of an entity's risk management activities in its financial statements. The amendments in ASU 2017-12 aim to better align an entity's risk management activities and financial reporting for hedging relationships by expanding and refining hedge accounting for both non-financial and financial risk components and aligning the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements.

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The amendments in ASU 2017-12 (i) permit hedge accounting for risk components in hedging relationships involving nonfinancial risk and interest rate risk; (ii) change the guidance for designating fair value hedges of interest rate risk and for measuring the change in fair value of the hedged item in fair value hedges of interest rate risk; (iii) continue to allow an entity to exclude option premiums and forward points from the assessment of hedge effectiveness; and (iv) permit an entity to exclude the portion of the change in fair value of a currency swap that is attributable to a cross-country basis spread from the assessment of hedge effectiveness. The amendments of ASU 2017-12 also include targeted improvements intended to simplify the application of hedge accounting. The amendments of ASU 2017-12 are effective for fiscal years, and interim periods within those years, beginning after December 15, 2018, which for Kentucky Bancshares is January 1, 2019. All transition requirements and elections must be applied to all hedging relationships existing at the date of adoption. Kentucky Bancshares plans to adopt ASU 2017-12 during the first quarter of 2019 using the required modified retrospective transition method. Kentucky Bancshares is currently not impacted by ASU 2017-12. However, if the Company does become involved with derivatives or hedge accounting, the Company will recognize the cumulative effect of the change, if any, in the beginning balance of each affected component of equity as of January 1, 2019. The adoption of ASU 2017-12 is not expected to have a material impact on the Company’s consolidated financial statements.

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2.SECURITIES

SECURITIES AVAILABLE FOR SALE

Period-end securities are as follows:

(in thousands)

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for Sale				
September 30, 2017				
U. S. government agencies	$ 30,391	$ 448	$ (179)	$ 30,660
States and political subdivisions	100,195	2,254	(158)	102,291
Mortgage-backed - residential	157,739	330	(1,406)	156,663
Equity securities	320	22	—	342
Total	$ 288,645	$ 3,054	$ (1,743)	$ 289,956
December 31, 2016				
U. S. government agencies	$ 36,454	$ 373	$ (299)	$ 36,528
States and political subdivisions	90,117	1,731	(716)	91,132
Mortgage-backed - residential	148,327	120	(2,677)	145,770
Equity securities	320	20	—	340
Total	$ 275,218	$ 2,244	$ (3,692)	$ 273,770

The amortized cost and fair value of securities September 30, 2017 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. Further discussion concerning Fair Value Measurements can be found in Note 9.

	Amortized Cost	Fair Value
Due in one year or less	$ 384	$ 384
Due after one year through five years	25,963	26,669
Due after five years through ten years	40,893	41,554
Due after ten years	63,346	64,344
	130,586	132,951

Mortgage-backed - residential	157,739	156,663
Equity	320	342
Total	$ 288,645	$ 289,956

Proceeds from sales of securities during the first nine months of 2017 and 2016 were $14.6 and $23.9 million. Gross gains of $105 thousand and $317 thousand and gross losses of $2 thousand and $0 were realized on those sales, respectively. The tax provision related to these realized net gains was $35 thousand and $108 thousand, respectively.

Proceeds from sales of securities during the three months ended September 30, 2017 and September 30, 2016 were $10.5 million and $2.5 million. Gross gains of $60 thousand and $40 thousand and gross losses of $2 thousand and $0 were realized on those sales, respectively. The tax provision related to these realized net gains was $20 thousand and $14 thousand, respectively.

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Securities with unrealized losses at September 30, 2017 and at December 31, 2016 not recognized in income are as follows:

September 30, 2017

	Less than 12 Months		12 Months or More		Total	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
Description of Securities	Value	Loss	Value	Loss	Value	Loss
U.S. Government agencies	$ 15,617	$ (79)	$ 6,056	$ (100)	$ 21,673	$ (179)
States and municipals	16,449	(110)	2,271	(48)	18,720	(158)
Mortgage-backed - residential	54,303	(385)	44,469	(1,021)	98,772	(1,406)
Total temporarily impaired	$ 86,369	$ (574)	$ 52,796	$ (1,169)	$ 139,165	$ (1,743)

December 31, 2016

	Less than 12 Months		12 Months or More		Total	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
Description of Securities	Value	Loss	Value	Loss	Value	Loss
U.S. Government agencies	$ 28,202	$ (299)	$ —	$ —	$ 28,202	$ (299)
States and municipals	27,834	(716)	—	—	27,834	(716)
Mortgage-backed - residential	119,802	(1,938)	13,652	(739)	133,454	(2,677)
Total temporarily impaired	$ 175,838	$ (2,953)	$ 13,652	$ (739)	$ 189,490	$ (3,692)

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 will recover as the securities approach maturity.

TRADING ASSETS

The trading assets, which totaled $5.7 million at September 30, 2017 and $5.6 million at December 31, 2016, are primarily comprised of cash and cash equivalents and municipal securities which are generally held for 60 days or less.

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3.LOANS

Loans at period-end are as follows:

(in thousands)

	9/30/2017	12/31/2016
Commercial	$ 75,061	$ 77,436
Real estate construction	34,289	29,169
Real estate mortgage:		
1-4 family residential	242,152	244,638
Multi-family residential	41,498	47,199
Non-farm & non-residential	179,399	176,024
Agricultural	58,930	62,491
Consumer	17,520	18,867
Other	116	183
Total	$ 648,965	$ 656,007

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

	Nine Months Ended September 30, 2017 (in thousands)				
	Beginning Balance	Charge-offs	Recoveries	Provision	Ending Balance
Commercial	$ 789	$ (35)	$ 17	$ 161	$ 932
Real estate Construction	564	—	1	120	685
Real estate mortgage:					
1-4 family residential	2,301	(203)	8	248	2,354
Multi-family residential	581	—	10	39	630
Non-farm & non-residential	1,203	(78)	—	304	1,429
Agricultural	856	—	47	(420)	483
Consumer	547	(128)	34	80	533
Other	60	(682)	573	91	42
Unallocated	640	—	—	27	667
	$ 7,541	$ (1,126)	$ 690	$ 650	$ 7,755

Three Months Ended September 30, 2017

	(in thousands) Beginning Balance	Charge-offs	Recoveries	Provision	Ending Balance
Commercial	$ 1,006	$ (20)	$ 2	$ (56)	$ 932
Real estate construction	584	—	—	101	685
Real estate mortgage:					
1-4 family residential	2,575	(170)	3	(54)	2,354
Multi-family residential	645	—	3	(18)	630
Non-farm & non-residential	1,322	(78)	—	185	1,429
Agricultural	504	—	19	(40)	483
Consumer	561	(26)	6	(8)	533
Other	76	(214)	172	8	42
Unallocated	685	—	—	(18)	667
	$ 7,958	$ (508)	$ 205	$ 100	$ 7,755

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	Nine Months Ended September 30, 2016 (in thousands)				
	Beginning Balance	Charge-offs	Recoveries	Provision	Ending Balance
Commercial	$ 486	$ —	$ 37	$ 164	$ 687
Real estate Construction	411	—	15	153	579
Real estate mortgage:					
1-4 family residential	2,081	(90)	8	252	2,251
Multi-family residential	458	—	7	111	576
Non-farm & non-residential	1,213	—	355	(355)	1,213
Agricultural	678	(3)	35	118	828
Consumer	525	(210)	77	163	555
Other	60	(705)	583	124	62
Unallocated	609	—	—	45	654
	$ 6,521	$ (1,008)	$ 1,117	$ 775	$ 7,405

	Three Months Ended September 30, 2016 (in thousands)				
	Beginning Balance	Charge-offs	Recoveries	Provision	Ending Balance
Commercial	$ 666	$ —	$ 3	$ 18	$ 687
Real estate Construction	552	—	2	25	579
Real estate mortgage:					
1-4 family residential	2,304	(26)	1	(28)	2,251
Multi-family residential	507	—	3	66	576
Non-farm & non-residential	1,158	—	82	(27)	1,213
Agricultural	801	(3)	12	18	828
Consumer	550	(47)	7	45	555
Other	50	(206)	143	75	62
Unallocated	671	—	—	(17)	654
	$ 7,259	$ (282)	$ 253	$ 175	$ 7,405

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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 $2.4 million as of September 30, 2017 and $2.4 million at December 31, 2016) in loans by portfolio segment and based on impairment method as of September 30, 2017 and December 31, 2016:

As of September 30, 2017 (in thousands)	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Purchased Credit Impaired	Total
Allowance for Loan Losses:				
Commercial	$ —	$ 932	$ —	$ 932
Real estate construction	—	685	—	685
Real estate mortgage:		—		
1-4 family residential	68	2,286	—	2,354
Multi-family residential	—	630	—	630
Non-farm & non-residential	—	1,429	—	1,429
Agricultural	—	483	—	483
Consumer	—	533	—	533
Other	—	42	—	42
Unallocated	—	667	—	667
	$ 68	$ 7,687	$ —	$ 7,755
Loans:				
Commercial	$ —	$ 75,061	$ —	$ 75,061
Real estate construction	—	34,289	—	34,289
Real estate mortgage:				
1-4 family residential	420	240,836	896	242,152
Multi-family residential	—	40,924	574	41,498
Non-farm & non-residential	1,133	178,263	3	179,399
Agricultural	286	58,460	184	58,930
Consumer	—	17,520	—	17,520
Other	—	116	—	116
	$ 1,839	$ 645,469	$ 1,657	$ 648,965

As of December 31, 2016 (in thousands)	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Purchased Credit Impaired	Total
Allowance for Loan Losses:				
Commercial	$ —	$ 789	$ —	$ 789
Real estate construction	—	564	—	564
Real estate mortgage:				
1-4 family residential	99	2,202	—	2,301
Multi-family residential	—	581	—	581
Non-farm & non-residential	15	1,188	—	1,203
Agricultural	427	429	—	856
Consumer	—	547	—	547

Other	—	60	—	60
Unallocated	—	640	—	640
	$ 541	$ 7,000	$ —	$ 7,541
Loans:				
Commercial	$ 97	$ 77,339	$ —	77,436
Real estate construction	153	29,016	—	29,169
Real estate mortgage:				
1-4 family residential	2,704	240,906	1,028	244,638
Multi-family residential	—	46,637	562	47,199
Non-farm & non-residential	1,725	174,154	145	176,024
Agricultural	3,315	58,998	178	62,491
Consumer	—	18,867	—	18,867
Other	—	183	—	183
Total	$ 7,994	$ 646,100	$ 1,913	$ 656,007

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The following table presents loans individually evaluated for impairment by class of loans as of and for the nine months ended September 30, 2017 (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:						
Real estate mortgage:						
Non-farm & non-residential	$ 1,133	$ 1,133	$ —	$ 1,243	$ 42	$ 42
Agricultural	286	286	—	410	9	9
With an allowance recorded:						
Real estate mortgage:						
1-4 family residential	420	420	68	1,045	8	8
Total	$ 1,839	$ 1,839	$ 68	$ 2,699	$ 59	$ 59

The recorded investment in loans excludes accrued interest receivable and loan origination fees, net due to immateriality.

The following table presents loans individually evaluated for impairment by class of loans for the nine months ended September 30, 2016:

(in thousands):	Average Recorded Investment	Year to Date Interest Income Recognized	Year to Date Cash Basis Interest Recognized
With no related allowance recorded:			
Real estate mortgage:			
Construction	$ 171	$ 37	$ 37
Agricultural	436	21	21
With an allowance recorded:			
Real estate mortgage:			
1-4 family residential	989	47	47
Non-farm & non-residential	1,983	70	70
Agricultural	3,868	—	—
Total	$ 7,447	$ 175	$ 175

The recorded investment in loans excludes accrued interest receivable and loan origination fees, net due to immateriality.

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The following table presents loans individually evaluated for impairment by class of loans as of and for the year ended December 31, 2016 (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	$ 97	$ 97	$ —	$ 48	$ 30	$ 30
Real-estate construction	153	153		494	9	9
Real-estate mortgage:						
1-4 family residential						
Non-farm & non-residential	606	606	—	488	—	—
Agricultural	654	654	—	561	—	—
With an allowance recorded:						
Real estate mortgage						
1-4 family residential	2,098	2,098	99	1,590	56	56
Non-farm & non-residential	1,725	1,725	15	2,303	71	71
Agricultural	2,661	2,661	427	3,309	25	25
Total	$ 7,994	$ 7,994	$ 541	$ 8,793	$ 191	$ 191

The recorded investment in loans excludes accrued interest receivable and loan origination fees, net due to immateriality. The following tables present loans individually evaluated for impairment by class of loans for the three months ended September 30, 2017 and September 30, 2016:

	Three Months Ending September 30, 2017		
(in thousands):	Average Recorded Investment	Interest Income Recognized	Cash Basis Interest Recognized
With no related allowance recorded:			
Real estate mortgage:			
Non-farm & non-residential	$ 2,431	$ 17	$ 17
Agricultural	491	2	2
With an allowance recorded:			
Real estate mortgage:			
1-4 family residential	455	1	1
	$ 3,377	$ 20	$ 20

	Three Months Ending September 30, 2016		
	Average Recorded	Interest Income	Cash Basis Interest

	Investment	Recognized	Recognized
With no related allowance recorded:			
Real estate mortgage:			
Construction	$ 167	$ 10	$ 10
Agricultural	654	—	—
With an allowance recorded:			
Real estate mortgage:			
1-4 family residential	949	17	17
Non-farm & non-residential	2,094	21	21
Agricultural	3,824	—	—
Total	$ 7,688	$ 48	$ 48

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The following tables present the recorded investment in nonaccrual, loans past due over 90 days still on accrual and accruing troubled debt restructurings by class of loans as of September 30, 2017 and December 31, 2016:

As of September 30, 2017 (in thousands)	Nonaccrual	Loans Past Due Over 90 Days Still Accruing	Troubled Debt Restructurings
Commercial	$ —	$ 32	$ —
Real estate construction	—	67	—
Real estate mortgage:			
1-4 family residential	1,213	47	—
Non-farm & non-residential	—	—	—
Agricultural	150	—	—
Consumer	30	5	—
Total	$ 1,393	$ 151	$ —

As of December 31, 2016 (in thousands)	Nonaccrual	Loans Past Due Over 90 Days Still Accruing	Troubled Debt Restructurings
Commercial	$ 3	$ 11	$ —
Real estate construction	—	153	—
Real estate mortgage:			
1-4 family residential	2,725	31	338
Multi-family residential	25	—	—
Non-farm & non-residential	272	—	1,725
Agricultural	1,541	724	—
Consumer	—	8	—
Total	$ 4,566	$ 927	$ 2,063

Nonaccrual loans secured by real estate make up 97.0% of the total nonaccrual loan balances at September 30, 2017.

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.

A loan is considered 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. Other 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 but not in accordance with contractual terms.

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.

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The following tables present the aging of the recorded investment in past due and non-accrual loans as of September 30, 2017 and December 31, 2016 by class of loans:

As of September 30, 2017 (in thousands)	30–59 Days Past Due	60–89 Days Past Due	Greater than 90 Days Past Due	Non-accrual	Total Past Due & Non-accrual	Loans Not Past Due
Commercial	$ 95	$ —	$ 32	$ —	$ 127	$ 74,934
Real estate construction	—	—	67	—	67	34,222
Real estate mortgage:						
1-4 family residential	1,512	706	47	1,213	3,478	238,674
Multi-family residential	—	—	—	—	—	41,498
Non-farm & non-residential	192	—	—	—	192	179,207
Agricultural	151	—	—	150	301	58,629
Consumer	95	10	5	30	140	17,380
Other	—	—	—	—	—	116
Total	$ 2,045	$ 716	$ 151	$ 1,393	$ 4,305	$ 644,660

As of December 31, 2016 (in thousands)	30–59 Days Past Due	60–89 Days Past Due	Greater than 90 Days Past Due	Non-accrual	Total Past Due & Non-accrual	Loans Not Past Due
Commercial	$ 54	$ 45	$ 11	$ 3	$ 113	$ 77,323
Real estate construction	—	—	153	—	153	29,016
Real estate mortgage:						
1-4 family residential	2,310	228	31	2,725	5,294	239,344
Multi-family residential	391	3	—	25	419	46,780
Non-farm & non-residential	159	61	—	272	492	175,532
Agricultural	647	61	724	1,541	2,973	59,518
Consumer	97	37	8	—	142	18,725
Other	—	—	—	—	—	183
Total	$ 3,658	$ 435	$ 927	$ 4,566	$ 9,586	$ 646,421

Troubled Debt Restructurings:

Management periodically reviews renewals and modifications of previously identified TDRs, for which there was no principal forgiveness, to consider if it is appropriate to remove the TDR classification. If the borrower is no longer experiencing financial difficulty and the renewal/modification did not contain a concessionary interest rate or other concessionary terms, management considers the potential removal of the TDR classification. If deemed appropriate based upon current underwriting, the TDR classification is removed as the borrower has complied with the terms of the loan at the date of renewal/modification and there was a reasonable expectation that the borrower will continue to comply with the terms of the loan after the date of the renewal/modification. Additionally, TDR classification can be removed in circumstances in which the Company performs a non-concessionary re-modification of the loan at terms considered to be at market for loans with comparable risk and management expects the borrower will continue to perform under the re-modified terms based on the borrower's past history of performance. In July 2017, the TDR classification was removed from one loan that met the requirements as discussed above. This loans totaled $1.7 million at December 31, 2016. This loan is no longer evaluated individually for impairment.

The Company had no loans classified as troubled debt restructurings as of September 30, 2017. The Company allocated $40 thousand for specific reserves to customers whose loan terms had been modified in troubled debt restructuring as of December 31, 2016.

The Company has not committed to lend additional amounts as of September 30, 2017 and December 31, 2016 to customers with outstanding loans that are classified as troubled debt restructurings.

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No loans were modified as troubled debt restructurings during the first nine months ended of 2017 or 2016.

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 one or more potential weaknesses that deserve 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.

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 and documented 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.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans.

As of September 30, 2017 and December 31, 2016, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

As of September 30, 2017 (in thousands)	Pass	Special Mention	Substandard	Doubtful

Commercial	$ 73,482	$ 1,537	$ 42	$ —
Real estate construction	34,289	—	—	—
Real estate mortgage:				
1-4 family residential	233,723	3,806	4,577	46
Multi-family residential	38,195	3,303	—	—
Non-farm & non-residential	171,052	7,275	1,072	—
Agricultural	55,865	2,258	807	—
Total	$ 606,606	$ 18,179	$ 6,498	$ 46

As of December 31, 2016 (in thousands)	Pass	Special Mention	Substandard	Doubtful
Commercial	$ 76,346	$ 1,078	$ 12	$ —
Real estate construction	28,577	—	592	—
Real estate mortgage:				
1-4 family residential	232,969	4,031	7,627	11
Multi-family residential	43,681	2,617	901	—
Non-farm & non-residential	167,451	8,185	388	—
Agricultural	58,155	1,367	2,969	—
Total	$ 607,179	$ 17,278	$ 12,489	$ 11

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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 $35 thousand at September 30, 2017 and $8 thousand at December 31, 2016.

4.REAL ESTATE OWNED

Activity in real estate owned, net was as follows:

	Nine Months Ended September 30,	
	2017	2016
Beginning of year	$ 1,824	$ 2,347
Additions	1,897	193
Sales	(911)	(571)
Fair value adjustments	(141)	(131)
End of period	$ 2,669	$ 1,838

Activity in the valuation allowance was as follows:

	2017	2016
Beginning of year	$ 803	$ 616
Fair value adjustments	141	131
Reductions from sale	(46)	—
End of Period	$ 898	$ 747

Expenses related to foreclosed assets include:

	Nine Months Ended September 30,	
	2017	2016
	(in thousands)	
Net (gain) loss on sales, included in other income on income statement	$ (11)	$ (163)
Fair value adjustments	141	131
Operating expenses, net of rental income	148	91
Repossession expense, net	289	222

Net expense, net of gain or loss on sales, for the period	$ 278	$ 59

	Three Months Ended September 30,	
	2017	2016
	(in thousands)	
Net (gain) loss on sales, included in other income on income statement	$ 6	$ (163)
Fair value adjustments	103	46
Operating expenses, net of rental income	1	33
Repossession expense, net	104	79
Net expense, net of gain or loss on sales, for the period	$ 110	$ (84)

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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 based compensation agreements.

The factors used in the earnings per share computation follow:

	Nine Months Ended September 30, 2017	2016
	(in thousands)	
Basic Earnings Per Share		
Net Income	$ 8,139	$ 6,284
Weighted average common shares outstanding	2,955	2,975
Basic earnings per share	$ 2.74	$ 2.10
Diluted Earnings Per Share		
Net Income	$ 8,139	$ 6,284
Weighted average common shares outstanding	2,955	2,975
Weighted average common and dilutive potential common shares outstanding	2,956	2,975
Diluted earnings per share	$ 2.74	$ 2.10

	Three Months Ended September 30, 2017	2016
	(in thousands)	
Basic Earnings Per Share		
Net Income	$ 2,592	$ 2,365
Weighted average common shares outstanding	2,955	2,976
Basic earnings per share	$ 0.87	$ 0.79
Diluted Earnings Per Share		
Net Income	$ 2,592	$ 2,365
Weighted average common shares outstanding	2,955	2,976
Weighted average common and dilutive potential common shares outstanding	2,956	2,976
Diluted earnings per share	$ 0.87	$ 0.79

Stock options for 0 shares of common stock for the nine and three months ended September 30, 2017 and 1,200 shares of common stock for the nine and three months ended September 30, 2016 were excluded from diluted earnings per share because their impact was antidilutive.

6.STOCK COMPENSATION

We have four stock based compensation plans as described below.

Two Stock Option Plans

Under its expired 1999 Employee Stock Option Plan, the Company has granted certain officers and key employees stock option awards which vest and become fully exercisable at the end of five years and provided for issuance of up to 100,000 options. Under the expired 1993 Non-Employee Directors Stock Ownership Incentive Plan, the Company also granted certain directors stock option awards which vest and become fully exercisable immediately and provided 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 the Company’s stock on the date of grant.

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Summary of activity in the stock option plan for the first nine months of 2017 follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (in thousands)
Outstanding, beginning of year	1,200	$ 31.00		
Granted	—	—		—
Forfeited or expired	—	—		—
Exercised	(600)	31.00		
Outstanding, end of period	600	$ 31.00	5 months	$ 6
Vested and expected to vest	600	$ 31.00	5 months	$ 6
Exercisable, end of period	600	$ 31.00	5 months	$ 6

(1) Aggregate intrinsic value in thousands

As of September 30, 2017, there was $0 of total unrecognized compensation cost related to nonvested stock options granted under the Plan. Since both stock option plans have expired, neither plan allows for additional options to be issued.

2005 Restricted Stock Grant Plan

On May 10, 2005, the Company's stockholders approved a restricted stock grant plan. Total shares issuable under the plan were 50,000. There were no shares issued during the first nine months of 2017 or 2016. The plan is now expired and no additional shares will be issued from the 2005 plan. There were 117 shares forfeited during the first nine months of 2017 and 639 shares were forfeited during the first nine months 2016.

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, 2017	10,636	$ 253,518	$ 23.84

Granted	—	—	—
Vested	(4,348)	(97,747)	22.48
Forfeited	(117)	(3,004)	—
Nonvested at September 30, 2017	6,171	$ 152,767	$ 24.76

(1) Grant date fair value in thousands

As of September 30, 2017, there was $99 thousand 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 1.8 years. As of September 30, 2017, no additional shares are available for issuance under the restricted stock grant plan.

2009 Stock Award Plan

On May 13, 2009, the Company's 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. There were 6,575 shares issued during the first nine months of 2017 and 6,170 shares were issued during the first nine months of 2016. There were 951 shares forfeited during the first nine months of 2017 and 360 shares were forfeited during the first nine months of 2016.

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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, 2017	7,297	$ 213,853	$ 29.31
Granted	6,575	213,688	32.50
Vested	(1,648)	(47,988)	29.12
Forfeited	(951)	(30,463)	32.03
Nonvested at September 30, 2017	11,273	$ 349,090	$ 30.97

(1) Grant date fair value in thousands

As of September 30, 2017, there was $292 thousand 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 3.7 years. As of September 30, 2017, 133,368, shares are still available for issuance.

7.REPURCHASE AGREEMENTS

Repurchase agreements totaled $24.1 million at September 30, 2017. Of this, $18.1 million were overnight obligations and $6.0 million had terms extending through May 2021 and a weighted remaining average life of 1.6 years. The Company pledged agencies and mortgage-backed securities with a carrying amount of $30.5 million to secure repurchase agreements as of September 30, 2017.

8.OTHER BORROWINGS

On July 20, 2015, the Company borrowed $5 million which had an outstanding balance of $3.8 million at September 30, 2017. The term loan has a fixed interest rate of 5.02%, requires quarterly principal and interest payments, matures July 20, 2025 and is collateralized by Kentucky Bank stock. The maturity schedule for the term loan as of September 30, 2017 is as follows (in thousands):

2017	$ 81
2018	399
2019	419
2020	441
2021	463
Thereafter	1,959
	$ 3,762

In addition, the Company also had $17.3 million in federal funds purchased at September 30, 2017.

9.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.

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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.

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 and Trading Assets: The fair values for available for sale investment securities and trading assets 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 for similar loans and collateral underlying such loans.

Adjustments totaled $68 thousand the first nine months of 2017 and $0 for the first nine months of 2016 and resulted in a Level 3 classification of the inputs for determining fair value.

Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business, resulting in a Level 3 fair value classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted in accordance with the allowance policy.

Other Real Estate Owned: Assets acquired through or instead of loan foreclosure and classified as other real estate owned (OREO) are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals which are updated no less frequently than annually. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach with data from comparable properties. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments were $141 thousand for the nine months ended September 30, 2017 and $131 thousand for the nine months ended September 30, 2016, and $103 thousand for the three months ended September 30, 2017 and $46 thousand for the three months ended September 30, 2016, and resulted in a Level 3 classification of the inputs for determining fair value. Real estate owned properties are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

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 and trading assets are the Company's only balance sheet items 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, 2017 (in thousands):

Description	Carrying 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	$ 30,660	$ —	$ 30,660	$ —
States and municipals	102,291	—	102,291	—
Mortgage-backed - residential	156,663	—	156,663	—
Equity securities	342	342	—	—
Trading Assets	5,714	1,959	3,755	—
Total	$ 295,670	$ 2,301	$ 293,369	$ —

Fair Value Measurements at December 31, 2016 (in thousands):

Description	Carrying 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	$ 36,528	$ —	$ 36,528	$ —
States and municipals	91,132	—	91,132	—
Mortgage-backed - residential	145,770	—	145,770	—
Equity securities	340	340	—	—
Trading Assets	5,592	1,608	3,984	—
Total	$ 279,362	$ 1,948	$ 277,414	$ —

There were no transfers between level 1 and level 2 during 2017 or 2016.

Assets measured at fair value on a non-recurring basis are summarized below (in thousands):

	Fair Value Measurements at September 30, 2017 Using :			
(In thousands)	Carrying Value	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Description				
Impaired loans:				
Real Estate Mortgage:				
1-4 family Residential	$ 353	$ —	$ —	$ 353
Other real estate owned, net:				
Residential	611	—	—	611
Commercial	57	—	—	57
Mortgage servicing rights	1,310	—	—	1,310

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	Fair Value Measurements at December 31, 2016 Using :			
(In thousands)	Carrying Value	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Description				
Impaired loans:				
Real Estate Mortgage:				
1-4 family residential	$ 1,685	$ —	$ —	$ 1,685
Agricultural	2,234	—	—	2,234
Other real estate owned, net:				
Residential	956	—	—	956
Commercial	272	—		272
Mortgage servicing rights	1,083	—	—	1,083

Impaired loans measured for impairment using the fair value of the collateral for collateral dependent loans had a carrying amount of $353 thousand, which includes a valuation allowance of $68 thousand at September 30, 2017. Impaired loans measured for impairment using the fair value of the collateral for collateral dependent loans had a net carrying amount of $3.9 million, with a valuation allowance of $502 thousand at December 31, 2016. One new loan became impaired during the nine month and three month period ended September 30, 2017 which resulted in $68 thousand in additional provision for loan losses for impaired loans. For the nine months and three months ended September 30, 2016, no loans which became impaired during 2016, resulted in additional loan loss provision expense.

Other real estate owned measured at fair value less costs to sell had a net carrying amount of $668 thousand, which is made up of the outstanding balance of $1.6 million, net of a valuation allowance of $898 thousand at September 30, 2017. Other real estate owned which was measured at fair value less costs to sell, had a net carrying amount of $1.6 million, which was made up of the outstanding balance of $2.4 million, net of a valuation allowance of $803 thousand at December 31, 2016. The Company recorded $141 thousand in write-downs of other real estate owned properties for the nine months ended September 30, 2017 and $103 thousand for the three months ended September 30, 2017. The Company recorded $131 thousand and $46 thousand in net write-downs of other real estate owned properties during the nine months and the three months ended September 30, 2016.

Impaired mortgage servicing rights, which are carried at the lower of cost or fair value, were carried at their fair value of $1.3 million, which is made up of the outstanding balance of $1.4 million, net of a valuation allowance of $86 thousand at September 30, 2017. At December 31, 2016, impaired loan servicing rights were carried at their fair value of $1.1 million, which is made up of the outstanding balance of $1.2 million, net of a valuation allowance of $125 thousand. For the first nine months of 2017, the Company recorded a net recovery of prior write-downs of $40 thousand and net write-downs of $106 thousand for the nine months ended September 30, 2016. For the three months ended September 30, 2017, the Company recorded a net recovery of prior write-downs of $6 thousand compared to net write-downs of $64 thousand for the three months ended September 30, 2016.

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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, 2017 and December 31, 2016:

September 30, 2017 (In thousands)	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted Average)	
Impaired loans					
Real estate mortgage:					
1-4 family residential	353	sales comparison	adjustment for differences between the comparable sales	0%-12%	(6)%
Other real estate owned:					
Residential	611	sales comparison	adjustment for differences between the comparable sales	1%-16%	(9)%
Commercial	57	income approach	capitalization rate	10%-10%	(10)%
Mortgage Servicing Rights	1,310	discounted cash flow	constant prepayment rates	8%-50%	(11)%

December 31, 2016 (In thousands)	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted Average)	
Impaired loans					
Real estate mortgage:					
1-4 family residential	1,685	sales comparison	adjustment for differences between the comparable sales	0%-21%	(10)%
Agricultural	2,234	sales comparison	adjustment for differences between the comparable sales	2%-75%	(9)%
Other real estate owned:					
Residential	956	sales comparison	adjustment for differences between the comparable sales	1%-16%	(9)%
Commercial	272	income approach	capitalization rate	10%-10%	(10)%
Mortgage Servicing Rights	1,083	discounted cash flow	constant prepayment rates	8%-45%	(13)%

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Fair Value of Financial Instruments

The carrying amounts and estimated fair values of financial instruments, at September 30, 2017 and December 31, 2016 are as follows:

September 30, 2017:

(in thousands)	Carrying Value	Level 1	Level 2	Level 3	Total
Financial assets					
Cash and cash equivalents	$ 18,612	$ 18,612	$ —	$ —	$ 18,612
Interest bearing time deposits	1,830	1,830	—	—	1,830
Securities available for sale	289,956	342	289,614	—	289,956
Trading assets	5,714	1,959	3,755	—	5,714
Loans held for sale	1,316	—	1,350	—	1,350
Net Loans	641,210	—	—	640,915	640,915
Federal Home Loan Bank stock	7,034	—	—	—	N/A
Interest receivable	3,785	—	1,338	2,447	3,785
Financial liabilities					
Total deposits	$ 748,379	$ 559,820	$ 189,475	$ —	$ 749,295
Federal funds purchased	17,302	17,302	—	—	17,302
Repurchase agreements	24,070	—	24,125	—	24,125
Short-term Federal Home Loan Bank advances	8,530	—	8,532	—	8,532
Long-term Federal Home Loan Bank advances	93,665	—	88,557	—	88,557
Note payable	3,762		4,208		4,208
Subordinated debentures	7,217	—	—	7,213	7,213
Interest payable	796	—	736	60	796

December 31, 2016:

(in thousands)	Carrying Value	Level 1	Level 2	Level 3	Total
Financial assets					
Cash and cash equivalents	$ 43,250	$ 43,250	$ —	$ —	$ 43,250
Interest bearing time deposits	5,029	5,029	—	—	5,029
Securities available for sale	273,770	340	273,430	—	273,770

Trading assets	5,592	1,608	3,984	—	5,592
Loans held for sale	724	—	750	—	750
Net Loans	648,466	—	—	648,234	648,234
Federal Home Loan Bank stock	7,034	—	—	—	N/A
Interest receivable	3,715	—	1,334	2,381	3,715
Financial liabilities					
Total deposits	$ 802,981	$ 607,617	$ 195,528	$ —	$ 803,145
Repurchase agreements	20,873	—	21,006	—	21,006
Long-term Federal Home Loan Bank advances	92,500	—	91,015	—	91,015
Note payable	4,090	—	4,564	—	4,564
Subordinated debentures	7,217	—	—	7,210	7,210
Interest payable	692	—	639	53	692

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 cash equivalents approximate fair values and are classified as Level 1.

Interest Bearing Deposits - The carrying amounts of interest bearing deposits 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 used to estimate the fair value of loans do not necessarily represent an exit price.

The fair value of mortgage 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.

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, Borrowings and Subordinated Debentures - The fair values of the Company's FHLB advances and other borrowings 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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10.CHANGES IN ACCUMULATED OTHER COMPREHENSIVE INCOME BY COMPONENT

Changes in Accumulated Other Comprehensive Income by Component (unaudited)

(in thousands)

	Unrealized Gains and Losses on Available for Sale Securities For the Nine Months Ended September 30,	
	2017	2016
Beginning Balance	$ (956)	$ 359
Unrealized holding gains (losses) for the period, net of tax	1,889	3,452
Reclassification adjustment for:		
Securities gains realized in income	103	317
Income taxes	(35)	(108)
	68	209
Net current period other comprehensive income	1,821	3,243
Ending balance	$ 865	$ 3,602

	Unrealized Gains and Losses on Available for Sale Securities For the Three Months Ended September 30,	
	2017	2016
Beginning Balance	$ 1,213	$ 4,402
Unrealized holding gains (losses) for the period, net of tax	(308)	(774)
Reclassification adjustment for:		
Securities gains realized in income, net	60	40
Income taxes	(20)	(14)

	40	26
Net current period other comprehensive income (loss)	(348)	(800)
Ending balance	$ 865	$ 3,602

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The following is significant amounts reclassified out of each component of accumulated other comprehensive income (loss) for the nine months ended September 30, 2017 and September 30, 2016:

September 30, 2017

Details about Accumulated Other Comprehensive Income Components	Amount Reclassified From Accumulated Other Comprehensive Income	Affected Line Item in the Statement Where Net Income is Presented
Unrealized gains and losses on available-for-sale securities	$ 103	Gain on sale of available for sale securities, net
	35	Income taxes
	68	Net income

September 30, 2016

Details about Accumulated Other Comprehensive Income Components	Amount Reclassified From Accumulated Other Comprehensive Income	Affected Line Item in the Statement Where Net Income is Presented
Unrealized gains and losses on available-for-sale securities	$ 317	Gain on sale of available for sale securities, net
	108	Income taxes
	209	Net income

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

Forward-Looking Statements

The following discussion provides information about the financial condition and results of operations of the Company and its subsidiaries as of the dates and periods indicated. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and Notes thereto appearing elsewhere in this report and the Management's Discussion and Analysis in the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

This discussion contains forward-looking statements under the Private Securities Litigation Reform Act of 1995 that involve risks and uncertainties. We intend such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the federal securities laws. 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," "estimates," "potential," "may," 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); ability to successfully gain regulatory approval when required; 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; future acquisitions, changes in technology, information security breaches or cyber security attacks involving the Company, it subsidiaries, or third-party service providers; 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.

As a result of the uncertainties and the assumptions on which this discussion and the forward-looking statements are based, actual future operations and results in the future may differ materially from those indicated herein.

You should not place undue reliance on any forward-looking statements made by us or on our behalf. Our forward-looking statements are made as of the date of the report, and 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 $8.1 million, or $2.74 basic earnings and diluted earnings per share for the first nine months ended September 30, 2017 compared to $6.3 million or $2.10 basic earnings and diluted earnings per share for the nine month period ended September 30, 2016. The first nine months net earnings reflect an increase of $1.9 million, or 29.5%, compared to the same time period in 2016. The increase in net earnings is mostly attributed to an increase of $903 thousand, or 3.8%, in net interest income, an increase of $1.7 million, or 18.4%, in non-interest income, a decrease of $483 thousand, or 1.9%, in non-interest expense, and a decrease of $125 thousand, or 16.1%, for the provision for loan losses. The increase in non-interest income is mostly attributed to the sale of a branch building located in Winchester, Kentucky, to a non-banking real estate investor. The sale was solely for the building and not for the loans or deposits associated with the branch. The sale of the building resulted in a pre-tax gain of approximately $1.2 million. Absent the sale of the building, net income would have been up approximately $1.1 million or 16.9%, net of tax, compared to the same period last year. The earnings for the three months ended September 30, 2017 were $2.6 million or $0.87 basic and diluted earnings per share compared to $2.4 million or $0.79 basic and diluted earnings per share for the three month period ended September 30, 2016. The earnings for the three month period in 2017 reflect an increase of 9.6% compared to the same time period in 2016.

For the nine months ended September 30, 2017 and compared to the nine months ended September 30, 2016, service charges increased $24 thousand, gain on the sale of loans increased $167 thousand, and debit card interchange income increased $221 thousand. Salaries and benefits expense increased $73 thousand, legal and professional fees decreased $552 thousand and debit card expenses increased $226 thousand. For the three months ended September 30, 2017 and compared to the three months ended September 30, 2016, service charges decreased $120 thousand, debit card interchange income increased $64 thousand, and gains on the sale of loans decreased $118 thousand.

For the three months ended September 30, 2017 and compared to the the three months ended September 30, 2016, salaries and benefits expense increased $52 thousand, legal and professional fees decreased $138 thousand, data processing expense increased $13 thousand, debit card expense increased $95 thousand and other expenses decreased $298 thousand. For the same three month comparision, repossession expense increased $25 thousand.

Return on average assets was 1.05% for the nine months ended September 30, 2017 and 0.84% for the nine months ended September 30, 2016. Return on average assets was 1.01% for the three months ended September 30, 2017 and 0.94% for the three months ended September 30, 2016. Return on average equity was 11.16% for the nine month period ended September 30, 2017 and 8.94% for the nine month period ended September 30, 2016. Return on average equity was 10.33% for the three month period ended September 30, 2017 and 9.83% for the three month period ended September 30, 2016.

Securities available for sale increased $16.2 million from $273.8 million at December 31, 2016 to $290.0 million at September 30, 2017. Trading assets increased by $122 thousand, or 2.20%, and totaled $5.7 million at September 30, 2017 compared to $5.6 million at December 31, 2016, and includes income on the investment totaling $86 thousand during the first nine months of 2017 compared to $117 thousand for the nine months ended September 30, 2016. Income (loss) on the trading account totaled $27 thousand for the three months ended September 30, 2017 compared to $44 thousand for the three months ended September 30, 2016.

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Gross Loans decreased $7.0 million from $656.0 million on December 31, 2016 to $649.0 million at September 30, 2017. The overall decrease in loan balances from December 31, 2016 to September 30, 2017 is comprised of the following: a decrease of $2.5 million in 1-4 family residential loans, a decrease of $2.4 million in commercial loans, a decrease of $5.7 million in multi-family residential loans, a decrease of $3.6 million in agricultural loans, an increase of $3.4 million in non-farm and non-residential loans, a decrease of $1.3 million in consumer loans, and an increase of $5.1 million in real-estate construction loans. Other loan balances decreased $67 thousand from December 31, 2016 to September 30, 2017.

Total deposits decreased from $803.0 million on December 31, 2016 to $748.0 million on September 30, 2017, a decrease of $55.0 million. Non-interest bearing demand deposit accounts increased $962 thousand from December 31, 2016 to September 30, 2017 while time deposits $250 thousand and over decreased $5.8 million and other interest bearing deposit accounts decreased $49.8 million from December 31, 2016 to September 30, 2017.

Public fund account balances decreased $41.2 million from December 31, 2016 to September 30, 2017. Public fund accounts typically decrease during the first three quarters of the year and increase during the last quarter of the year due to tax payments collected during the fourth quarter and then withdrawn from the Bank during the following months.

Borrowings from the Federal Home Loan Bank increased $9.7 million from December 31, 2016 to September 30, 2017, repurchase agreements increased $3.2 million, and the note payable decreased $328 thousand.

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 $25.0 million for the nine months ended September 30, 2017 compared to $24.1 million for the nine months ended September 30, 2016, an increase of 3.8%. Net interest income was $8.4 million for the three months ended September 30, 2017 compared to $8.1 million for the three months ended September 30, 2016, an increase of 4.4%.

The interest spread, excluding tax equivalent adjustments, was 3.33% for the first nine months of 2017 compared to 3.37% for the first nine months of 2016. For the first nine months in 2017, the yield on assets increased from 3.86% in 2016 to 3.87% in 2017, excluding tax equivalent adjustments. The yield on loans decreased three basis points compared to the nine months ended September 30, 2016 from 4.74% to 4.71% for the nine months ended September

30, 2017. The yield on securities, excluding tax equivalent adjustments, increased from 2.30% during the first nine months of 2016 to 2.35% during the first nine months of 2017. The cost of liabilities was 0.53% for the first nine months in 2017 compared to 0.49% in 2016.

Year to date average loans, excluding overdrafts, increased $8.9 million, or 1.4% for the nine months ended September 30, 2017 compared to the nine months ended September 30, 2016. Loan interest income increased $553 thousand during the first nine months of 2017 compared to the first nine months of 2016. Year to date average total deposits increased from September 30, 2016 to September 30, 2017 by $36.3 million or 4.7%. Year to date average interest bearing deposits increased $38.7 million, or 7.0%, from September 30, 2016 to September 30, 2017. Deposit interest expense increased $330 thousand for the first nine months of 2017 compared to the same period in 2016. Year to date average borrowings, including repurchase agreements, increased $1.4 million, or 1.1%, from September 30, 2016 to September 30, 2017. Interest expense on borrowed funds, including repurchase agreements, increased $57 thousand for the first nine months of 2017 compared to the same period in 2016. Year to date average federal funds purchased increased $864 thousand.

The volume rate analysis for the nine months ended September 30, 2017 indicates that $313 thousand of the increase in loan interest income is attributable to an increase in loan volume and $611 thousand of the increase in securities interest income is attributable to an increase in the volume of our security portfolio. Further, an increase in loan rates caused an increase of $240 thousand in interest income and a decrease in rates in our security portfolio contributed to a decrease of $10 thousand in securities interest income. The net effect to interest income was an increase of $1.3 million for the first nine months of 2017 compared to the same time period in 2016.

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Also based on the following volume rate analysis for the nine months ended September 30, 2017, an increase in demand deposit interest rates resulted in $196 thousand additional interest expense, a decrease in interest rates paid for savings deposits resulted in a reduction of $4 thousand in interest expense, and increases in interest rates for time deposits resulted in an increase of $94 thousand in interest expense. Further, an increase in rates for repurchase agreements and other borrowings resulted in $47 thousand additional expense.

The change in volume in deposits and borrowings was responsible for a $52 thousand increase in interest expense, of which an increase in demand deposits resulted in an increase of $69 thousand in interest expense, a decrease in time deposits resulted in a decrease of $25 thousand in interest expense, a decrease in repurchase agreements and other borrwings resulted in a decrease of $37 thousand in interest expense, and a decrease in other borrowings resulted in a decrease of $45 thousand in interest expense. The net effect to interest expense was an increase of $386 thousand. As a result, the increase in net interest income for the first nine months in 2017 is mostly attributed to growth in the Company's loan and security portfolios.

The volume rate analysis for the three months ended September 30, 2017 indicates that $166 thousand of the increase in net interest income is attributable to growth in the Company's balance sheet and an increase of $192 thousand is a result of changes in rates.

Changes in Interest Income and Expense

	Nine Months Ended September 30 2017 vs. 2016 Increase (Decrease) Due to Change in		
(in thousands)	Volume	Rate	Net Change
INTEREST INCOME			
Loans	$ 313	$ 240	$ 553
Investment Securities	611	(10)	601
Other	14	121	135
Total Interest Income	938	351	1,289
INTEREST EXPENSE			
Deposits			
Demand	69	196	265
Savings	—	(4)	(4)
Negotiable Certificates of Deposit and Other Time Deposits	(25)	94	69
Securities sold under agreements to repurchase and other borrowings	(37)	47	10
Federal Home Loan			
Bank advances	45	1	46
Total Interest Expense	52	334	386

Net Interest Income	$ 886	$ 17	$ 903

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	Three Months Ended September 30 2017 vs. 2016 Increase (Decrease) Due to Change in		
	Volume	Rate	Net Change
INTEREST INCOME			
Loans	$ (50)	$ 199	$ 149
Investment Securities	290	43	333
Other	(19)	50	31
Total Interest Income	221	292	513
INTEREST EXPENSE			
Deposits			
Demand	12	80	92
Savings	—	(1)	(1)
Negotiable Certificates of Deposit and Other Time Deposits	(11)	33	22
Securities sold under agreements to repurchase and other borrowings	26	(22)	4
Federal Home Loan			
Bank advances	28	10	38
Total Interest Expense	55	100	155
Net Interest Income	$ 166	$ 192	$ 358

Non-Interest Income

Non-interest income increased $1.7 million for the nine months ended September 30, 2017, compared to the same period in 2016, to $10.8 million. Non-interest income increased $79 thousand for the three months ended September 30, 2017, compared to the thee months ended September 30 2016, to $3.2 million.

As previously noted, non-interest income increased $1.7 million for the nine months ended September 30, 2017 in comparison to the nine months ended September 30, 2016. Favorable variances to non-interest income for the first nine months of 2017 include an increase of $24 thousand in service charges, an increase of $211 thousand in loan net service fee income, an increase of $83 thousand in trust department income, an increase of $221 thousand in debit card interchange income, and an increase of $167 thousand in gains on the sale of loans.

The largest favorable variance to non-interest income for the first nine months of 2017 is an increase of $1.2 million in gains on bank premises due to the sale of a bank building located in Winchester, Kentucky. The sale was solely for the building and not for the loans or deposits associated with the branch.

Decreases to non-interest income for the nine months ended September 30, 2017 compared to the nine months ended September 30, 2016 include a decrease of $214 thousand in gains on the sale of securities, a decrease of $13 thousand in brokerage income, and a decrease of $12 thousand in gains on trading assets.

The gain on the sale of loans increased from $1.3 million during the first nine months of 2016 to $1.5 million during the first nine months of 2017, an increase of $167 thousand. For the three months ended September 30, the gain on the sale of loans decreased from $533 thousand in 2016 to $415 thousand in 2017.

The volume of loans originated to sell during the first nine months of 2017 increased $3.2 million compared to the same time period in 2016. The volume of loans originated to sell the during the three months ended September 30, 2017 compared to the nine months ended September 30, 2016 decreased $5.8 million. 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 and impairment expense, was $234 thousand for the nine months ended September 30, 2017 compared to $23 thousand for the nine months ended September 30, 2016, an increase of $211 thousand. During the first nine months of 2017, the market value adjustment to the carrying value of the mortgage servicing right was a net recovery of prior-writedowns of $40 thousand, as the fair value of this asset increased. During the first nine months of 2016, the market value adjustment to the carrying value of the mortgage servicing right asset was a net write-down of $106 thousand as the fair value of the mortgage servicing asset decreased.

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For the three months ended September 30, 2017, the market value adjustment to the carrying value of the mortgage serving right asset was a net recovery of prior write-downs of $6 thousand compared to a net write-down of $64 thousand during the third quarter of 2016.

Non-Interest Expense

Total non-interest expense decreased $476 thousand for the nine month period ended September 30, 2017 compared to the same period in 2016. Total non-interest expense decreased $275 thousand for the three month period ended September 30, 2017 compared to the three months ended September 30, 2016. Management continues to consider opportunities for branch expansion, and will also consider acquisition opportunities that help advance its strategic objectives, which would result in additional future non-interest expense.

For the comparable nine month periods, salaries and employees benefits expense increased $73 thousand, an increase of 0.5%. The number of full-time employee equivalent employees decreased from 247 at September 30, 2016 to 236 at September 30, 2017, a decrease of 11 full-time employee equivalent employees. For the three months ended September 30, 2017 compared to the three months ended September 30, 2016, salaries and employee benefits expense decreased $52 thousand, or 1.1%.

Occupancy expense increased $53 thousand to $2.9 million for the first nine months of 2017 compared to the same time period in 2016. Building rent expense increased $76 thousand mostly due to rent expense being lower in 2016 due to the Company recovering $20 thousand in accrued expense for a former branch leased in Richmond, KY. In addition, the Company incurred an additional $42 thousand in building rents during the first nine months of 2017, compared to the same time period in 2016, due to rent expense associated with leasing back the branch building that was sold in Winchester, KY during the first quarter of 2017. The Company is leasing back the formerly owned building until a new building is contructed which is expected to be completed in 2018.

Depreciation expense decreased $107 thousand for the nine months ended September 30, 2017 compared to September 30, 2016. Expenses incurred for assets not depreciated increased $121 thousand during the first nine months of 2017 compared to the first nine months of 2016. This increase is attributed to purchasing additional equipment during the first quarter of 2017 and increasing the threshold for which we depreciate assets. The capitalization policy, during the first nine months of 2016, stated assets purchased with a cost of $1,000 or greater would be capitalized and depreciated. This policy was changed during the last half of 2016 and now states the minimum threshold for an asset to be capitalized is $2,500.

Occupancy expense was $935 thousand for the three months ended September 30, 2017 compared to $974 thousand for the three months ended September 30, 2016, a decrease of $39 thousand.

Legal and professional fees decreased $505 thousand for the nine months ended September 30, 2017 compared to the first nine months in 2016 and decreased $91 thousand for the three months ended September 30, 2017 compared to the three months ended September 30, 2016. The reduction in legal and professional fees is mostly attributed to expenses being higher for the nine months ended September 30, 2016 due to the Company incurring $625 thousand for expenses related to acquiring the services of an outside firm to help the Company identify ways to become more efficient and profitable. Similar expenses totaled $198 thousand for the nine months ended September 30, 2017, a decrease of $427 thousand.

Debit card expenses increased $226 thousand for the nine months ended September 30, 2017 compared to the first nine months of 2016 and increased $95 thousand for the three months ended September 30, 2017 compared to the three months ended September 30, 2016. The increase in debit card expense is attributed to an increase in debit card interchange activity which also resulted in increases in debit card interchange income as shown on the income statement. Debit card expenses have also increased during 2017 due to issuing new debit cards.

Repossession expense increased $67 thousand for the first nine months ended September 30, 2017 compared to the same time period in 2016 and increased $25 thousand for the three month period ended September 30, 2017 compared to the three months ended September 30, 2016. Repossession expenses are reported net of rental income earned on repossessed properties. Net repossession expenses were higher during the first nine months of 2017 when compared to 2016 due to net write-downs totaling $141 in 2017 compared to net write-downs of $131 thousand in 2016.

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Income Taxes

The effective tax rate for the nine months ended September 30, 2017 was 19.1% compared to 8.5% in 2016. The effective tax rate for the three months ended September 30, 2017 was 18.0% compared to 0.3% in 2016. The effective tax rate is higher in 2017 due to an increase in taxable income, largely due to the $1.2 million gain on the sale of the branch building. These effective tax rates are less than the statutory rate as a result of the Company investing in tax-free securities, loans and other investments which generate tax credits for the Company.

The Company also has a captive insurance subsidiary which contributes to reducing taxable income. Income tax expense increased $1.3 million for the nine months ended September 30, 2017 compared to the first nine months in 2016. Tax-exempt interest income decreased $166 thousand for the first nine months of 2017 compared to the first nine months of 2016. Further, for the first nine months of 2017, the Company had tax credits totaling $416 thousand for investments made in low income housing projects compared to similar tax credits of $836 thousand for the first nine months of 2016.

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, 2017, the Company averaged $92 million in tax free securities and $40 million in tax free loans. As of September 30, 2017, the weighted average remaining maturity for the tax free securities is 112 months, while the weighted average remaining maturity for the tax free loans is 138 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 Federal Home Loan Bank borrowings.

Liquidity risk is the possibility that we may not be able to meet our cash requirements in an orderly manner. 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 $18.6 million as of September 30, 2017 compared to $43.2 million at December 31, 2016. The decrease in cash and cash equivalents is attributed to a decrease of $23.6 million in cash and due from banks and a decrease of $1.0 million in federal funds sold. The decrease in cash and cash equivalents is mostly attributed to deposit balances being greater at December 31 for our public entity depositors due to the recent collection of tax revenues. As the tax dollars are dispursed throughout the year, the balances for these depositors will decrease resulting in a decrease in the Company’s cash and cash equivalents.

In addition to cash and cash equivalents, the securities portfolio provides an important source of liquidity. Securities available for sale totaled $290.0 million at September 30, 2017 compared to $273.8 million at December 31, 2016. Securities classified as trading assets totaled $5.7 million at September 30, 2017 compared to $5.6 million at December 31, 2016. The securities available for sale and trading assets 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 2017, deposits decreased $54.6 million compared to December 31, 2016. The Company's borrowed funds from the Federal Home Loan Bank increased $9.7 million from December 31, 2016 to September 30, 2017, federal funds purchased increased $17.3 million, and total repurchase agreements increased $3.2 million from December 31, 2016 to September 30, 2017.

Management is aware of the challenge of funding sustained loan growth. Therefore, in addition to deposits, other sources of funds, such as Federal Home Loan Bank advances, may be used. We rely on Federal Home Loan Bank 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, 2017, we have sufficient collateral to borrow an additional $69 million from the Federal Home Loan Bank.

In addition, as of September 30, 2017, $30 million is available in overnight borrowing through various correspondent banks and the Company has access to an additional $289 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.

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, including Common Equity Tier 1 Capital, (as defined in the applicable banking regulations) to risk-weighted assets (as defined), and of Tier I capital to average assets (as defined). Management believes, as of September 30, 2017 and December 31, 2016, 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, Common Equity Tier 1 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.

In July 2013, the FDIC and the other federal bank regulatory agencies issued a final rule that revised their leverage and risk-based capital requirements and the method of calculating risk-weighted assets to make them consistent with agreements that were reached by the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. Among other things, the rule establishes a new common equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets), increases the minimum Tier 1 capital to risk-based assets requirement (from 4% to 6% of risk-weighted assets) and assigns a higher risk weight (150%) to exposures that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance the acquisition, development or construction of real property. The final rule also requires unrealized gains and losses on certain "available-for-sale" securities holdings to be included for purposes of calculating regulatory capital requirement unless a one-time opt-in or opt-out is exercised, which the Company did opt-out of. The rule limits a banking organization's capital distributions and certain discretionary bonus payments if the banking organization does not hold a "capital conservation buffer" consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements.

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The capital conservation buffer was 1.25% at September 30, 2017 and the Company is in compliance with the capital conservation buffer. The final rule became effective for the Bank on January 1, 2016. In accordance with the final rule, the capital conservation buffer requirement began being phased in beginning January 1, 2016 and will continue through January 1, 2019, when the full capital conservation buffer requirement will be effective. The Company's and the Bank's actual amounts and ratios, exclusive of the capital conservation buffer, are presented in the table below:

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in Thousands)					
September 30, 2017						
Consolidated						
Total Capital (to Risk-Weighted Assets)	$ 100,029	14.2 %	$ 56,479	8.0 %	N/A	N/A
Tier I Capital (to Risk-Weighted Assets)	92,189	13.1	42,359	6.0	N/A	N/A
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	85,189	12.1	31,770	4.5	N/A	N/A
Tier I Capital (to Average Assets)	92,189	9.1	40,607	4.0	N/A	N/A
Bank Only						
Total Capital (to Risk-Weighted Assets)	$ 98,654	14.7 %	$ 53,759	8.0 %	$ 67,198	10.0 %
Tier I Capital (to Risk-Weighted Assets)	90,814	13.5	40,319	6.0	53,759	8.0
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	90,814	13.5	30,239	4.5	43,679	6.5
Tier I Capital (to Average Assets)	90,814	9.0	40,469	4.0	50,587	5.0
December 31, 2016						
Consolidated						
Total Capital (to Risk-Weighted Assets)	$ 94,343	13.9 %	$ 54,280	8.0 %	N/A	N/A
Tier I Capital (to Risk-Weighted Assets)	86,718	12.8	40,710	6.0	N/A	N/A
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	79,718	11.8	30,533	4.5	N/A	N/A
Tier I Capital (to Average Assets)	86,718	8.7	39,795	4.0	N/A	N/A
Bank Only						
Total Capital (to Risk-Weighted Assets)	$ 95,118	14.0 %	$ 54,246	8.0 %	$ 67,808	10.0 %
	87,493	12.9	40,685	6.0	54,246	8.0

Tier I Capital (to Risk-Weighted Assets)						
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	87,493	12.9	30,513	4.5	44,075	6.5
Tier I Capital (to Average Assets)	87,493	8.8	39,671	4.0	49,588	5.0

Non-Performing Assets

As of September 30, 2017, our non-performing assets totaled $4.2 million or 0.42% of assets compared to $9.4 million or 0.91% of assets at December 31, 2016 (See table below.) The Company experienced a decrease of $3.2 million in non-accrual loans from December 31, 2016 to September 30, 2017. As of September 30, 2017, non-accrual loans include $150 thousand in loans secured by farmland, $1.2 million in loans secured by 1-4 family properties, and $30 thousand in consumer loans.

Loans secured by real estate composed 97.8% of the non-performing loans as of September 30, 2017 and 96.9% as of December 31, 2016. Forgone interest income on non-accrual loans totaled $63 thousand for the first nine months of 2017 compared to forgone interest of $65 thousand for the same time period in 2016.

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Accruing loans that are contractually 90 days or more past due as of September 30, 2017 totaled $151 thousand compared to $757 thousand at December 31, 2016, a decrease of $606 thousand.

Total nonperforming and restructured loans decreased $6.0 million from December 31, 2016 to September 30, 2017. The decrease in non-performing loan balances contributed to the decrease in the ratio of nonperforming and restructured loans to loans which decreased 91 basis points to 0.24% from December 31, 2016 to September 30, 2017.

In addition, the amount the Company has recorded as other real estate owned increased $845 thousand from December 31, 2016 to September 30, 2017. As of September 30, 2017, the amount recorded as other real estate owned totaled $2.7 million compared to $1.8 million at December 31, 2016. During the first nine months of 2017, $1.9 million in loan balances were foreclosed upon and added to other real estate properties while $911 thousand in other real estate properties were sold. The allowance as a percentage of non-performing and restructured loans and other real estate owned increased from 80% at December 31, 2016 to 184% at September 30, 2017.

Nonperforming and Restructured Assets

	9/30/2017	12/31/2016
	(in thousands)	
Non-accrual Loans	$ 1,393	$ 4,566
Accruing Loans which are Contractually past due 90 days or more	151	927
Accruing Troubled Debt Restructurings	—	2,063
Total Nonperforming and Restructured Loans	1,544	7,556
Other Real Estate	2,669	1,824
Total Nonperforming and Restructured Loans and Other Real Estate	$ 4,213	$ 9,380
Nonperforming and Restructured Loans as a Percentage of Loans	0.24 %	1.15 %
Nonperforming and Restructured Loans and Other Real Estate as a Percentage of Total Assets	0.42 %	0.91 %
Allowance as a Percentage of Period-end Loans	1.19 %	1.15 %
Allowance as a Percentage of Non-performing and Restructured Loans and Other Real Estate	184 %	80 %

We maintain a “watch list” of agricultural, commercial, real estate mortgage, and real estate construction loans and review those loans at least quarterly but more often if needed. 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 the loan should be evaluated for impairment and whether specific allocations are needed.

Provision for Loan Losses

The loan loss provision for the first nine months of 2017 was $650 thousand compared to $775 thousand for the first nine months of 2016. The loan loss provision for the three months ended September 30, 2017 was $100 thousand compared to $175 thousand for the three months ended September 30, 2016. The decrease in the total loan loss provision during the first nine months of 2017 compared to the same time period in 2016 is mostly attributed to improved loan credit quality. The allowace for loan losses as a percentage of loans was 1.19% at September 30, 2017 compared to 1.15% at September 30, 2016.

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.

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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.

The Company recorded net charge-offs of $436 thousand for the nine months ended September 30, 2017 compared to net recoveries of $109 thousand for the nine months ended September 30, 2016. During the first quarter of 2016, the Company recorded a recovery of $259 thousand for one loan which was charged-off in a prior year. 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.

Loan Losses

	Nine Months Ended September 30, (in thousands)	
	2017	2016
Balance at Beginning of Period	$ 7,541	$ 6,521
Amounts Charged-Off:		
Commercial	35	—
1-4 family residential	203	90
Multi-family residential	—	—
Non-farm & non-residential	78	—
Agricultural	—	3
Consumer and other	810	915
Total Charged-off Loans	1,126	1,008
Recoveries on Amounts Previously Charged-off:		
Commercial	17	37
Real Estate Construction	1	15
1-4 family residential	8	8
Multi-family residential	10	7
Non-farm & non-residential	—	355
Agricultural	47	35
Consumer and other	607	660
Total Recoveries	690	1,117
Net Charge-offs (Recoveries)	436	(109)
Provision for Loan Losses	650	775
Balance at End of Period	7,755	7,405
Loans		
Average	652,387	642,998
At September 30,	648,965	659,970

As a Percentage of Average Loans:				
Net Charge-offs for the period	0.07	%	(0.02)	%
Provision for Loan Losses for the period	0.10	%	0.12	%
Allowance as a Multiple of Net Charge-offs annualized	13.3		(51.0)	

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	Three Months Ended September 30, (in thousands)			
	2017		2016	
Balance at Beginning of Period:	$ 7,958		$ 7,259	
Amounts Charged-Off:				
Commercial	20		—	
1-4 family residential	170		26	
Non-farm & non-residential	78		—	
Agricultural	—		3	
Consumer and other	240		253	
Total Charged-off Loans	508		282	
Recoveries on Amounts Previously Charged-off:				
Commercial	2		3	
Real Estate Construction	0		2	
1-4 family residential	3		1	
Multi-family residential	3		3	
Non-farm & non-residential	0		82	
Agricultural	19		12	
Consumer and other	178		150	
Total Recoveries	205		253	
Net Charge-offs	303		29	
Provision for Loan Losses	100		175	
Balance at End of Period	7,755		7,405	
Loans				
Average	647,103		657,336	
At September 30,	648,965		659,970	
As a Percentage of Average Loans:				
Net Charge-offs (Recoveries) for the period	0.05	%	0.00	%
Provision for Loan Losses for the period	0.02	%	0.03	%
Allowance as a Multiple of Net Charge-offs annualized	6.4		63.8	

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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 since a bank's net income is largely dependent on net interest income. 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.

Management realizes certain risks are inherent and that the goal is to identify and minimize the risks. The primary tools used by management are interest rate shock and economic value of equity (EVE) simulations. The Company has $5.7 million in market risk sensitive instruments which are held for trading purposes. These assets are held for a minimal period of time and are used to generate profits on short-term differences in price while earning interest for the time they are held.

Using interest rate shock simulations, the following table depicts the change in net interest income resulting from 100 and 300 basis point changes in rates on the Company's interest earning assets and interest bearing liabilities.

The projections are based on balance sheet growth assumptions and repricing opportunities for new, maturing and adjustable rate amounts. As of September 30, 2017, 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. Similar to prior periods, this period's volatility is comparable 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, 2017 is as follows:

PROJECTED NET INTEREST INCOME

(dollars in thousands)

Change in basis points:	Level - 100		Rates	+ 100		+ 300	
Year One (10/17 - 9/18)							
Net interest income	$ 32,881		$ 33,724	$ 33,658		$ 33,547	
Net interest income dollar change	(843)		N/A	(66)		(177)	
Net interest income percentage change	(2.5)	%	N/A	(0.2)	%	(0.5)	%
Board approved limit	>(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, 2016 is as follows:

PROJECTED NET INTEREST INCOME

(dollars in thousands)

Change in basis points:	Level - 100		Rates	+ 100		+ 300	
Year One (10/16-9/17)							
Net interest income	$ 31,479		$ 32,176	$ 32,120		$ 32,038	
Net interest income dollar change	(697)		N/A	(56)		(138)	
Net interest income percentage change	(2.2)	%	N/A	(0.2)	%	(0.4)	%
Board approved limit	>(4.0)	%	N/A	>(4.0)	%	>(10.0)	%

Projections from September 30, 2017 and September 30, 2016, year one reflected declines of 2.5% and 2.2% in net interest income assuming rates were to decline 100 basis points. Assuming an increase in rates of 100 basis points, projections reflected a 0.2% decrease in net interest income for both periods.

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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, 2017, balance sheet, a 100 basis point decrease in rates results in an 11.1% decrease in EVE. A 100 basis point increase in rates results in a 0.4% decrease in EVE. These are within the Board approved limits.

Item 4 - CONTROLS AND PROCEDURES

As of the end of the period covered by this report, and pursuant to Rule 13a-15(b) of the Securities Exchange Act of 1934 (“Exchange Act”), 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 (as that term is defined in Rule 13a-15(e) of the Exchange Act). 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 2. Unregistered Sales of Equity Securities and Use of Proceeds

ISSUER PURCHASES OF EQUITY SECURITIES

	(a) Total Number of	(b) Average	(c) Total Number of Shares (or Units) Purchased as Part	(d) Maximum Number (or Approximate Dollar Value) of Shares (or

Period	Shares (or Units) Purchased	Price Paid Per Share (or Unit)	of Publicly Announced Plans Or Programs	Units) that May Yet Be Purchased Under the Plans or Programs	
7/1/17-7/31/17	—	$ —	—	100,912	shares
8/1/17-8/31/17	—	—	—	100,912	shares
9/1/17-9/30/17	—	—	—	100,912	shares
Total	—	$ —	—	100,912	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. On November 18, 2016, the Board of Directors approved and authorized the Company's repurchase of an additional 50,000 shares. Shares will be purchased from time to time in the open market depending on market prices and other considerations. Through September 30, 2017, 349,088 shares have been purchased.

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Item 6. Exhibits

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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 on Form 8-K dated and filed February 24, 2006.

2.2 Agreement and Plan of Share Exchange with Madison Financial Corporation is incorporated by reference to Exhibit 2.1 of the Registrant's Current Report on Form 8-K dated and filed January 21, 2015.

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 ended 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 Current Report on Form 8-K dated and filed November 21, 2007.

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 ended 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, 2017, filed with the SEC November 13, 2017, formatted in Extensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets at September 30, 2017,and December 31, 2016, (ii) Consolidated Statements of Income and Comprehensive Income (Loss) for the nine months and three months ended September 30, 2017 and September 30, 2016, (iii) Consolidated Statement of Stockholders' Equity for the nine months ended September 30, 2017, (iv) Consolidated Statements of Cash Flows for the nine months ended September 30, 2017 and September 30, 2016 and (v) Notes to Consolidated Financial Statements.

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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 11/13/17	/s/Louis Prichard Louis Prichard, President and C.E.O.
Date 11/13/17	/s/Gregory J. Dawson Gregory J. Dawson, Chief Financial Officer