

FIRST FARMERS & MERCHANTS CORP  
Form 10-K/A  
February 10, 2015

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

Amendment No. 2

(Mark one)

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

For the fiscal year ended **December 31, 2013**

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 000-10972

**First Farmers and Merchants Corporation**

(Exact name of registrant as specified in its charter)

Tennessee

62-1148660

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification No.)

816 South Garden Street

Columbia, Tennessee

38402 1148

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code (931) 388-3145

Securities registered pursuant to Section 12(b) of the Act:

Title of each class

Name of each exchange on which registered

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None

None

Securities registered pursuant to Section 12(g) of the Act:  
Common Stock, \$10.00 par value per share  
(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes  No

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 (§ 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Accelerated filer

Smaller reporting company

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

The aggregate market value of the registrant's common stock held by non-affiliates as of June 30, 2013 was approximately \$121,936,983 based on the reported price at which the common stock was last sold in a transaction known to the registrant.

As of March 1, 2014, the registrant had outstanding 5,021,012 shares of common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Selected sections from Annual Report to Shareholders for Fiscal Year Ended December 31, 2013 titled "Comparative Performance and Management's Discussion and Analysis of Financial Condition and Results of Operations" -- Part I and II of this Report.

Proxy Statement for 2014 Annual Shareholders Meeting to be held on April 15, 2014 -- Part III of this Report.

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**EXPLANATORY NOTE AMENDMENT NO. 2**

The purpose of this Amendment No. 2 on Form 10-K/A ( Amendment No. 2 ) is to amend the Annual Report on Form 10-K for the year ended December 31, 2013 originally filed with the Securities and Exchange Commission ( SEC ) on March 5, 2014 (as previously amended by Amendment No. 1 on Form 10-K/A filed with the SEC on September 9, 2014, the Original Filing ) of First Farmers and Merchants Corporation (the Corporation ).

As described in more detail in Note 2 of the Notes to our Consolidated Financial Statements, this Amendment No.2 addresses an error in accounting for the Corporation s defined benefit post-retirement healthcare plan. This Amendment No. 2 (i) amends and restates the Corporation s financial statements and the notes thereto as of and for the years ended December 31, 2013 and 2012 (the Financial Statements ) in Item 8 of Part II ( Financial Statements and Supplementary Data ), as included in Exhibit 13 of the Original Filing, (ii) amends and restates the Management Report on Internal Control Over Financial Reporting and the Report of Independent Registered Public Accounting Firm , each as incorporated by reference into Item 8 of Part II ( Financial Statements and Supplementary Data ), as included in Exhibit 13 of the Original Filing, (iii) amends and restates Item 9A of Part II ( Controls and Procedures ) to reflect management s finding of a material weakness in the Corporation s disclosure controls and procedures and remediation plan to address the material weakness, (iv) amends and restates Item 7 of Part II ( Management s Discussion and Analysis of Financial Condition and Results of Operations ) included in Exhibit 13 of the Original Filing to reflect the changes to the Financial Statements, (v) amends and restates Item 6 of Part II ( Selected Financial Data ) included in Exhibit 13 of the Original Filing to reflect the changes to the Financial Statements, and (vi) includes new certifications of the Corporation s principal executive officer and principal financial officer as Exhibits 31.1, 31.2 and 32.1, as required by Rule 12b-15 under the Securities Exchange Act of 1934, as amended. The remainder of Parts I through IV have not changed and can be found in the Original Filing. This Amendment No. 2 does not reflect events occurring after the Original Filing, nor does it modify or update the disclosures and information contained in the Original Filing in any way other than described in this Explanatory Note.

Management has evaluated the impact of the error in accounting for the Corporation s defined benefit post-retirement healthcare plan on the unaudited financial statements included in the Corporation s Quarterly Reports on Form 10-Q for the periods ended March 31, June 30 and September 30, 2014 and determined that such impact is not material and that no restatement of such unaudited financial statements is required.

The Corporation s management has concluded that, because of the Corporation s failure to interpret correctly and account for certain actuarial information provided to the Corporation in connection with the accounting for its defined benefit post-retirement healthcare plan in the Financial Statements, a material weakness in internal control over financial reporting existed for the years ended December 31, 2013 and 2012.

This Amendment No. 2 should be read in conjunction with our other filings with the SEC.

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## PART II

### Item 6. Selected Financial Data.

Selected Financial Data is included in the amended Exhibit 13 to this Annual Report on Form 10-K and is incorporated herein by reference.

### Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Management's Discussion and Analysis of Financial Condition and Results of Operations is included in the amended Exhibit 13 to this Annual Report on Form 10-K and is incorporated herein by reference.

### Item 8. Financial Statements and Supplementary Data.

(a) *Consolidated Financial Statements*: The Corporation's consolidated financial statements are included in the amended and restated Exhibit 13 to this Annual Report on Form 10-K and is incorporated herein by reference.

### Item 9A. Controls and Procedures.

#### *Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures*

The Corporation with the participation of its management, including the Corporation's Chief Executive Officer and Treasurer (principal financial officer), carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rules 13a-15 and 15d-15 under the Securities and Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this Report.

Based upon that evaluation and as of the end of the period covered by this Report, the Corporation's Chief Executive Officer and Treasurer (principal financial officer) concluded that, as a result of the material weakness referenced in the Management Report on Internal Control Over Financial Reporting incorporated by reference into Item 8 of this Report, the Corporation's disclosure controls and procedures were not effective

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in ensuring that information required to be disclosed in the reports that the Corporation files or submits to the SEC under the Exchange Act is recorded, processed, summarized and reported on a timely basis. Notwithstanding the identification of this material weakness, the Corporation's Chief Executive Officer and Treasurer (principal financial officer) have concluded that the Consolidated Financial Statements of the Corporation incorporated by reference into Item 8 of this Report fairly present in all material respects the Corporation's financial condition, results of operations and cash flows as of the dates and for the periods presented in this Report.

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, the Corporation has included a report of management's assessment of the design and operating effectiveness of its internal controls as part of this Report.

### ***Changes in Internal Control Over Financial Reporting***

Management's assessment of the Corporation's internal control over financial reporting identified a material weakness related to errors in accounting for the Corporation's defined benefit post-retirement health care plan as of December 31, 2013. These errors were the result of a lack of sufficient personnel with the requisite expertise regarding the accounting for the plan. Other than the identification of this material weakness, there was no change in the Corporation's internal control over financial reporting during the fourth quarter ended December 31, 2013 that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

### ***Remediation Plan for Material Weakness in Internal Control Over Financial Reporting***

In 2013, management began taking steps to remediate the material weaknesses identified during the audit of the Corporation's financial statements as of and for the year ended December 31, 2012. The remediation plan has required intermediate steps over several quarters. These steps began in 2013 when the Corporation's Disclosure Committee, composed of members of management, evolved its role to review new accounting pronouncements, as well as new events

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within the organization that may impact financial reporting. In 2013, the Corporation's accounting and finance department formalized the monthly, quarterly, and annual close process with a procedures checklist. At the end of 2013, management hired a certified public accountant as Controller who has several years of accounting and financial reporting experience. The Controller has enabled the Corporation to establish an additional layer of review over recording transactions in the general ledger, as well as review of the Corporation's financial reporting and internal control structure. During 2014, the Controller became fully acclimated in the affairs of the Corporation and functioned at a level that demonstrated a sufficient and adequate review over recording complex accounting transactions. The review function pertaining to the defined benefit post-retirement health care plan detected the errors in financial reporting as described above. The Corporation has also implemented a closing procedure to obtain outsourced expertise regarding complex accounting transactions that in-house accounting staff does not have the inherent resources of time or expertise to record and report. Other than the remediation actions described, there was no change in the Corporation's internal control over financial reporting during the year ended December 31, 2013 that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

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**PART IV**

**Item 15. Exhibits and Financial Statement Schedules.**

(a) Index to Consolidated Financial Statements, Financial Statement Schedules and Exhibits:

- |      |   |
|------|---|
| (1)  | <i>Consolidated Financial Statements:</i> See Item 8 under Part II, Financial Statements and Supplementary Data.  |
| (2)  | <i>Consolidated Financial Statement Schedules:</i> All schedules are omitted because they are not applicable or not required, or because the required information is included in the consolidated financial statements or notes in this report. |
| (3)  | <i>Exhibits:</i>  |
| 3.1  | Charter. (1)  |
| 3.2  | Articles of Amendment to Charter. (1)   |
| 3.3  | Second Amended and Restated Bylaws, as amended. (2)   |
| 4    | Specimen Stock Certificate. (1)   |
| 10.1 | Profit Sharing Plan. (3)*   |
| 10.2 | First Amendment to Profit Sharing Plan. (3)*  |
| 10.3 | Second Amendment to Profit Sharing Plan. (3)*   |
| 10.4 | Executive Salary Continuation Agreement by and between First Farmers and Merchants National Bank and Waymon L. Hickman, dated as of December 1, 1992. (3)*  |
| 10.5 | Benefits Agreement by and between First Farmers and Merchants Bank and Thomas Randall Stevens, the Bank's and the Corporation's Chairman and Chief Executive Officer, dated as of January 26, 2007. (4)*  |
| 10.6 | Benefits Agreement by and between John P. Tomlinson, III, the Bank's and Corporation's Chief Administrative Officer, dated as of January 29, 2007. (4)*   |
| 10.7 |   |



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Form of First Farmers and Merchants Corporation Amended and Restated Director Deferred Compensation Agreement. (5)\*

- 10.8 First Amendment to the First Farmers and Merchants Corporation Amended and Restated Director Deferred Compensation Agreement with John P. Tomlinson, III, dated as of December 18, 2007. (5)\*
- 10.9 Form of First Farmers and Merchants Bank Amended and Restated Director Deferred Compensation Agreement. (5)\*
- 10.10 First Amendment to the First Farmers and Merchants Bank Director Deferred Compensation Agreement with Thomas Randall Stevens, dated as of January 5, 2007. (5)\*
- 10.11 First Amendment to the First Farmers and Merchants Bank Amended and Restated Director Deferred Compensation Agreement with John P. Tomlinson, III, dated as of December 18, 2007. (5)\*
- 10.12 Form of First Farmers and Merchants National Bank Director Split Dollar Agreement. (5)\*
- 10.13 Form of Amendment to the First Farmers and Merchants National Bank Director Split Dollar Agreement. (5)\*
- 10.14 First Farmers & Merchants Bank Group Term Carve-Out Plan, dated as of March 27, 2007. (5)\*
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- 10.15 First Farmers and Merchants National Bank Group Term Carve-Out Plan, dated as of July 23, 2002. (5)\*
- 10.16 Amendment to the First Farmers and Merchants National Bank Group Term Carve-Out Plan, dated as of July 23, 2002. (5)\*
- 10.17 First Farmers & Merchants Bank Life Insurance Endorsement Method Split Dollar Plan Agreement, dated as of January 7, 2008. (5)\*
- 10.18 Form of First Farmers and Merchants Corporation Director Deferred Compensation Agreement. (5)\*
- 10.19 Form of First Farmers and Merchants Bank Director Deferred Compensation Agreement. (5)\*
- 10.20 First Farmers and Merchants Bank Director Deferred Compensation Agreement with Tim E. Pettus, dated as of March 5, 2008. (5)\*
- 10.21 First Farmers and Merchants Corporation Director Deferred Compensation Agreement with Tim E. Pettus, dated as of March 5, 2008. (5)\*
- 13 Selected sections from Annual Report to Shareholders.
- 21 List of Subsidiaries. (6)
- 31.1 Certification of the Chief Executive Officer of First Farmers and Merchants Corporation pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Treasurer (principal financial officer) of First Farmers and Merchants Corporation pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certification of the Chief Executive Officer and Treasurer (principal financial officer) of First Farmers and Merchants Corporation pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101 Pursuant to Rule 405 of Regulation S-T, the following financial information from the Company's Annual Report on Form 10-K for the year ended December 31, 2013, is formatted in XBRL (Extensible Business Reporting Language) interactive data files: (i) the Consolidated Balance Sheets as of December 31, 2013 and 2012; (ii) the Consolidated Statements of Income for each of the years ended December 31, 2013, 2012 and 2011; (iii) the Consolidated Statements of Changes in Shareholders' Equity for each of the years ended December 31, 2013, 2012 and 2011; (iv) the Consolidated Statements of Cash Flows for each of the years ended December 31, 2013, 2012 and 2011; and (v) the Notes to Consolidated Financial Statements, tagged as blocks of text.

\* Indicates a compensatory plan or arrangement.

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(5) Incorporated by reference to the First Farmers and Merchants Corporation Annual Report on Form 10-K for the year ended December 31, 2008, as filed with the Securities and Exchange Commission on March 13, 2009 (File Number 000-10972).

(6) Included in the original filing.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FIRST FARMERS AND MERCHANTS CORPORATION

By: /s/ T. Randy Stevens

T. Randy Stevens

Chief Executive Officer

Date: February 10, 2015

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**EXHIBIT INDEX**

**FIRST FARMERS AND MERCHANTS CORPORATION**

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(6) Included in the original filing.

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**COMPARATIVE PERFORMANCE**

Set forth below is a graph comparing the yearly change in the cumulative total shareholder return on the common stock of First Farmers and Merchants Corporation (FF&M in the graph) against the cumulative total return of the S&P 500 Index and the Dow Jones Select Regional Bank Index for the five-year period commencing December 31, 2008 and ending December 31, 2013.

**VALUE OF \$100 INVESTED ON DECEMBER 31, 2008**

	2008	2009	2010	2011	2012	2013
FF&M *	\$ 100.00	\$ 91.53	\$ 67.52	\$ 62.30	\$ 51.83	\$ 59.19
DOW JONES SELECT REGIONAL BANK INDEX **	100.00	110.47	133.61	117.13	138.77	191.75
S & P 500 ***	100.00	126.47	145.54	148.61	172.23	227.99

\* Assumes that the value of the investment in FF&M was \$100 on December 31, 2008, with all dividends reinvested.

\*\* Assumes that the value of the investment in the index was \$100 on December 31, 2008, with all dividends reinvested.

\*\*\* Assumes that the value of the investment in the index was \$100 on December 31, 2008, with all dividends reinvested.

**EXHIBIT 13**

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION**

**FORWARD-LOOKING STATEMENTS**

Certain statements contained in this Annual Report to Shareholders may not be based on historical facts and are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements may be identified by, among other things, the use of forward-looking terminology such as believes, expects, hopes, may, plans, will, or anticipates, or the negatives of such terms. We caution you not to place undue reliance on such forward-looking statements in this Annual Report to Shareholders because results could differ materially from those anticipated as a result of a variety of factors. These forward-looking statements include, without limitation, those relating to the quality of service provided to customers, reduction in net loans, the effect of fluctuating interest rates on net interest income, the stability of market rates, adequate access to capital to meet liquidity needs, capital expenditures, the completion of our new branch, cash dividends, cash flows on impaired loans, the present value of servicing income, deferred tax assets, potential issuance of shares, the fair value of bonds, impairment of securities, lease commitments, troubled debt restructurings, the Federal Home Loan Bank of Cincinnati (the "FHLB") credit line, repayment of loans by borrowers, legal claims, capital adequacy requirements, fair value valuation methodologies, fair value of other assets, valuation of financial instruments, post-retirement benefit payments, interest rate sensitivity and risk, diversification of the loan portfolio, gross interest income, the adequacy of allowance for loan and lease losses, the loan concentration, expected maturity of investment securities, intent of management to hold certain loans until maturity or payoff, the value of underlying collateral and the impact of accounting standards on the financial statements. Factors that could affect our results include, but are not limited to, changes in economic conditions; fluctuations in prevailing interest rates and the effectiveness of our risk monitoring systems; our ability to maintain credit quality; our ability to provide market competitive products and services; laws and regulations affecting financial institutions in general; our ability to operate and integrate new technology; the effectiveness of our interest rate hedging strategies; government fiscal and monetary policies; changes in our operating or expansion strategy; changes in our assumptions or estimation methodologies; the availability of and costs associated with maintaining and/or obtaining adequate and timely sources of liquidity; limitations on our ability to pay dividends and to meet our cash obligations; assumption and judgments about the collectability of our loan portfolio; our ability to compete with other financial services companies and other factors generally understood to affect the financial results of financial services companies.

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**EXECUTIVE OVERVIEW**

**General**

First Farmers and Merchants Corporation (the "Corporation") was incorporated on March 31, 1982 as a Tennessee corporation. As of December 31, 2013, the only direct subsidiary of the Corporation was First Farmers and Merchants Bank (the "Bank"), which conducts the principal business of the consolidated company. The Bank was organized as a national bank in 1954 as a successor to a state bank that was organized in 1909. The Bank remained a national bank until July 5, 2005, when it converted back to a state-chartered bank and changed its name from First Farmers and Merchants National Bank to First Farmers and Merchants Bank. The Bank has direct and indirect subsidiaries through which it holds F&M West, Incorporated, Maury Tenn, Incorporated and Maury Tenn Properties, Incorporated. The principal executive offices of the Corporation are located at 816 South Garden Street, Columbia, Maury County, Tennessee. Management of the Corporation evaluates the financial condition of the Corporation in terms of the Bank's operations within its service area.

**All dollar amounts in this Annual Report to Shareholders, other than share and per-share amounts, are in thousands unless otherwise noted.**

### **Financial Condition**

The Corporation's assets consist primarily of its investment in the Bank and other smaller investments. Its primary activities are conducted through the Bank. The Bank is committed to providing quality services in diverse markets and a changing interest rate environment. Management hopes to provide Bank customers the quality service of a community bank and the safety and strength of a regional bank.

At December 31, 2013, the Corporation's consolidated total assets were \$1,092,874, its consolidated net loans were \$598,171, its total deposits were \$957,337 and its total shareholders' equity was \$104,204. The economic climate in the Corporation's market area of middle Tennessee began to stabilize in 2013, as evidenced by the Corporation's loan volume, an increase of 7.1% of net loans at December 31, 2013 compared to December 31, 2012. Total deposits increased by 2.6% and total shareholders' equity decreased by 7.6% over the same period. The net unrealized loss on securities, which makes up a portion of other comprehensive income, contributed to the decrease in shareholders' equity.

### **Results of Operations**

Consolidated net income in 2013 totaled \$9,611, a 2.2% increase from 9,404 in 2012 and a 34.4% increase from \$6,996 in 2011. Net interest income increased 5.9% from 2012 and increased 4.3% from 2011. With interest rates continuing on a downward trend, loan yields have continued to decrease, while volume has increased. On a per common share basis, net income totaled \$1.88 for 2013 versus \$1.77 for 2012 and \$1.30 for 2011.

The accompanying tables and the discussion and financial information are presented to aid in understanding the Corporation's financial position and results of operations. The emphasis of this discussion is on the years ended December 31, 2013, 2012 and 2011; however, financial information for prior years will also be presented where appropriate or required. This discussion should be read in conjunction with the Consolidated Financial Statements and the Notes to Consolidated Financial Statements included elsewhere in this Annual Report to Shareholders.

The Corporation's financial condition is dependent on a variety of factors, including the quality and nature of its assets, its liability and capital structure, the market and economic conditions and the quality of its personnel.

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## **FINANCIAL CONDITION**

### **Net Interest Margin**

Net interest margin is defined as the difference between the revenue from earning assets (primarily interest income) and interest expense related to interest bearing liabilities. Net interest margin is a function of the average balances of earning assets and interest bearing liabilities and the yields earned and rates paid on those balances. In order to succeed in the banking industry, it is critical to maintain the net interest margin at a level that, when coupled with noninterest revenues, exceeds additions to the allowance for loan and lease losses, noninterest expenses and income taxes and yields an acceptable profit.

The Corporation plans the Bank's operations with the goal of maintaining a satisfactory spread between the yields on earning assets and the related cost of interest bearing funds. The gross interest spread is determined by comparing the taxable equivalent gross interest margin to average earning assets before deducting the allowance for loan losses. This spread reflects the overall profitability of earning assets, including both those funded by interest bearing sources and those that do not generate interest (primarily noninterest bearing demand deposits). This spread is most often used when analyzing a banking institution's overall gross margin profitability compared to that of other financial institutions. Management uses calculations and similar ratios to assist in pricing decisions for interest-related products. Table A below presents the average daily balances, the components of the gross interest margin (on a taxable equivalent basis), the yield or rate, and the incremental and gross interest spread for each of the last three years by major categories of assets and liabilities.

**TABLE A - Distribution of Assets, Liabilities, Shareholders' Equity, Interest Rates and Interest Differential**

(Dollars in thousands)	YEAR ENDED DECEMBER 31,								
	2013			2012			2011		
	Average Balance	Rate/ Yield	Interest	Average Balance	Rate/ Yield	Interest	Average Balance	Rate/ Yield	Interest
<b>ASSETS</b>									
Interest earning assets									
Loans, net, see note 2	\$ 572,913	5.05%	\$ 28,949	\$ 518,158	5.50%	\$ 28,474	\$ 534,841	5.67%	\$ 30,338
Bank deposits	21,706	1.73%	375	41,560	0.28%	116	28,594	0.25%	71
Taxable securities	311,796	1.82%	5,677	295,004	1.75%	5,148	205,631	2.18%	4,485
Tax exempt securities, see note 2	78,138	5.97%	4,667	83,788	5.95%	4,956	95,814	5.93%	5,679
Federal funds sold	12,732	0.25%	32	14,780	0.25%	37	11,920	0.23%	27
<b>TOTAL EARNING ASSETS</b>	<b>997,285</b>	<b>3.98%</b>	<b>\$ 39,700</b>	<b>953,290</b>	<b>4.06%</b>	<b>\$ 38,731</b>	<b>876,800</b>	<b>4.63%</b>	<b>\$ 40,600</b>
Noninterest earning assets									
Cash and due from banks	16,775			16,096			16,198		
Bank premises and equipment	25,795			25,886			23,914		
Other assets	47,632			59,047			58,400		
<b>TOTAL ASSETS</b>	<b>\$ 1,087,487</b>			<b>\$ 1,054,319</b>			<b>\$ 975,312</b>		
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>									
Interest bearing liabilities									
Time and savings deposits:									
NOW and money market accounts	\$ 432,853	0.15%	\$ 630	\$ 408,077	0.22%	\$ 896	\$ 368,319	0.35%	\$ 1,273
Savings	89,453	0.05%	47	80,026	0.08%	62	74,309	0.12%	91
Time up to \$100	122,947	0.75%	916	130,391	0.87%	1,132	136,691	1.09%	1,493
Time over \$100	119,130	0.92%	1,101	118,208	1.06%	1,253	105,514	1.29%	1,366
<b>TOTAL INTEREST BEARING DEPOSITS</b>	<b>764,383</b>	<b>0.35%</b>	<b>2,694</b>	<b>736,702</b>	<b>0.45%</b>	<b>3,343</b>	<b>684,833</b>	<b>0.62%</b>	<b>4,223</b>
Federal funds purchased and securities									
sold under agreements to repurchase	19,855	0.31%	62	18,934	0.38%	72	11,980	0.48%	57
FHLB borrowing	3,868	3.90%	151	11,802	3.61%	426	18,807	3.52%	662
Other liabilities	-	-	-	-	0.00%	-	400	-	-
<b>TOTAL INTEREST BEARING LIABILITIES</b>	<b>788,106</b>	<b>0.37%</b>	<b>\$ 2,907</b>	<b>767,438</b>	<b>0.50%</b>	<b>\$ 3,841</b>	<b>716,020</b>	<b>0.69%</b>	<b>\$ 4,942</b>
Noninterest bearing liabilities									
Demand deposits	173,648			156,784			135,417		
Other liabilities	14,800			15,700			14,494		
<b>TOTAL LIABILITIES</b>	<b>976,554</b>			<b>939,922</b>			<b>865,931</b>		
Shareholders' equity	110,933			114,397			109,381		
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<b>\$ 1,087,487</b>			<b>\$ 1,054,319</b>			<b>\$ 975,312</b>		
Spread between combined rate earned and									
combined rates paid*		3.61%			3.56%			3.94%	
Net yield on interest-earning assets*		3.69%			3.66%			4.07%	



\* Taxable equivalent basis

Notes:

1. U.S. government (agency, state and political subdivision), and corporate debt securities plus equity securities in the available-for-sale and held-to-maturity categories are taxable securities. Most municipal debt securities are nontaxable.
2. The taxable equivalent adjustment has been computed based on a 34% federal income tax rate and has given effect to the disallowance of interest expense, for federal income tax purposes, related to certain tax-free assets. Loans include nonaccrual loans for all years presented.
3. The average balances of the amortized cost of available-for-sale securities were used in the calculations in this table.

Table B below sets forth, for the periods indicated, a summary of consolidated changes in interest earned and interest paid, reflected by the interest generated by volume changes and the interest generated by changes in the yield or rate. On a tax equivalent basis, net interest income increased \$1,904 for the year ended December 31, 2013 compared to the year ended December 31, 2012, primarily because of an increase in earning assets. Interest paid on interest bearing deposits was down in 2013 compared to 2012 primarily because of lower average interest rates. Interest paid on the FHLB line of credit was \$151 in 2013 compared to \$426 in 2012.

**TABLE B - Volume and Yield/Rate Variances**

(Taxable Equivalent Basis)

	2013 Compared to 2012			2012 Compared to 2011		
	Volume	Yield /Rate	Net Increase (Decrease)	Volume	Yield /Rate	Net Increase (Decrease)
<b>Revenue earned on</b>						
Loans, net	\$ 3,012	\$ (2,537)	\$ 475	\$ (946)	\$ (918)	\$ (1,864)
Bank deposits	(56)	315	259	32	13	45
<b>Investment securities</b>						
Taxable securities	292	238	530	1,948	(1,285)	663
Tax-free securities	(354)	65	(289)	(782)	34	(748)
Other Investments	-	-	-	-	4	4
Federal funds sold	(5)	0	(5)	7	3	10
Total interest earning assets	2,889	(1,919)	970	259	(2,149)	(1,890)
<b>Interest paid on</b>						
NOW and money market accounts	54	(320)	(266)	139	(516)	(377)
Savings deposits	8	(23)	(15)	7	(36)	(29)
Time deposits up to \$100	(65)	(151)	(216)	(69)	(292)	(361)
Time deposits over \$100	10	(162)	(152)	164	(277)	(113)
<b>Federal funds purchased and securities</b>						
sold under agreements to repurchase	3	(13)	(10)	33	(18)	15
Short term debt	-	-	-	-	-	-
Long term debt	(286)	11	(275)	(247)	11	(236)
Total interest-bearing funds	(276)	(658)	(934)	27	(1,128)	(1,101)
<b>Net interest earnings</b>	<b>\$ 3,165</b>	<b>\$ (1,261)</b>	<b>\$ 1,904</b>	<b>\$ 232</b>	<b>\$ (1,021)</b>	<b>\$ (789)</b>

Notes:

1. The change in interest earned or paid resulting from both volume and rate or yield has been allocated accordingly in proportion to the relationship of the absolute amounts of the change in each. Loans include nonaccrual loans for all years presented.
2. The computation of the taxable equivalent adjustment has given effect to the disallowance of interest expense, for federal income tax purposes, related to certain tax-exempt assets.
3. U.S. government (agency, state and political subdivision), and corporate debt securities plus equity securities in the available-for-sale and held-to-maturity categories are taxable securities.

**Assets and Liabilities**

Average earning assets increased 4.6% in 2013 compared to 2012 and increased 8.7% in 2012 compared to 2011. As a financial institution, the Corporation's primary earning assets are loans made by the Bank. In 2013, average net loans represented 57.4% of average earning assets compared to 54.4% of average earnings assets at December 31, 2012. Average net loans increased 10.6% in 2013 compared to 2012 and decreased 3.1% in 2012 compared to 2011. Management of the Corporation believes that average net loans will increase throughout 2014 because of the increase in demand for loans over the past six months.

Average investment securities, which comprised 39.1% of average earning assets in 2013, increased 2.9% from 2012 compared to a 25.7% increase in 2012 from 2011. This increase in average investments was the result of sluggish loan growth in the half of the year and therefore management grew the investment portfolio during this time. Average total assets increased 3.2% during 2013 compared to an increase of 8.1% between 2012 and 2011.

The Bank's average deposits increased 5.0% in 2013 compared to 2012. The increase in average deposits for 2012 was primarily a result of an increase in interest bearing deposits, which also contributed to the Bank's 8.9% increase in average deposits in 2012 compared to 2011. Average interest-bearing transaction accounts in 2013 increased 3.8% from 2012. Time deposits up to \$100 decreased 5.7% as of December 31, 2013 compared to December 31, 2012 and time deposits over \$100 increased 0.8% over the same period. Average savings deposits increased 11.8% in 2013 compared to 2012. Average Negotiable Order of Withdrawal (NOW) and money market accounts increased 6.1% in 2013 compared to 2012. Savings deposits have historically been steady providers of a core, low cost source of funding.

Customer relationship development helped maintain a relatively stable base in noninterest bearing deposits during 2013. The Bank's noninterest bearing deposits have remained strong and were 18.5% of average total deposits in 2013, 17.5% of average total deposits in 2012 and 16.5% of average total deposits in 2011. Average noninterest bearing deposits increased 10.8% for 2013 and 15.8% for 2012.

The Bank has a Blanket Agreement for Advances and Security Agreement with the FHLB for term debt or other obligations. For more information, see Note 11 of the Notes to Consolidated Financial Statements included elsewhere in this Annual Report to Shareholders.

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## **LIQUIDITY AND CAPITAL RESOURCES**

The Bank uses a formal asset and liability management process to ensure adequate liquidity and control interest rate risk. The Bank's goal of liquidity management is to provide adequate funds to meet loan demand and any potential unexpected deposit withdrawals. The Bank accomplishes this goal by striving for consistent core deposit growth, holding adequate liquid assets and maintaining unused capacity to borrow funds. The Bank's objective of interest rate risk management is to maintain reasonable stability in the gross interest margin despite changes in the level of interest rates and the spread among interest rates.

### **Liquidity**

Most of the capital needs of the Bank historically have been financed with retained earnings and deposits received, and the Corporation's primary source of liquidity has been dividends declared by the Bank. The Bank's Board of Directors has adopted a liquidity policy that outlines specific liquidity target balances. Compliance with this policy is reviewed quarterly by the Bank's Asset/Liability Committee and results are reported to the Bank's Board of Directors. At December 31, 2013, available liquidity was \$271,383 compared to \$282,724 as of December 31, 2012.

Management believes that the Corporation's traditional sources of cash generated from the Bank's operating activities are adequate to meet the Corporation's liquidity needs for normal ongoing operations; however, the Bank also has access to additional sources of funds, if necessary, through additional advances from the FHLB or the Cash Management Advance Line of Credit Agreement with the FHLB. In March 2008, the Bank obtained five advances at \$7,000 each from the FHLB, and in September 2008, the Bank obtained two additional advances of \$3,100 each for a total borrowing in 2009 of \$41,200. The first three scheduled repayments of the advances were made in March 2010, March and September 2011, and March 2012. The remaining payments occurred in March and September 2013. The borrowings from the FHLB have been used generally for investment strategies to enhance the Bank's portfolio.

**Interest Rate Risk**

The Bank uses an earnings simulation model to evaluate the impact of different interest rate scenarios on the gross margin. Each quarter, the Bank's Asset/Liability Committee assesses the relationship of rate sensitive earning assets to rate sensitive interest bearing liabilities (interest rate sensitivity), which is the principal factor in determining the effect that fluctuating interest rates will have on future net interest income. Rate sensitive earning assets and interest bearing liabilities are those that can be repriced to current market rates within a defined time period. The Asset/Liability

Committee measures near-term risk (within the next 12 and 24 months) to net interest income resulting from changes in interest rates. The model incorporates the Bank's assets and liabilities, together with forecasted changes in the balance sheet mix and assumptions that reflect the current interest rate environment, to simulate the effect of possible changes in interest rates on net interest income. The Asset/Liability Committee's policy is to conduct a monthly review of budgeted financial goals where the actual dollar change in net interest income is different from interest rate movements. A negative dollar change in net interest income for a 12- and 24- month period of less than 10.0% of net interest income given a 200 basis point shift in interest rates is considered an acceptable rate risk position. At December 31, 2013, if interest rates were to rise 200 basis points (2.0%) over the next 24 months, net interest income would be \$385 more than currently projected if rates were to remain stable. This would represent an increase in net interest income of 1.2%. At December 31, 2013, if interest rates were to decline 100 basis points (1.0%) over the next 24 months, net interest income would be \$2,498 less than the projection of rates remaining stable. This would represent a decrease in net interest income of 7.5%. The changes in percentages in both cases are within policy guidelines established by the Bank's Board of Directors.

Another tool used to monitor the Bank's overall interest rate sensitivity is a gap analysis (the difference between the earning asset and interest bearing liability amounts scheduled to be re-priced to current market rates in subsequent periods). Table C below shows the Bank's rate-sensitive position at December 31, 2013, as measured by the gap analysis. Non-maturing balances such as money market, savings and NOW accounts have no contractual or stated maturities. Management has attempted to use historical data (pricing history) on these categories to best determine the impact of these non-maturing balances on the net interest margin as interest rates change. Management anticipates that rates will remain steady through most of 2014 and has determined that the Bank is in an acceptable rate risk position. Table A under the heading "Net Interest Margin" above provides additional information regarding the largest components of interest bearing liabilities.

**TABLE C - Rate Sensitivity of Earning Assets and Interest-Bearing Liabilities**

(Dollars in Thousands)	Three Months or Less	Three to Six Months	Six to 12 Months	Over One Year	Total
<b>As of December 31, 2013</b>					
<b>Earning assets</b>					
Bank time deposits	\$35,017	\$-	\$-	\$-	\$35,017
Taxable investment securities	1,104	712	1,382	280,179	283,377
Tax-exempt investment securities	-	425	332	73,418	74,175
Loans and leases, net of deferred fees	23,909	27,700	64,238	482,324	598,171
<b>Total earning assets</b>	<b>60,030</b>	<b>28,837</b>	<b>65,952</b>	<b>835,921</b>	<b>990,740</b>
<b>Interest-bearing liabilities</b>					
NOW and money market accounts	141,927	-	-	304,740	446,667
Savings	-	-	-	92,013	92,013
Time up to \$100	26,437	32,278	32,032	25,310	116,057
Time over \$100	31,514	27,309	36,120	27,834	122,777
Other short-term debt	18,095	-	-	-	18,095
FHLB borrowing	-	-	-	-	-
<b>Total interest bearing liabilities</b>	<b>217,973</b>	<b>59,587</b>	<b>68,152</b>	<b>449,897</b>	<b>795,609</b>
Period gap	(157,943)	(30,750)	(2,200)	386,024	195,131
Cumulative gap	\$(157,943)	\$(188,693)	\$(190,893)	\$195,131	

### Capital Expenditures

Historically, internal growth has financed the capital needs of the Bank. In 2012, the Bank completed the construction of a new branch in Williamson County, Tennessee. The branch opened in April of 2012. The Bank signed a ground lease to build a branch in Davidson County, Tennessee. The branch is expected to be completed by second quarter 2014.



**Contractual Obligations**

The following table summarized the Corporation's contractual obligations as of December 31, 2013:

<b>Contractual Obligations</b>	<b>Payment due by period</b>				
	<b>Total</b>	<b>Less than 1 year</b>	<b>1-3 years</b>	<b>3-5 years</b>	<b>More than 5 years</b>
Operating lease obligations	\$ 5,525	\$ 336	\$ 667	\$ 580	\$3,942
Repurchase agreements and time deposits	256,929	203,782	40,134	13,013	-
<b>Total</b>	<b>\$ 262,454</b>	<b>\$ 204,118</b>	<b>\$ 40,801</b>	<b>\$ 13,593</b>	<b>\$3,942</b>

**Dividends**

Cash dividends declared in 2013 were 38.9% of net income compared to 41.4% of net income for 2012. The Corporation plans to continue an average annual payout ratio over 20% while continuing to maintain a capital to asset ratio reflecting financial strength and adherence to regulatory guidelines.

**Regulatory Capital**

Under federal regulatory standards, in order to be adequately capitalized the Corporation's Tier 1 Risk-Based Capital Ratio (ratio of Tier 1 Capital to risk-weighted assets) must be at least 4%, its Total Risk-Based Capital Ratio (ratio of total capital to risk-weighted assets) must be at least 8%, and its Tier 1 Leverage Capital Ratio (ratio of Tier 1 Capital to average assets) must be at least 4%. Tier 1 Capital generally consists of common stock.

As of December 31, 2013, the Corporation's Tier 1 Risk-Based Capital Ratio, Total Risk-Based Capital Ratio and Tier 1 Leverage Capital Ratio were 14.4%, 15.5% and 9.5%, respectively. At December 31, 2012, the comparable ratios were 14.6%, 15.8% and 9.7% respectively. Please refer to Note 13 in the Notes to Consolidated Financial Statements included elsewhere in this Annual Report to Shareholders for more information on the capital strength of the Corporation and the Bank.

**Loans and Loan Quality**



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The Bank's loan portfolio is the largest component of earning assets and, therefore, provides the highest amount of revenue. The loan portfolio also contains the highest exposure to risk, as a result of credit quality. When analyzing potential loans, management assesses both interest rate objectives and credit quality objectives in determining whether to authorize a given loan and the appropriate pricing for that loan. The Bank maintains a diversified portfolio in order to spread its risk and reduce its exposure to economic downturns that may occur in different segments of the economy or in particular industries. As of December 31, 2013, total loans maturing and repricing after one year that have predetermined interest rates and floating or adjustable interest rates totaled \$482,324. The composition of the loan portfolio is disclosed in detail in Note 4 in the Notes to Consolidated Financial Statements included elsewhere in this Annual Report to Shareholders.

The following table presents the maturities of the Bank's loans by category as of December 31, 2013:

	Within One Year	One to Five Years	After Five Years	Total
Commercial, financial and agricultural	\$ 45,366	\$ 48,421	\$ 11,488	\$ 105,275
Tax exempt municipal loans	3,553	9,818	9,931	23,302
Real estate				
Construction	15,495	8,831	5,612	29,938
Commercial mortgages	26,685	100,829	68,346	195,860
Residential mortgages	21,233	70,218	122,312	213,763
Other	3,211	12,940	6,202	22,353
Retail loans	9,198	6,942	135	16,275
<b>Total</b>	<b>\$ 124,741</b>	<b>\$ 257,999</b>	<b>\$ 224,026</b>	<b>\$ 606,766</b>

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The lending activities of the Bank are subject to written underwriting standards and policies established by the Bank's Board of Directors and management that include loan review procedures and approvals. Applications for loans are received by designated employees at 15 of the Bank's offices. Depending primarily on the dollar amount of the loan, there are various approval levels required, including that of the Executive Committee of the Bank's Board of Directors.

The composition of the Bank's loan and lease portfolio for the years ended December 31, 2013, 2012, 2011, 2010 and 2009 were as follows:

	2013	Percentage of Total	2012	2011	2010	2009
Commercial and industrial:						
Commercial	\$94,702	15.6%	\$83,631	\$60,448	\$61,192	\$63,695
Other	10,573	1.7%	11,594	2,601	5,446	2,943
Tax exempt municipal loans	23,302	3.8%	21,004	25,130	38,877	34,138
Real estate						
Construction	30,685	5.1%	37,008	33,270	37,374	38,877
Commercial mortgages	195,860	32.3%	183,373	152,539	156,704	149,332
Residential mortgages	214,211	35.3%	196,349	196,913	221,748	238,349
Other	22,353	3.6%	19,393	30,410	31,129	32,464
Retail loans	16,275	2.6%	15,651	17,027	15,753	17,124
Lease financing receivables	-	-	-	-	-	274
Net unamortized loan origination fees	(1,195)	-	(844)	(536)	(490)	(541)
	\$606,766	100.0%	\$567,159	\$517,802	\$559,179	\$576,655

A slight majority of the Bank's outstanding loans continue to be housed in the Maury County portfolio in 2013. Maury County housed 47.5% of the Bank's outstanding loans at December 31, 2013, including most of its out-of-territory loans and participations purchased. The Maury County portfolio experienced a \$3,863 increase in outstanding loans for 2013. The majority of the growth came from commercial lending.

Loan demand showed a marked improvement in the latter part of 2013, mainly due to commercial lending. Commercial loans grew 5.5% from the previous year. Portfolio growth and asset quality remain strong. The bank will continue to diligently review its pricing structure and to seek out new lending opportunities and bank relationships within the seven-county footprint.

The Bank has a credit administration function that is responsible for assisting loan officers in underwriting new loans, reviewing problem loans, monitoring the status of problem loans from period to period, and assisting in their resolution. This review process also includes semi-annual reviews by an outside party to assess the quality of the loan portfolio independently. Management has concluded that this independent review has served to strengthen underwriting practices. The analysis and review by the Bank's credit administration department also includes a formal review that is prepared quarterly to assess the risk in the loan portfolio and to determine the adequacy of the allowance for loan and lease losses ( ALLL ). Loan reviews of all relationships aggregating \$400 and greater are completed on an annual schedule.

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Loans that are impaired and not accruing interest were actively monitored in 2013 to determine those for which more aggressive action plans should be taken. The Bank ended 2013 with \$214, or 0.04% in net charge-offs. The Bank's charge-off level is tracking well under the Bank's target level of 0.25% and below its peer group average of 0.27% for 2013. Management believes that the ALLL was adequate at December 31, 2013.

Table D below summarizes average loan balances and reconciles the ALLL for each of the last five years. Additions or reductions to the allowance, which are included in operating expenses, are also included.

**TABLE D - Loan Portfolio**

(Dollars In Thousands)	December 31,				
	2013	2012	2011	2010	2009
Average amount of gross loans outstanding	\$ 581,596	\$ 526,973	\$ 543,203	\$ 573,524	\$ 588,821
Balance of allowance for possible loan losses at beginning of year	8,809	9,200	9,420	8,929	8,625
Loans charged off					
Commercial loans	222	1,690	3,353	2,046	2,069
Residential real estate loans	27	176	52	108	134
Loans to individuals	49	19	147	77	101
<b>TOTAL LOANS CHARGED OFF</b>	<b>298</b>	<b>1,885</b>	<b>3,552</b>	<b>2,231</b>	<b>2,304</b>
Recoveries of loans previously charged off					
Commercial loans	53	364	103	782	312
Residential real estate loans	2	2	-	-	19
Loans to individuals	29	8	104	44	42
<b>TOTAL RECOVERIES</b>	<b>84</b>	<b>374</b>	<b>207</b>	<b>826</b>	<b>373</b>
<b>NET LOANS CHARGED OFF</b>	<b>214</b>	<b>1,511</b>	<b>3,345</b>	<b>1,405</b>	<b>1,931</b>
Provision (reduction) charged (credited)					
to operating expenses	-	1,120	3,125	1,896	2,235
<b>BALANCE AT END OF YEAR</b>	<b>\$ 8,595</b>	<b>\$ 8,809</b>	<b>\$ 9,200</b>	<b>\$ 9,420</b>	<b>\$ 8,929</b>
Ratio of net charge-offs during the period					
to average gross loans outstanding	0.04 %	0.29 %	0.62 %	0.24 %	0.33 %

In reviewing the Bank's loan portfolio, management categorizes certain loans as classified assets, which consist of substandard, doubtful and loss categories of loans, and special mention, which is a less severe category of loans that do not warrant an adverse classification. The Bank closed 2013 with \$8,065 in classified assets compared to \$14,113 in 2012; of these amounts, \$2,325 were classified as doubtful at December 31, 2013 compared to \$2,455 as of December 31, 2012, \$4,302 and \$5,980 were classified as substandard at December 31, 2013 and 2012, respectively, and \$1,438 and \$5,678 were classified as OREO at December 31, 2013 and 2012, respectively. At December 31, 2013, loans totaling \$4,898, or 0.81% of the portfolio, were classified as special mention loans. This compares to loans totaling \$1,580 so classified at December 31, 2012, representing an increase of \$3,318.

Loans having recorded investments of \$9,225 and \$8,642 at December 31, 2013 and 2012 have been identified as impaired. Loans amounting to \$5,396 and \$8,074 at December 31, 2013 and 2012, respectively, were not accruing interest. These loans are considered nonaccrual loans and represented 0.9% and 1.4% of gross loans as of December 31, 2013 and 2012, respectively. Interest received on nonaccrual loans during 2013 was \$326, during 2012 was \$484, and during 2011 was \$959. The Bank had no loans that were 90 days or more past due that were not included in nonaccrual loans as of December 31, 2013 or 2012.

The Bank had \$3,607 and \$4,156 that qualified as troubled debt restructurings as defined in ASC Topic 310-40 as of December 31, 2013 and 2012, respectively. Troubled debt restructurings are loans for which the Bank, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower which would otherwise not be considered. For a loan to be classified as a troubled debt restructuring, the borrower must be experiencing financial difficulties (even if the borrower is not currently in default on any of its indebtedness), and because of those difficulties the Bank must have made a concession that would otherwise not be granted. These concessions can take many forms, including but not limited to granting temporary payment relief, restructuring a loan to extend the amortization or lower the

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required payment amount, and forgiveness of principal. Likewise, the financial difficulty being experienced by a borrower can take many forms, including but not limited to:

- Being in default on any existing indebtedness;
- Declaring, or being in the process of declaring, bankruptcy;
- Significant doubt as to whether an existing business can continue to operate as a going concern;

- Historically demonstrating, or forecasting, insufficient cash flows with which to service all debt in a timely manner; or
- Absent the modification, the borrower cannot continue to keep all indebtedness current.

Once identified as a troubled debt restructuring, the bank will track these loans and periodically report to the Board of Directors the aggregate balances thereof. Please refer to Note 1 and Note 4 in the Notes to Consolidated Financial Statements that are included elsewhere in this Annual Report to Shareholders for more information on the Bank's policy regarding loan impairment and troubled debt restructuring.

## RESULTS OF OPERATIONS

### Interest Income and Expense

Total interest income increased 2.7% during 2013 as a result of an increase in loan volume and slight increase in investment yields. Interest and fees earned on loans totaled 76.7% of gross interest income during 2013 and increased 2.5% from 2012 as a result of an increase in loan volume. Interest earned on securities and other investments totaled 23.3% of total interest income during 2013 and increased 3.3% from 2012 primarily because the investment portfolio's yields have increased in same period.

Total interest expense decreased 24.3% in 2013, compared to a 22.3% decrease in 2012 and a 29.4% decrease in 2011. Decreases in the average interest rate paid on interest bearing liabilities contributed to the lower interest expense. The cost of interest bearing deposits is monitored quarterly by the Bank's Asset/Liability Committee. The net interest margin (tax equivalent net interest income divided by average earning assets) was 3.69%, 3.66% and 4.07% for years ended December 31, 2013, 2012 and 2011, respectively.

Net interest income on a fully taxable equivalent basis is influenced primarily by changes in: (i) the volume and mix of earning assets and sources of funding; (ii) market rates of interest. The impact of some of these factors can be controlled by management policies and actions. External factors can also have a significant impact on changes in net interest income from one period to another. Some examples of such factors include: (i) the strength of credit demands by customers; (ii) Federal Reserve Board monetary policy; and fiscal and debt management policies of the federal government, including changes in tax laws. For the 12 months ended December 31, 2013, net interest income was \$34,454, compared to \$32,543 and \$33,026 for the 12 months ended December 31, 2012 and 2011, respectively.

### Noninterest Income and Expenses

The components of non-interest income were as follows:

	2013	2012	2011
Trust	\$ 2,298	\$ 2,119	\$ 1,999
Deposit fees	6,479	6,689	6,784

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Mortgage banking income (gains of loans sold)	437	511	469
Earnings on bank owned life insurance	497	705	717
Gain/loss on investment securities	829	2,294	1,458
Gain/loss on other real estate owned	(308)	(1,317)	(948)
Other	884	630	493
	\$ 11,116	\$ 11,631	\$ 10,972

Noninterest income decreased 4.4% in 2013 compared to 2012 and increased 6.0% in 2012 compared to 2011. Mortgage banking had a nominal decrease in 2013 compared to 2012. There was an \$829 gain on sale of available-for-sale securities in 2013 compared to a \$2,294 gain in 2012. Income from service charges on accounts decreased 3.1% in 2013 compared to 2012, representing 58% of total noninterest income. Income from fiduciary services offered in the Bank's Trust Department increased 8.4% in 2013 compared to 2012, representing 20.7% of total noninterest income. Stability in the equity and bond markets impacted the market value of the assets managed by the Trust Department and the related investment fees earned by the Bank.

The components of noninterest expense were as follows:

	2013	2012	2011
Personnel	\$ 18,331	\$ 16,486	\$ 18,836
Occupancy	2,581	2,528	2,488
Equipment	1,397	1,334	1,224
Other	10,934	10,246	10,569
	\$ 33,243	\$ 30,594	\$ 33,117

Noninterest expenses increased 8.6% in 2013 compared to 2012. A 11.2% increase in salaries and benefits was the primary contributor to this increase, due mainly to increased insurance expense for the year. Furniture and equipment increased \$53 in 2013, which was included in the 2013 budget. Noninterest expenses decreased 7.6% in 2012 compared to 2011.

### **Income Tax Expense**

Applicable income taxes on 2013 earnings amounted to \$2,700, resulting in an effective tax rate of 21.9% compared to \$3,040, or 24.4% in 2012. The effective tax rate for 2013 and 2012 is a function of the net income earned and the effect of having a real estate investment trust structure, which results in having no Tennessee excise tax expense and the effects of interest earned on tax-exempt loans and securities.

### **Net Income**

Net income was 2.2% higher in 2013 than in 2012. No provision for loan losses was expensed in 2013, which was the primary reason for the increase in net income. The Bank's annualized charge-offs ended the year at 0.04%, an improvement from 0.27% in 2012. Classified assets declined \$7,192, or 40.2% from 2013 to 2012. Based on these improving trends, the allowance for loan losses was adequate for our loan portfolio. Net income was 34.4% higher in 2012 than in 2011 primarily because of the 64.2% decrease in the provision for loan losses from 2012 to 2011.

### **OFF-BALANCE SHEET ARRANGEMENTS**

As of December 31, 2013, the Bank was a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments included commitments to extend credit and standby letters of credit. Please refer to Note 11 of the Notes to Consolidated Financial Statements included elsewhere in this Annual Report to Shareholders for more information on the Bank's commitments and contingencies. Please refer to Table C above under the heading "Liquidity and Capital Resources" for a summary of the Corporation's earning assets and interest bearing liabilities by maturities.



**CRITICAL ACCOUNTING POLICIES**

The accounting and reporting policies followed by the Corporation conform, in all material respects, to GAAP and to general practices within the financial services industry. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. In connection with the application of those principles, the Corporation's management has made judgments and estimates that, in the case of determining the ALLL and the recognition of deferred income tax assets has been critical to the determination of the Corporation's financial position, results of operations and cash flows.

**Allowance for Loan and Lease Losses**

The adequacy of the allowance for loan and lease losses is evaluated quarterly in conjunction with loan review reports and evaluations that are discussed in meetings with loan officers, credit administration and the Corporation's Board of Directors. The Bank's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect a borrower's ability to repay (including the timing of future payments), the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors are considered in this evaluation. This process is inherently subjective as it requires material estimates that are susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans. The allowance for loan and lease losses is maintained at a level believed adequate by management to absorb estimated losses inherent in the loan portfolio.

Groups of loans with similar risk characteristics are collectively evaluated for impairment based on the group's historical loss experience adjusted for changes in trends, conditions and other relevant factors that affect repayment of the loans. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment measurements, unless such loans are the subject of a restructuring agreement due to financial difficulties of the borrower.

Management has implemented procedures that give detailed historical data by segment of retail and commercial credit and performance characteristics to broaden the analysis and improve monitoring of potential credit risk.

Criteria considered and processes utilized in evaluating the adequacy of the ALLL are:

- Portfolio quality trends;
- Changes in the nature and volume of the portfolio;
- Present and prospective economic and business conditions, locally and nationally;
- Management review systems and board oversight, including external loan review processes;
- Changes in credit policy, credit administration, portfolio management and procedures;
- Changes in personnel, management and staff; and
- Existence and effect of any concentrations of credit.

In assessing the adequacy of the ALLL, the risk characteristics of the entire loan portfolio are evaluated. This process includes the judgment of management, input from independent loan reviews and reviews that may have been conducted by bank regulators as part of their usual examination process. Refer to notes 1, 4 and 5 in the consolidated financial statements for more information on the allowance for loan losses.

The following table gives a breakdown of the ALLL for each loan category:

	December 31,		2012	
	2013	Percent of	Amount	Percent of
Balance at End of Period Applicable to:	Amount	ALLL	Amount	ALLL
Commercial	\$ 7,359	85.62%	\$ 7,528	85.46%
Residential real estate	1,084	12.61%	1,109	12.59%
Consumer and other retail	152	1.77%	172	1.95%
Total loans	\$ 8,595	100.00%	\$ 8,809	100.00%

**Deferred Income Tax Assets**

Deferred income tax assets consist mainly of the tax effect of excess provisions for loan and lease losses over actual losses incurred, the unrealized loss on available-for-sale securities and deferred compensation. The Corporation and the Bank have paid taxes for many years. Management believes that it is more likely than not that these assets will be realized in future years.

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## SHAREHOLDER INFORMATION

The 5,021,012 shares of common stock of the Corporation outstanding at December 31, 2013 had an estimated market value of \$125,525 and were held by 2,054 shareholders located primarily in the Corporation's market area. A small number of shareholders are not identified individually because some bank nominees, including the Bank's Trust Department, are listed as record owners when, in fact, these holdings represent more than one beneficial owner. No single shareholder's ownership exceeded 5% at year end.

There is no established public trading market for shares of the Corporation's common stock. The table below shows the high and low price of the Corporation's common stock taken from reported prices by those buyers and sellers

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willing to disclose this information. This table also shows the semi-annual dividend declared per share of common stock, in each of the last two years. In 2013, the Corporation repurchased 158,988 shares of its common stock in several privately negotiated transactions.

			High		Low	Dividend
2013	First Quarter	\$	27.50	\$	18.52	\$ -
	Second Quarter		25.00		19.00	0.370
	Third Quarter		22.50		20.00	-
	Fourth Quarter		25.00		23.00	0.370
2012	First Quarter	\$	30.00	\$	27.00	\$ -
	Second Quarter		28.00		20.00	0.370
	Third Quarter		45.00		21.00	-
	Fourth Quarter		23.00		22.48	0.370

**ADDITIONAL FINANCIAL DATA**

The following table presents consolidated comparative data for the Corporation for the years shown:

**COMPARATIVE DATA**

(Dollars In Thousands)

	2013	2012	2011	2010	2009	2008	2007
Total Assets	\$ 1,092,874	\$ 1,091,487	\$ 1,017,808	\$ 941,625	\$ 935,009	\$ 911,137	\$ 823,046
Average assets	\$ 1,087,487	\$ 1,054,316	\$ 975,671	\$ 953,155	\$ 922,549	\$ 855,278	\$ 797,239
Average loans (net)	\$ 572,913	\$ 518,158	\$ 534,841	\$ 564,388	\$ 579,998	\$ 534,441	\$ 484,308
Average deposits	\$ 938,032	\$ 893,486	\$ 820,250	\$ 795,786	\$ 760,315	\$ 701,428	\$ 673,728
<b>Return on</b>							
average assets	0.88%	0.90%	0.72%	0.76%	0.87%	1.08%	1.08%
<b>Return on</b>							
average equity	8.66%	8.22%	6.21%	6.84%	7.50%	8.60%	8.36%
<b>Tier 1 capital</b>							
to average assets	9.53%	9.69%	10.24%	10.38%	10.55%	10.93%	12.22%



## Selected Financial Information

(Dollars in Thousands, Except Per Share Data)

	2013	2012	2011	2010	2009	2008
<b>Interest Income</b>						
Interest and fees on loans	\$ 28,653	\$ 27,951	\$ 29,838	\$ 31,925	\$ 31,815	\$ 32,901
<b>Income on investment securities</b>						
Taxable interest	5,501	4,967	4,219	3,857	4,894	6,649
Exempt from federal income tax	2,913	3,106	3,616	3,575	3,761	3,866
Dividends	197	207	197	194	204	194
	8,611	8,280	8,032	7,626	8,859	10,709
Other interest income	97	153	98	58	66	271
<b>Total Interest Income</b>	<b>37,361</b>	<b>36,384</b>	<b>37,968</b>	<b>39,609</b>	<b>40,740</b>	<b>43,881</b>
<b>Interest Expense</b>						
Interest on deposits	2,694	3,343	4,223	6,029	7,916	11,626
Interest on other short term borrowings	213	498	719	972	1,156	831
<b>Total Interest Expense</b>	<b>2,907</b>	<b>3,841</b>	<b>4,942</b>	<b>7,001</b>	<b>9,072</b>	<b>12,457</b>
<b>Net Interest Income</b>	<b>34,454</b>	<b>32,543</b>	<b>33,026</b>	<b>32,608</b>	<b>31,668</b>	<b>31,424</b>
Provision For Possible Loan Losses	-	1,120	3,125	1,896	2,235	1,687
<b>Net Interest Income After</b>						
Provision for Loan Losses	34,454	31,423	29,901	30,712	29,433	29,737
<b>Noninterest Income</b>						
Trust department income	2,298	2,119	1,999	1,965	1,924	2,463
Service fees on deposit accounts	6,479	6,689	6,784	6,781	7,231	7,705
Other service fees, commissions, and fees	563	610	584	708	431	393
Other operating income	947	(81)	147	(1,300)	793	974
Securities gains	829	2,294	1,458	1,614	2,482	1,351
<b>Total Noninterest Income</b>	<b>11,116</b>	<b>11,631</b>	<b>10,972</b>	<b>9,768</b>	<b>12,861</b>	<b>12,886</b>
<b>Noninterest Expense</b>						
Salaries and employee benefits	18,331	16,486	18,836	15,811	17,137	16,562
Net occupancy expense	2,581	2,528	2,488	2,116	2,662	2,620
Furniture and equipment expense	1,397	1,334	1,224	1,076	1,120	1,007
Other operating expenses	10,950	10,262	10,585	13,191	12,148	11,259
<b>Total Noninterest Expense</b>	<b>33,259</b>	<b>30,610</b>	<b>33,133</b>	<b>32,194</b>	<b>33,067</b>	<b>31,448</b>
<b>Income Before Provision</b>						
For income Taxes	12,311	12,444	7,740	8,286	9,227	11,175
Provision For Income Taxes	2,700	3,040	744	1,043	1,187	1,967
<b>Net Income</b>	<b>\$ 9,611</b>	<b>\$ 9,404</b>	<b>\$ 6,996</b>	<b>\$ 7,243</b>	<b>\$ 8,040</b>	<b>\$ 9,208</b>
Earnings Per Common Share	\$ 1.88	\$ 1.77	\$ 1.30	\$ 1.32	\$ 1.45	\$ 1.63
Weighted Average Shares Outstanding	5,110,849	5,315,634	5,400,063	5,486,183	5,537,611	5,635,060

(See Note 1 of Notes to Consolidated Financial Statements)



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Report of Independent Registered Public Accounting Firm

Audit Committee, Board of Directors

and Shareholders

First Farmers and Merchants Corporation

Columbia, Tennessee

We have audited First Farmers and Merchants Corporation's (Corporation) internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control - Integrated Framework* (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying management report on internal control over financial reporting. Our responsibility is to express an opinion on the Corporation's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Corporation, (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles and receipts and expenditures of the Corporation are being made only in accordance with authorizations of management and directors of the Corporation and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Corporation's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

In our report dated March 5, 2014, we expressed an unqualified opinion on internal control over financial reporting. As described in the following paragraphs, a material weakness was subsequently identified in connection with the restatement of the previously issued financial statements. Accordingly, management revised its assessment about the effectiveness of the Corporation's internal control over financial reporting and our present opinion on the effectiveness of the Corporation's internal control over financial reporting as of December 31, 2013, expressed herein, is different from that expressed in our previous report.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility a material misstatement of the Corporation's annual or interim financial statements will not be prevented or detected on a timely



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basis. The following material weakness has been identified and included in management's assessment.

- Errors in recording and accounting for the Corporation's defined benefit post-retirement health care plan were identified. The errors were the result of a lack of sufficient resources within the Corporation with the requisite expertise regarding the accounting for the plan, and have resulted in restatement of the Corporation's financial statements for the years ended December 31, 2013 and 2012. This material weakness was considered in determining the nature, timing and extent of auditing procedures applied in our audit of the Corporation's consolidated financial statements, and this report does not affect our report dated March 5, 2014 (February 10, 2015, as to the effects of the restatement discussed in Note 2), on those consolidated financial statements.

In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, the Corporation has not maintained effective internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control - Integrated Framework (1992)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of December 31, 2013, and our report dated March 5, 2014 (February 10, 2015, as to the effects of the restatement discussed in Note 2), expressed an unqualified opinion thereon and included an explanatory paragraph relating to the restatement.

//s//**BKD, LLP**

Louisville, Kentucky

March 5, 2014 (February 10, 2015, as to the effects of the material weakness described above)

**FIRST FARMERS AND MERCHANTS CORPORATION**

COLUMBIA, TENNESSEE

**MANAGEMENT REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

We, as management of First Farmers and Merchants Corporation (the Corporation) and its subsidiaries, are responsible for establishing and maintaining adequate internal control over financial reporting. Pursuant to the rules and regulations of the Securities and Exchange Commission, internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Corporation;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Corporation are being made only in accordance with authorizations of management and directors of the Corporation; and
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

All internal control systems, no matter how well designed, have inherent limitations, including the possibility of human error and the circumvention of overriding controls. Accordingly, even effective internal control can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of internal control may vary over time.

Because of the inherent limitations, any system of internal control over financial reporting, no matter how well designed, may not prevent or detect misstatements due to the possibility that a control can be circumvented or overridden or that misstatements due to error or fraud may occur that are not detected. Also, projections of the effectiveness to future periods are subject to the risk that the internal controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures included in such controls may deteriorate.

Management has evaluated the effectiveness of its internal control over financial reporting as of December 31, 2013, based on the control criteria established in a report entitled Internal Control - Integrated Framework (1992), issued by the Committee of Sponsoring Organizations of the Treadway Commission. Errors in recording and accounting for the Corporation's defined benefit post-retirement health care plan were identified. The errors were the result of a lack of personnel with the requisite expertise regarding the accounting for the plan. Based on such evaluation, management concluded that there was a material weakness in the Corporation's internal control over financial reporting as of December 31, 2013.

**Remediation Plan of Material Weakness in Internal Control**

Management proposes to make modifications to the internal control procedures for identifying, calculating and recording transactions to remediate the material weakness. At the end of 2013, management hired a certified public accountant as Controller to serve as an additional layer of review over recording complex transactions in the general ledger, as well as review of the Corporation's financial reporting and internal

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controls structure. Additionally, the Company's remediation action will include obtaining outsourced expertise for those complex accounting transactions that in-house accounting staff does not have sufficient resources of time or expertise to record and report. The effectiveness of the Corporation's internal control over financial reporting as of December 31, 2013, has been audited by BKD, LLP, an independent registered public accounting firm that audited the Corporation's consolidated financial statements included in this annual report and has issued an adverse opinion as a result of the material weakness identified.

Report of Independent Registered Public Accounting Firm

Audit Committee, Board of Directors

and Shareholders

First Farmers and Merchants Corporation

Columbia, Tennessee

We have audited the accompanying consolidated balance sheets of First Farmers and Merchants Corporation (Corporation) as of December 31, 2013 and 2012, and the related consolidated statements of income, comprehensive income (loss), changes in shareholders' equity and cash flows for each of the years in the two-year period ended December 31, 2013. The Corporation's management is responsible for these financial statements. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. Our audits included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management and evaluating the overall financial statement presentation. We believe our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Corporation as of December 31, 2013 and 2012, and the results of its operations and its cash flows for each of the years in the two-year period ended December 31, 2013, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 2 to the consolidated financial statements, the accompanying 2013 and 2012 consolidated financial statements have been restated to correct a misstatement.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Corporation's internal control over financial reporting as of December 31, 2013, based on criteria established in *Internal Control - Integrated Framework* (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 5, 2014 (February 10, 2015, as to the effects of the material weaknesses described in *Management's Report on Internal Control Over Financial Reporting*, as revised), expressed an adverse opinion on the effectiveness of the Corporation's internal control over financial reporting because of the material weakness.

//s//BKD, LLP

Louisville, Kentucky

March 5, 2014 (February 10, 2015, as to the effects of the restatement discussed in Note 2)



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

	December 31, 2013	December 31, 2012
	<i>Restated</i>	<i>Restated</i>
<i>(Dollars in Thousands, Except Per Share Data)</i>		
<b>ASSETS</b>		
Cash and due from banks	\$20,391	\$23,443
Interest-bearing due from banks	25,167	31,953
Federal funds sold	9,850	15,000
Total cash and cash equivalents	55,408	70,396
Securities		
Available-for-sale (amortized cost \$346,892 and \$339,971 as of December 31, 2013 and December 31, 2012, respectively)	329,714	345,718
Held-to-maturity (fair market value \$28,595 and \$33,420 as of December 31, 2013 and December 31, 2012, respectively)	27,839	31,755
Total securities	357,553	377,473
Loans, net of deferred fees	606,766	567,159
Allowance for loan and lease losses	(8,595)	(8,809)
Net loans	598,171	558,350
Bank premises and equipment, net	24,868	26,417
Other real estate owned	1,438	5,678
Bank owned life insurance	25,867	25,112
Goodwill	9,018	9,018
Deferred tax asset	9,946	5,008
Other assets	10,605	14,035
<b>TOTAL ASSETS</b>	<b>\$1,092,874</b>	<b>\$1,091,487</b>
<b>LIABILITIES</b>		
Deposits		
Noninterest-bearing	\$179,823	\$169,136
Interest-bearing	777,514	763,713
Total deposits	957,337	932,849
Securities sold under agreements to repurchase	18,095	17,068
Accounts payable and accrued liabilities	13,238	18,675
Federal Home Loan Bank (FHLB) advances	-	10,100
<b>TOTAL LIABILITIES</b>	<b>988,670</b>	<b>978,692</b>
<b>SHAREHOLDERS' EQUITY</b>		
Common stock - \$10 par value per share, 8,000,000 shares authorized; 5,021,012 and 5,180,000 shares issued and outstanding as of December 31, 2013 and December 31, 2012, respectively	50,210	51,800
Retained earnings	62,900	59,162
Accumulated other comprehensive income (loss)	(9,001)	1,738
<b>TOTAL SHAREHOLDERS' EQUITY BEFORE NONCONTROLLING INTEREST - PREFERRED STOCK OF SUBSIDIARY</b>	<b>104,109</b>	<b>112,700</b>
Noncontrolling interest - preferred stock of subsidiary	95	95

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TOTAL SHAREHOLDERS' EQUITY	104,204	112,795
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$1,092,874	\$1,091,487

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

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**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME**

		Years Ended December 31,		
		<b>2013</b>	<b>2012</b>	<b>2011</b>
		<i>Restated</i>	<i>Restated</i>	
<i>(Dollars in Thousands, Except Per Share Data)</i>				
<b>INTEREST AND DIVIDEND INCOME</b>	Interest and fees on loans	\$28,653	\$27,951	\$29,838
	Income on investment securities			
	Taxable interest	5,501	4,967	4,219
	Exempt from federal income tax	2,913	3,106	3,616
	Dividends	294	360	295
	Total interest income	37,361	36,384	37,968
<b>INTEREST EXPENSE</b>	Interest on deposits	2,694	3,343	4,223
	Interest on other borrowings	213	498	719
	Total interest expense	2,907	3,841	4,942
	Net interest income	34,454	32,543	33,026
	Provision for loan and lease losses	-	1,120	3,125
	Net interest income after provision	34,454	31,423	29,901
<b>NONINTEREST INCOME</b>	Gain on loans sold	437	511	469
	Trust department income	2,298	2,119	1,999
	Service fees on deposit accounts	6,479	6,689	6,784
	Brokerage fees	361	231	36
	Earnings on bank owned life insurance	497	705	717
	Gain on sale of securities	829	2,294	1,458
	Loss on foreclosed property	(308	) (1,317	) (948
	Other non-interest income	523	399	457
	Total noninterest income	11,116	11,631	10,972
<b>NONINTEREST EXPENSE</b>	Salaries and employee benefits	18,331	16,486	18,836
	Net occupancy expense	2,581	2,528	2,488
	Furniture and equipment expense	1,397	1,334	1,224
	Data processing expense	2,288	2,007	1,867
	Legal and professional fees	1,037	943	997
	Stationary and office supplies	293	279	286
	Advertising and promotions	1,090	1,179	1,217
	FDIC Insurance premium expense	728	703	875
	Other real estate expense	128	309	640
	Other noninterest expense	5,370	4,826	4,687
	Total noninterest expenses	33,243	30,594	33,117
	Income before provision for income taxes	12,327	12,460	7,756
	Provision for income taxes	2,700	3,040	744
	Net income before noncontrolling interest - dividends on preferred stock of subsidiary	9,627	9,420	7,012
	Noncontrolling interest-dividends on preferred stock subsidiary	16	16	16
	Net income for common shareholders	\$9,611	\$9,404	\$6,996
<b>PER SHARE</b>	Weighted Average Shares Outstanding	5,110,849	5,315,634	5,393,765



Earnings per share	\$1.88	\$1.77	\$1.30
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The accompanying notes are an integral part of the consolidated financial statements.

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**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (LOSS)**

<i>(Dollars in thousands)</i>	Year Ended December 31,		
	2013 <i>Restated</i>	2012 <i>Restated</i>	2011
Net Income for common shareholders	\$9,611	\$9,404	\$6,996
Other Comprehensive Income (Loss)			
Unrealized appreciation (depreciation) on available-for-sale securities, net of tax (benefit) expenses of (\$8,507), \$1,204, and \$2,960	(13,589)	1,923	4,728
Reclassification adjustment for realized gains included in net income, net of taxes of (\$319), (\$883), and (\$561), respectively	(510 )	(1,411 )	(897 )
Change in unfunded portion of postretirement benefit obligations, net of tax (benefit) expenses of \$2,102, (\$1,243) and \$1,214, respectively	3,360	(1,982 )	1,940
Other Comprehensive Income (Loss)	(10,739)	(1,470 )	5,771
Total Comprehensive Income (Loss)	\$(1,128 )	\$7,934	\$12,767

The accompanying notes are an integral part of the consolidated financial statement

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

Years Ended December 31, 2013, 2012 and 2011	Shares of stock	Preferred Stock	Common Stock	Retained Earnings <i>Restated</i>	Accumulated Other Comprehensive Income (Loss) <i>Restated</i>	Total <i>Restated</i>
<b>Balance at December 31, 2010</b>	5,430,000	\$ 95	\$ 54,300	\$ 54,524	\$ (2,563)	)\$106,356
Net income before dividends on preferred stock of subsidiary				7,012		7,012
Other comprehensive income					5,771	5,771
Repurchase of common stock	(100,000 )		(1,000 )	(2,011 )		(3,011 )
Cash dividends declared, \$0.74 per share				(3,963 )		(3,963 )
Cash dividends - preferred stock of subsidiary				(16 )		(16 )
<b>Balance at December 31, 2011</b>	5,330,000	95	53,300	55,546	3,208	112,149
Net income before dividends on preferred stock of subsidiary, as restated				9,420		9,420
Other comprehensive income, as restated					(1,470 )	(1,470 )
Repurchase of common stock	(150,000 )		(1,500 )	(1,900 )		(3,400 )
Cash dividends declared, \$0.74 per share				(3,888 )		(3,888 )
Cash dividends - preferred stock of subsidiary				(16 )		(16 )
<b>Balance at December 31, 2012 (Restated)</b>	5,180,000	95	51,800	59,162	1,738	112,795
Net income before dividends on preferred stock of subsidiary, as restated				9,627		9,627
Other comprehensive loss, as restated					(10,739 )	(10,739 )
Repurchase of common stock	(158,988 )		(1,590 )	(2,132 )		(3,722 )
Cash dividends declared, \$0.74 per share				(3,741 )		(3,741 )
Cash dividends - preferred stock of subsidiary				(16 )		(16 )
<b>Balance at December 31, 2013 (Restated)</b>	5,021,012	\$ 95	\$ 50,210	\$ 62,900	\$ (9,001)	)\$104,204

*(Dollars in thousands, except per share data)*

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

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

		Years Ended Dec	
		2013	2012
		<i>Restated</i>	<i>Restated</i>
		<i>(Dollars in thousands)</i>	
<b>OPERATING</b>	Net income available for common shareholders	\$9,611	\$9,400
<b>ACTIVITIES</b>	Adjustments to reconcile net income to net cash provided by (used in) operating activities		
	Provision for loan losses	-	1,121
	Provision for depreciation and amortization of premises and equipment	1,543	1,411
	Deferred tax benefit (expense)	1,785	784
	Net securities gains	(829 )	(2,200 )
	Gains on loans sold	(437 )	(511 )
	Proceeds from sale of mortgage loans held for sale	21,047	28,000
	Funding of mortgage loans held for sale	(18,481 )	(28,000 )
	Loss on other real estate owned	308	1,311
	Gain (loss) on sale of premises and equipment	38	(100 )
	Amortization of investment security premiums, net of accretion of discounts	1,312	3,521
	Increase in cash surrender value of life insurance contracts	(497 )	(700 )
	(Increase) decrease in		
	Other assets	1,243	741
	Increase (decrease) in		
	Other liabilities	143	(270 )
	Total adjustments	7,175	5,661
	Net cash provided by operating activities	16,786	15,061
<b>INVESTING</b>	Proceeds from sales of available-for-sale securities	137,150	421
<b>ACTIVITIES</b>	Proceeds from maturities and calls of available-for-sale securities	44,908	68,600
	Proceeds from maturities and calls of held-to-maturity securities	3,890	3,400
	Purchases of investment securities available-for-sale	(189,436)	(52,000)
	Net (increase) decrease in loans	(38,267 )	(50,000 )
	Proceeds from sale of other real estate owned	2,378	1,811
	Proceeds from sale of premises and equipment	799	-
	Purchases of premises and equipment	(831 )	(780 )
	Purchase of life insurance policies	(258 )	(2,200 )
	Net cash used in investing activities	(39,667 )	(80,000 )
<b>FINANCING</b>	Net increase in deposits	24,488	76,400
<b>ACTIVITIES</b>	Net increase in securities sold under agreements to repurchase	1,027	721
	Payments to FHLB borrowings	(10,100 )	(7,000 )
	Repurchase of common stock	(3,722 )	(3,400 )
	Cash dividends paid on common stock	(3,800 )	(3,900 )
	Net cash provided by financing activities	7,893	62,700
	Increase (decrease) in cash and cash equivalents	(14,988 )	(2,600 )
	Cash and cash equivalents at beginning of period	70,396	73,000
	Cash and cash equivalents at end of period	\$55,408	\$70,300
	Supplemental disclosures of cash flow information		
	Cash paid during the period for expenses		
	Interest on deposits and borrowed funds	\$2,816	\$3,700

Income taxes	2,072	860
Loans to facilitate sale of other real estate owned	1,905	1,77
Real estate acquired in settlement of loans	312	1,35

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

## **NOTE 1 – GENERAL AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

### **Accounting Policies**

The accounting principles followed and the methods of applying those principles conform with accounting principles generally accepted in the United States (“GAAP”) and to general practices in the banking industry. The significant accounting policies applicable to First Farmers and Merchants Corporation (the Corporation) are summarized as follows.

### **Nature of Operations**

The Corporation is a bank holding company whose principal activity is the ownership and management of its wholly-owned subsidiary, First Farmers and Merchants Bank (the Bank). The Bank is primarily engaged in providing a full range of banking and financial services, including lending, investing of funds, obtaining deposits, trust and wealth management operations, and other financing activities to individual and corporate customers in the middle Tennessee area. The Bank is subject to competition from other financial institutions. The Corporation and Bank are subject to the regulation of certain federal and state agencies and undergo periodic examinations by those regulatory authorities.

### **Basis of Presentation**

The accompanying consolidated financial statements present the accounts of the Corporation and its wholly-owned subsidiary, First Farmers and Merchants Bank. The Bank has the following direct and indirect subsidiaries: F & M West, Inc., Maury Tenn, Inc., and Maury Tenn Properties, Inc. Noncontrolling interests consist of preferred shares in Maury Tenn Properties, Inc. that are owned by third parties and Maury Tenn, Inc. The preferred shares in Maury Tenn Properties, Inc. receive dividends, which are included in the consolidated statements of income. Intercompany accounts and transactions have been eliminated in consolidation.

Certain items in prior financial statements have been reclassified to conform to the current presentation. These reclassifications had no effect on net income.

### **Use of Estimates in the Preparation of Financial Statements**

The preparation of financial statements in conformity with GAAP requires management of the Corporation and the Bank to make estimates and assumptions that affect the reported amounts of assets and liabilities. Those estimates and assumptions also affect 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. Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of the allowance for loan and lease losses, the fair value of financial instruments, the valuation of foreclosed real estate, valuation of goodwill, valuation of deferred tax assets and the liability related to post-retirement benefits.

### **Concentrations of Credit Risk**

The Corporations' banking activities include granting commercial, residential, and consumer loans to customers primarily located in central and south central Tennessee and Northern Alabama. The Corporation is continuing to manage all components of its portfolio mix in a manner to reduce risk from changes in economic conditions. Concentrations of credit, as defined for regulatory purposes, are reviewed quarterly by management to ensure that internally established limits based on Tier 1 Capital plus allowance for loan losses and total capital are not exceeded. At December 31, 2013 our concentrations of commercial real estate, rental and leasing loans were 119.6% of Tier 1 Capital plus the allowance for loan and lease losses, respectively. Health care and social assistance loans were 46.3%. Manufacturing and construction loans were 25.4%. Wholesale trade credits were 25.2%. These percentages are within our internally established limits regarding concentrations of credit.

Loans secured by non-farm, non-residential real estate comprised 29.0% of the loan portfolio at December 31, 2013. Management remains comfortable with the real estate exposure levels within the commercial loan portfolio. Management believes the commercial real estate portion remains well diversified across several different property types and several different geographic markets, stretching primarily from Davidson County, Tennessee to northern Alabama.

### **Cash and Due From Banks**

Included in cash and due from banks are reserve amounts that are required to be maintained in the form of cash and balances due from the Federal Reserve Bank and other banks. At December 31, 2013, the Bank's required reserve was \$2,560 at the Federal Reserve. From time to time throughout the year, the Bank's balances due from other financial institutions exceeded Federal Deposit Insurance Corporation (FDIC) insurance limits. The Bank had one account over the limit at December 31, 2013 and it was \$261. Furthermore, federal funds sold are essentially uncollateralized loans to other financial institutions.

### **Cash Equivalents**

The Corporation considers all liquid investments with original maturities of three months or less to be cash equivalents. Cash equivalents include cash on hand, cash due from banks and federal funds sold. Federal funds are sold for one-day periods.

### **Securities**

Certain debt securities that management has the positive intent and ability to hold to maturity are classified as "held to maturity" and recorded at amortized cost. Securities not classified as held to maturity are classified as "available for sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income, net of tax. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

For debt securities with fair value below amortized cost when the Corporation does not intend to sell a debt security, and it is more likely than not the Corporation will not have to sell the security before recovery of its cost basis, it recognizes the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income. For held-to-maturity debt securities, the amount of an



other-than-temporary impairment recorded in other comprehensive income for the noncredit portion of a previous other-than-temporary impairment is amortized prospectively over the remaining life of the security on the basis of the timing of future estimated cash flows of the security.

If declines in fair value are other than temporary, the carrying value of the securities is written down to fair value as a realized loss with a charge to income for the portion attributable to credit losses and a charge to other comprehensive income for the portion that is not credit related. For available-for-sale and held-to-maturity debt securities that management has no intent to sell and believes that it more likely than not will not be required to sell prior to recovery, only the credit loss component of the impairment is recognized in earnings, while the noncredit loss is recognized in accumulated other comprehensive income. The credit loss component recognized in earnings is identified as the amount of principal cash flows not expected to be received over the remaining term of the security based on cash flow projections.

### **Loans**

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoffs are reported at their outstanding principal balances adjusted for unearned income, charge-offs, the allowance for loan losses, any unamortized deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans.

For loans amortized at cost, interest income is accrued based on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, as well as premiums and discounts, are deferred and amortized as a level yield adjustment over the respective term of the loan.

The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days past due unless the credit is well-secured and in process of collection. Past-due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on nonaccrual or charged off are reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Discounts and premiums on purchased commercial loans are amortized to income using the interest method over the remaining period to contractual maturity and adjusted for anticipated prepayments.

#### **Allowance for Loan and Lease Losses**

The allowance for loan and lease losses is established through provisions for loan and lease losses charged against income. Loan losses are charged against the allowance when management determines that the uncollectibility of a loan has been confirmed. Subsequent recoveries, if any, are credited to the allowance account in the period received.

The adequacy of the allowance for loan and lease losses is evaluated quarterly in conjunction with loan review reports and evaluations that are discussed in meetings with loan officers, credit administration and the Corporation's Board of Directors. The Bank's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect a borrower's ability to repay (including the timing of future payments), the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors are considered in this evaluation. This process is inherently subjective as it requires material estimates that are susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans. The allowance for loan and lease losses is maintained at a level believed adequate by management to absorb estimated losses inherent in the loan portfolio.

A loan is considered impaired when it is probable that the Bank will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in

relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Groups of loans with similar risk characteristics are collectively evaluated for impairment based on the group's historical loss experience adjusted for changes in trends, conditions and other relevant factors that affect repayment of the loans. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment measurements, unless such loans are the subject of a restructuring agreement due to financial difficulties of the borrower.

When any secured commercial loan is considered uncollectable, whether past due or not, a current assessment of the value of the underlying collateral is made. If the balance of the loan exceeds the fair value of the collateral, the loan is placed on nonaccrual and the loan is charged down to the value of the collateral less estimated cost to sell or a specific reserve equal to the difference between book value of the loan and the fair value assigned to the collateral is created until such time as the loan is foreclosed. When the foreclosed collateral has been legally assigned to the Corporation, a charge off is taken, if necessary, in order that the remaining balance reflects the fair value estimated less costs to sell the collateral then transferred to other real estate owned or other repossessed assets. When any unsecured commercial loan is considered uncollectable the loan is charged off no later than at 90 days past due.

All closed-end consumer loans (excluding conventional 1-4 family residential loans and installment and revolving loans secured by real estate) are charged off no later than 120 days (4 monthly payments) delinquent. If a loan is considered uncollectable, it is charged off earlier than 120 days delinquent. For conventional 1-4 family residential loans and installment and revolving loans secured by real estate, when a loan is 90 days past due, a current assessment of the value of the real estate is made. If the balance of the loan exceeds the fair value of the property, the loan is placed on nonaccrual and foreclosure proceedings are initiated. When the foreclosed property has been legally assigned to the Corporation, a charge-off is taken with the remaining balance, reflecting the fair value less estimated costs to sell, transferred to other real estate owned.

### **Loans Held for Sale**

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or fair value in the aggregate. Net unrealized losses, if any, are recognized through a valuation allowance by charges to noninterest income. Gains and losses on loan sales are recorded in noninterest income. The Corporation does not retain servicing rights on loans sold. Loans held for sale at December 31, 2013 and 2012 totaled \$327 and \$2,456, respectively.

### **Other Real Estate**

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in net income or expense from foreclosed assets.

When foreclosed properties are acquired current appraisals are obtained on the properties. Additionally, periodic updated appraisals are obtained on unsold foreclosed properties. When an updated appraisal reflects a market value below the current book value, a charge is booked to current earnings to reduce the property to its new market value less expected selling costs. Our policy for determining the frequency of periodic reviews is based upon consideration of the specific properties and the known or perceived market fluctuations in a particular market and is typically between 12 and 24 months.

### **Premises and Equipment**

Premises and equipment are stated at cost, less accumulated depreciation and amortization. The provision for depreciation is computed principally on an accelerated method over the estimated useful life of an asset, which ranges from 15 to 39 years for buildings and from three to 25 years for equipment. Costs of major additions and improvements are capitalized. Expenditures for maintenance and repairs are charged to operations as incurred. Gains or losses from the disposition of property are reflected in operations, and the asset accounts and related allowances for depreciation are reduced.

### **Federal Reserve and Federal Home Loan Bank Stock**

Federal Reserve and Federal Home Loan Bank stock are required investments for institutions that are members of the Federal Reserve and Federal Home Loan Bank systems. The required investment in the common stock is based on a predetermined formula, carried at cost and evaluated for impairment. At December 31, 2013 and 2012 Federal Reserve and Federal Home Loan Bank stock totaled \$3,879.

### **Goodwill**

Goodwill is evaluated annually for impairment. Quantitative and qualitative assessments are performed to determine whether the existence of events or circumstances leads to a determination that it is more likely than not the fair value is less than the carrying amount, including goodwill. If, based on the evaluation, it is determined to be more likely than not that the fair value is less than the carrying value, then goodwill is tested further for impairment. If the implied fair value of goodwill is lower than its carrying amount, a goodwill impairment is indicated and goodwill is written down to its implied fair value. Subsequent increases in goodwill value are not recognized in the financial statements.

### **Transfers of Financial Assets**

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Corporation—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets and (3) the Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

### **Income Taxes**

The Corporation files consolidated income tax returns with its subsidiaries. The Corporation accounts for income taxes in accordance with income tax accounting guidance (ASC 740, *Income Taxes*). The income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Corporation determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur. Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

Tax positions are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances and information available at the reporting date and is subject to management's judgment. With a few exceptions, the Corporation is no longer subject to U.S. federal tax examinations for years before 2010, and state and local tax examinations by tax authorities for years before 2010.

The Corporation recognizes interest and penalties on income taxes as a component of income tax expense.

### **Securities Sold Under Agreements to Repurchase**

Securities sold under agreements to repurchase, which are classified as secured borrowings, generally mature within one to four days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction

### **Fair Value Measurements**

FASB ASC Topic 820, "Fair Value Measurements and Disclosures", defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and requires certain disclosures about fair value measurements. See Note 13 – Fair Value Measurement. In general, fair values of financial instruments are based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as input, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the Corporation's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time.

### **Shareholders' Equity and Earnings Per Share**

Basic earnings per share represent income available to shareholders divided by the weighted average number of shares of Corporation common stock outstanding during the period. Diluted earnings per share reflect additional shares of common stock that would have been outstanding if potentially dilutive shares of common stock had been issued, as well as any adjustment to income that would result from the assumed conversion. For the years ended December 31, 2013, 2012 and 2011, there were no potentially dilutive shares of common stock issuable.

In 2013, the Corporation adopted a plan to repurchase shares of its common stock. The plan allowed the purchase of up to 200,000 shares. The Corporation purchased 158,988 shares in 2013. In 2012, the Corporation adopted a plan to repurchase up to 150,000 shares of common stock . The Corporation repurchased 150,000 shares in 2012. For 2011, the Corporation adopted a similar plan allowing it to repurchase up to 100,000 shares of common stock. The Corporation repurchased 100,000 shares in 2011.

### **Accumulated Other Comprehensive Income (Loss)**

Comprehensive income (loss) consists of net income and other comprehensive income (loss), net of applicable income tax expenses or benefits. Other comprehensive (loss) income includes unrealized appreciation or depreciation on available-for-sale securities and changes in the net actuarial gain or loss of the postretirement benefit obligation.

The components of accumulated other comprehensive income (loss), included in shareholder's equity, are as follows as of December 31, 2013, 2012 and 2011 (dollars in thousands):

	Years Ended December 31,		
	2013	2012 <i>Restated</i>	2011
Net unrealized gains (losses) on available-for-sale securities	\$(17,178)	\$ 5,747	\$4,914
Net actuarial gain (loss) on unfunded portion of postretirement benefit obligation	2,542	(2,920 )	305
	(14,636)	2,827	5,219
Tax effect - (expense) benefit	5,635	(1,089 )	(2,011)
Accumulated other comprehensive income (loss)	\$(9,001 )	\$ 1,738	\$3,208

### **Transfers Between Fair Value Hierarchy Levels**

Transfers in and out of Level 1 (quoted market prices), Level 2 (other significant observable inputs) and Level 3 (significant unobservable inputs) are recognized on the period end date.

### **Segment Reporting**

Management analyzes the operations of the Corporation assuming one operating segment, community lending services.

### **Recent Accounting Pronouncements**



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

ASU 2013-11, “*Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax loss, or a Tax Credit Carryforward Exists (Topic 740-10) – a consensus of the FASB Emerging Issues Task Force.*” ASU 2013-11 provides guidance on financial statement presentation of an unrecognized tax benefit when a net operating loss (NOL) carryforward, a similar tax loss, or a tax credit carryforward exists. The objective is to eliminate diversity in practice resulting from a lack of guidance on this topic. ASU 2013-11 will be effective for the Corporation after December 15, 2013 and is not expected to have a significant impact on the Corporation’s financial statements.

*ASU 2013-12, "Definition of a Public Business Entity – An Addition to the Master Glossary"* amends the Master Glossary of the FASB Accounting Standards Codification to include one definition of public business entity for future use in U.S. GAAP. The definition of a public business entity will be used in considering the scope of new financial guidance and will identify whether the guidance does or does not apply to business entities. The amendment does not affect existing requirements, but instead improves U.S. GAAP by providing a single definition of public business entity for use in future financial accounting and reporting guidance. There is no actual effective date for the amendment in this Update. However, the term public business entity will be used beginning with ASU 2014-01. ASU 2013-12 is not expected to have a significant impact on the Corporation's financial statements.

*ASU 2014-04, "Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40)"* clarifies when an in substance repossession or foreclosure occurs – that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The new update requires a creditor to reclassify a collateralized consumer mortgage loan to real estate property upon obtaining legal title to the real estate collateral, or the borrower voluntarily conveying all interest in the real estate property to the lender to satisfy the loan through a deed in lieu of foreclosure or similar legal agreement. The update is effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014 and is not expected to have a significant impact on the Corporation's financial statements.

**NOTE 2 RESTATEMENT OF PREVIOUSLY REPORTED CONSOLIDATED FINANCIAL STATEMENTS**

As part of the Corporation's 2014 year-end closing procedures, management determined that the Corporation had not properly recorded the liability related to its defined benefit post-retirement healthcare plan in its financial statements for the years ended December 31, 2013 and 2012 because of the Corporation's failure to interpret correctly and account for certain actuarial information provided to the Corporation, resulting in the need to make adjustments to the Corporation's financial statements for those years. The Corporation's failure to interpret correctly and account for such actuarial information resulted in a decrease to net income of \$265 and an increase to shareholder's equity of \$1,531 as of December 31, 2013. The same error resulted in an increase to net income of \$1,796 and a decrease to shareholder's equity of \$1,796 as of December 31, 2012. Management has evaluated the impact of the error in accounting for the Corporation's defined benefit post-retirement healthcare plan on the unaudited financial statements included in the Corporation's Quarterly Reports on Form 10-Q for the periods ended March 31, June 30 and September 30, 2014 and determined that such impact is not material and that no restatement of such unaudited financial statements is required. The effects of the necessary adjustments and related tax impact on the Corporation's financial statements as included in the Company's Annual Reports on Form 10-K for the years ended December 31, 2013 and 2012 are detailed in the following tables (dollars in thousands, except per-share amounts):

	<b>December 31, 2013</b>		
	As Reported	Adjustment	As Restated
<b>Consolidated Balance Sheet</b>			
Deferred tax asset	\$ 10,905	\$ (959 )	\$ 9,946
Total assets	1,093,833	(959 )	1,092,874
Accounts payable and accrued liabilities	15,728	(2,490 )	13,238
Total liabilities	991,160	(2,490 )	988,670
Retained earnings	61,369	1,531	62,900
Total shareholders' equity before noncontrolling interest-preferred stock of subsidiary	102,578	1,531	104,109
Total shareholders' equity	102,673	1,531	104,204
Total liabilities and shareholders' equity	1,093,833	(959 )	1,092,874
<b>Consolidated Statement of Income</b>			
Salaries and employee benefits	\$ 17,901	\$ 430	\$ 18,331
Total noninterest expense	32,813	430	33,243
Income before provision for income taxes	12,757	(430 )	12,327
Provision for income taxes	2,865	(165 )	2,700
Net income before noncontrolling interest - dividends on preferred stock of subsidiary	9,892	(265 )	9,627
Net income available for common shareholders	9,876	(265 )	9,611

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Earnings per weighted average shares outstanding	1.93	(0.05	) 1.88
<b>Consolidated Statement of Comprehensive Income (Loss)</b>			
Net income available for common shareholders	\$9,876	\$ (265	)\$9,611
Change in unrecognized portion of postretirement benefit obligations	(232	) 3,592	3,360
Tax effect - (expense) benefit on postretirement benefit obligations	(146	) 2,248	2,102
Total other comprehensive income (loss)	(14,331	) 3,592	(10,739 )
Total comprehensive income (loss)	(4,455	) 3,327	(1,128 )
<b>Consolidated Statements of Changes in Shareholders' Equity</b>			
Total net income before dividends on preferred stock of subsidiary	\$9,892	\$ (265	)\$9,627
Total other comprehensive loss	(14,331	) 3,592	(10,739 )
Total balance at December 31, 2013	102,673	1,531	104,204
<b>Consolidated Statement of Cash Flows</b>			
Net income available for common shareholders	\$9,876	\$ (265	)\$9,611
Deferred tax benefit (expense)	1,950	(165	) 1,785
Other liabilities	(287	) 430	143
Total adjustments	6,910	265	7,175

	<b>December 31, 2012</b>		
	As Reported	Adjustment	As Restated
<b>Consolidated Balance Sheet</b>			
Deferred tax asset	\$3,884	\$ 1,124	\$5,008
Total assets	1,090,363	1,124	1,091,487
Accounts payable and accrued liabilities	15,755	2,920	18,675
Total liabilities	975,772	2,920	978,692
Retained earnings	57,366	1,796	59,162
Accumulated other comprehensive income (loss)	5,330	(3,592 )	1,738
Total shareholders' equity before noncontrolling interest-preferred stock of subsidiary	114,496	(1,796 )	112,700
Total shareholders' equity	114,591	(1,796 )	112,795
Total liabilities and shareholders' equity	1,090,363	1,124	1,091,487
<b>Consolidated Statement of Income</b>			
Salaries and employee benefits	\$19,406	\$ (2,920 )	\$16,486
Total noninterest expense	33,514	(2,920 )	30,594
Income before provision for income taxes	9,540	2,920	12,460
Provision for income taxes	1,916	1,124	3,040
Net income before noncontrolling interest - dividends on preferred stock of subsidiary	7,624	1,796	9,420
Net income available for common shareholders	7,608	1,796	9,404
Earnings per weighted average shares outstanding	1.43	0.34	1.77
<b>Consolidated Statement of Comprehensive Income (Loss)</b>			
Net income available for common shareholders	\$7,608	\$ 1,796	\$9,404
Change in unrecognized portion of postretirement benefit obligations	1,610	(3,592 )	(1,982 )
Tax effect - (expense) benefit on postretirement benefit obligations	1,008	(2,251 )	(1,243 )
Total other comprehensive income (loss)	2,122	(3,592 )	(1,470 )
Total comprehensive income (loss)	9,730	(1,796 )	7,934
<b>Consolidated Statements of Changes in Shareholders' Equity</b>			
Total net income before dividends on preferred stock of subsidiary	\$7,624	\$ 1,796	\$9,420
Total other comprehensive income	2,122	(3,592 )	(1,470 )
Total balance at December 31, 2012	114,591	(1,796 )	112,795
<b>Consolidated Statement of Cash Flows</b>			
Net income available for common shareholders	\$7,608	\$ 1,796	\$9,404
Deferred tax benefit (expense)	(340 )	) 1,124	784
Other liabilities	2,647	(2,920 )	(273 )
Total adjustments	7,463	(1,796 )	5,667



**NOTE 3 ACCUMULATED OTHER COMPREHENSIVE INCOME (“AOCI”) BY COMPONENT**

Amounts reclassified from AOCI and the affected line items in the statements of income during the periods ended December 31, 2013, 2012 and 2011, were as follows (dollars in thousands):

	Amounts Reclassified from AOCI			Affected Line Item in the Statements of Income
	December 31, 2013	Years Ended December 31, 2012	December 31, 2011	
Unrealized gains (losses) on available-for-sale securities	\$829	\$ 2,294	\$ 1,458	Realized gain (loss) on sale of securities
	(319)	(883)	(561)	) Tax (expense) benefit
	\$510	\$ 1,411	\$ 897	Net reclassified amount
Amortization of defined benefit pension items	\$(190)	\$ -	\$ 205	
Actuarial gains (losses)	73	-	(79)	) Tax (expense) benefit
	\$(117)	\$ -	\$ 126	Net reclassified amount
Total reclassifications out of AOCI	\$393	\$ 1,411	\$ 1,023	

**NOTE 4 SECURITIES**

The amortized cost and fair value of securities available-for-sale and held-to-maturity at December 31, 2013 and 2012 are summarized as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized		Fair Value
		Gains	Losses	
<b>December 31, 2013</b>				
Available-for-sale securities				
U.S. Government agencies	\$ 112,863	\$-	\$7,791	\$105,072
U.S. Government sponsored agency mortgage backed securities	168,045	27	10,649	157,423
States and political subdivisions	45,237	1,240	140	46,337
Corporate bonds	20,747	280	145	20,882
	\$ 346,892	\$ 1,547	\$ 18,725	\$ 329,714
Held-to-maturity securities States and political subdivisions	\$ 27,839	\$ 756	\$ -	\$ 28,595

	Amortized Cost	Gross Unrealized		Fair Value
		Gains	Losses	
<b>December 31, 2012</b>				
Available-for-sale securities				
U.S. Government agencies	\$ 143,897	\$ 400	\$ 280	\$ 144,017
U.S. Government sponsored agency mortgage backed securities	131,917	1,856	55	133,718
States and political subdivisions	47,273	3,306	-	50,579
Corporate bonds	16,884	529	9	17,404
	\$ 339,971	\$ 6,091	\$ 344	\$ 345,718
Held-to-maturity securities States and political subdivisions	\$ 31,755	\$ 1,665	\$ -	\$ 33,420

Certain investments in debt securities are reported in the financial statements at an amount less than their historical cost. Total fair value of these investments at December 31, 2013 and 2012 was approximately \$269,691 and \$83,579, which was approximately 75% and 22%, respectively, of the Corporation's available-for-sale and held-to-maturity investment portfolio. The Corporation evaluates its investment portfolio on a quarterly basis for impairment. The analysis performed as of December 31, 2013 and December 31, 2012 indicated that all impairment was considered temporary, market driven due primarily to fluctuations in market interest rates and not credit-related.



The following table shows the Corporation's investments' gross unrealized losses and fair value of the Corporation's investments with unrealized losses that were not deemed to be other-than-temporarily impaired, aggregated by investment class and length of time that individual securities had been in a continuous unrealized loss position at December 31, 2013 and 2012 (dollars in thousands):

December 31, 2013 Type of Security	Less than 12 months		12 months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
US Government agencies	\$100,533	\$ 7,330	\$4,539	\$ 461	\$105,072	\$ 7,791
US Government sponsored agency mortgage backed securities	144,134	10,073	8,698	576	152,832	10,649
States and political subdivisions	2,615	140	-	-	2,615	140
Corporate bonds	8,590	121	582	24	9,172	145
	\$255,872	\$ 17,664	\$13,819	\$ 1,061	\$269,691	\$ 18,725

  

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

The unrealized losses on the Corporation's investments in direct obligation of U.S. government agencies and U.S. government sponsored agency mortgage backed securities were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Corporation does not intend to sell the investments and it is not more likely than not the Corporation will be required to sell the investments before recovery of their amortized basis, which may be maturity, the Corporation does not consider those investments to be other-than-temporarily impaired at December 31, 2013.

The amortized cost and fair value of available-for-sale securities and held-to-maturity securities at December 31, 2013, by contractual maturity, are shown below (dollars in thousands). Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

December 31, 2013	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value

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Within one year	\$5,841	\$5,920	\$3,135	\$ 3,208
One to five years	26,404	26,489	7,043	7,305
Five to ten years	131,468	124,308	16,554	16,953
After ten years	15,134	15,574	1,107	1,129
Mortgage-backed securities	168,045	157,423	-	-
<b>Total</b>	\$346,892	<b>\$329,714</b>	<b>\$27,839</b>	\$ 28,595

The carrying value of securities pledged as collateral to secure public deposits and for other purposes was \$210,494 at December 31, 2013 and \$210,800 at December 31, 2012.

The book value of securities sold under agreements to repurchase amounted to \$34,978 and \$26,500 at December 31, 2013 and 2012, respectively.

Gross gains of \$1,026, \$2,455, and \$1,509 resulting from sales of available-for-sale securities were realized for at December 31, 2013, 2012 and 2011, respectively. A loss of \$197 was included in the net gain of \$829 for December 31, 2013. A loss of \$161 was included in the net gain of \$2,294 for December 31, 2012. Losses of \$51 were included in the net gain of \$1,458 for December 31, 2011.

## NOTE 5 – LOANS

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

	December 31, 2013	December 31, 2012
<b><u>Commercial</u></b>		
Commercial and industrial	\$94,702	\$83,631
Non-farm, nonresidential real estate	176,213	167,565
Construction and development	29,938	36,323
Commercial loans secured by real estate	26,940	23,983
Other commercial	26,582	24,423
<b>Total commercial</b>	<b>354,375</b>	<b>335,925</b>
<b><u>Residential</u></b>		
Consumer loans	10,957	11,621
Single family residential	213,763	196,349
Other retail	27,671	23,264
<b>Total residential and consumer</b>	<b>252,391</b>	<b>231,234</b>
	<b>\$606,766</b>	<b>\$567,159</b>
Less:		
Allowance for possible loan losses	(8,595 )	(8,809 )
<b>Total net loans</b>	<b>\$598,171</b>	<b>\$558,350</b>

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

Commercial and industrial loans are underwritten after evaluating and understanding the borrower's ability to operate profitably and prudently expand its business. Underwriting standards are designed to promote relationship banking

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

Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. As a general rule, the Corporation avoids financing single-purpose projects unless other underwriting factors are present to help mitigate risk. The Corporation also utilizes third-party experts to provide insight and guidance about economic conditions and trends affecting market areas it serves. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans. At December 31, 2013, approximately seventy percent of the outstanding principal balance of the Corporation's commercial real estate loans was secured by owner-occupied properties, compared to eighty percent at December 31, 2012.

With respect to loans to developers and builders that are secured by non-owner occupied properties that the Corporation may originate from time to time, the Corporation generally requires the borrower to have had an existing relationship with the Corporation and have a proven record of success. Construction loans are underwritten utilizing feasibility studies, independent appraisal reviews, sensitivity analysis of absorption and lease rates and financial analysis of the developers and property owners. Construction loans are generally based upon estimates of costs and value associated with the complete project. These estimates may be inaccurate. Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Corporation until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

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

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

The goal of the bank is to diversify loans to avoid a concentration of credit in a specific industry, person, entity, product, service, or any area vulnerable to a tax law change or an economic event. A concentration of credit occurs when obligations, direct or indirect, of the same or affiliated interests represent 15 percent or more of the Bank's capital structure. Commercial real estate rental and leasing represented the highest concentration at 120% of tier 1 capital. The Board of Directors recognizes that the Bank's geographic trade area imposes some limitations regarding loan diversification if the bank is to perform the function for which it has been chartered. Specifically, lending to qualified borrowers within the bank's trade area will naturally cause concentrations of real estate loans in the primary communities served by the bank and loans to employees of major employers in the area.

The following table provides details regarding the aging of the Bank's loan portfolio (dollars in thousands):

<b>December 31, 2013</b>	30 - 90 Days	90 Days	Total	Current	Total
	Days	and	Past		Loans

	Past Due	Greater Past Due	Due		
<b><u>Retail</u></b>					
Consumer	\$182	\$3	\$185	\$10,772	\$10,957
Single family residential	3,805	83	3,876	209,887	213,763
Other retail	319	28	359	27,312	27,671
<b>Retail total</b>	<b>\$4,306</b>	<b>\$114</b>	<b>\$4,420</b>	<b>\$247,971</b>	<b>\$252,391</b>
<b><u>Commercial</u></b>					
Commercial and industrial	\$428	\$1,328	\$1,756	\$92,946	\$94,702
Non-farm, non-residential real estate	393	-	393	175,820	176,213
Construction and development	-	28	28	29,910	29,938
Commercial loans secured by real estate	38	178	216	26,724	26,940
All other commercial	-	1,249	1,249	25,333	26,582
<b>Commercial total</b>	<b>\$859</b>	<b>\$2,783</b>	<b>\$3,642</b>	<b>\$350,733</b>	<b>\$354,375</b>
<b>Total</b>	<b>\$5,165</b>	<b>\$2,897</b>	<b>\$8,062</b>	<b>\$598,704</b>	<b>\$606,766</b>

<b>December 31, 2012</b>	30 - 89 Days Past Due	90 Days and Greater Past Due	90 Days and Greater Past Due	Current	Total Loans
<b><u>Retail</u></b>					
Consumer	\$ 112	\$ 7	\$ 119	\$ 11,502	\$ 11,621
Single family residential	3,543	387	3,930	192,419	196,349
Other retail	193	-	193	23,071	23,264
<b>Retail total</b>	<b>\$3,848</b>	<b>\$ 394</b>	<b>\$ 4,242</b>	<b>\$ 226,992</b>	<b>\$ 231,234</b>
<b><u>Commercial</u></b>					
Commercial and industrial	\$ 618	\$ 1,457	\$ 2,075	\$ 81,556	\$ 83,631
Non-farm, non-residential real estate	666	448	1,114	166,451	167,565
Construction and development	160	-	160	36,163	36,323
Commercial loans secured by real estate	22	193	215	23,768	23,983
All other commercial	741	1,379	2,120	22,303	24,423
<b>Commercial total</b>	<b>\$ 2,207</b>	<b>\$ 3,477</b>	<b>\$ 5,684</b>	<b>\$ 330,241</b>	<b>\$ 335,925</b>
<b>Total</b>	<b>\$ 6,055</b>	<b>\$ 3,871</b>	<b>\$ 9,926</b>	<b>\$ 557,233</b>	<b>\$ 567,159</b>

A loan is considered impaired, in accordance with the impairment accounting guidance (ASC 310-10-35-16), when based on current information and events, it is probable the Corporation will be unable to collect all amounts due from the borrower in accordance with the contractual terms of the loan. Impaired loans include nonperforming commercial loans but also include loans modified in troubled debt restructurings.

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

<b>December 31, 2013</b>	Unpaid Contractual Principal Balance	Recorded investment with no allowance	Recorded Investment with allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment Year To Date	Interest Received	Interest Accrued
<b><u>Commercial</u></b>								
Commercial and industrial	\$ 2,190	\$ 1,338	\$ 234	\$ 1,572	\$ 16	\$ 1,620	\$ 23	\$ 134
Non-farm, non-residential real estate	3,236	1,155	1,551	2,706	282	2,819	157	168
Construction and development	461	461	-	461	44	556	30	30
Other commercial	3,834	3,310	178	3,488	-	3,704	225	241
<b>Commercial total</b>	<b>9,721</b>	<b>6,264</b>	<b>1,963</b>	<b>8,227</b>	<b>342</b>	<b>8,699</b>	<b>435</b>	<b>573</b>
<b><u>Retail</u></b>								
Single family residential	1,121	568	419	987	118	1044	52	55
Other retail	11	-	11	11	11	11	-	-
<b>Retail total</b>	<b>1,132</b>	<b>568</b>	<b>430</b>	<b>998</b>	<b>129</b>	<b>1,097</b>	<b>52</b>	<b>55</b>

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<b>Total</b>	\$ 10,853	\$ 6,382	\$ 2,393	\$ 9,225	\$ 471	\$ 9,796	\$ 487	\$ 628
<b>December 31, 2012</b>	Unpaid Contractual Principal Balance	Recorded investment with no allowance	Recorded Investment with allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment Year To Date	Interest Received	Interest Accrued
<b><u>Commercial</u></b>								
Commercial and industrial	\$ 2,036	\$ 1,076	\$ 328	\$ 1,404	\$ 103	\$ 3,483	\$ 74	\$ 259
Non-farm, non-residential real estate	3,613	2,417	-	2,417	-	1,606	83	78
Construction and development	682	-	682	682	118	682	35	40
Other commercial	3,124	3,124	-	3,124		3,520	126	279
Commercial total	9,455	6,617	1,010	7,627	221	9,291	318	656
<b><u>Retail</u></b>								
Single family residential	1,237	402	613	1,015	82	638	39	64
Retail total	1,237	402	613	1,015	82		39	64
<b>Total</b>	\$ 10,692	\$ 7,019	\$ 1,623	\$ 8,642	\$ 303	\$ 9,291	\$ 357	\$ 720



<b>December 31, 2011</b>	Unpaid Contractual Principal Balance	Recorded investment with no allowance	Recorded Investment with allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment Year To Date	Interest Received	Interest Accrued
<b><u>Commercial</u></b>								
Commercial and industrial	\$ 5,839	\$ 738	\$ 5,678	\$ 5,446	\$ 601	\$ 5,069	\$ 193	\$ 337
Non-farm, non-residential real estate	4,378	2,986	2,115	4,573	307	5,232	35	70
Construction and development	870	-	870	870	203	941	39	45
Other commercial	3,238	-	-	1,498	-	1,527	190	310
<b>Commercial total</b>	<b>14,325</b>	<b>3,724</b>	<b>8,663</b>	<b>12,387</b>	<b>1,111</b>	<b>12,769</b>	<b>457</b>	<b>762</b>
<b><u>Retail</u></b>								
Single family residential	1,388	142	1,075	1,217	131	1,269	44	68
<b>Retail total</b>	<b>1,388</b>	<b>142</b>	<b>1,075</b>	<b>1,217</b>	<b>131</b>	<b>1,269</b>	<b>44</b>	<b>68</b>
<b>Total</b>	<b>\$ 15,713</b>	<b>\$ 3,866</b>	<b>\$ 9,738</b>	<b>\$ 13,604</b>	<b>\$ 1,242</b>	<b>\$ 14,038</b>	<b>\$ 501</b>	<b>\$ 830</b>

\* Interest income received is recognized interest income and approximates cash basis.

Non-accrual loans, segregated by class of loans, were as follows at December 31, 2013 and 2012 (dollars in thousands):

	2013	2012
Commercial and industrial	\$1,649	\$1,595
Nonfarm, nonresidential real estate	737	1,372
Construction and development	68	50
Commercial real estate	6	126
Other commercial	1,248	1,379
Consumer	21	11
Single family residential	1,667	3,541
<b>Total</b>	<b>\$5,396</b>	<b>\$8,074</b>

Included in certain loan categories of impaired loans are certain loans that have been modified in a troubled debt restructuring where economic concessions have been granted to borrowers who have experienced financial difficulties. These concessions typically result from our loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. Modifications of terms for our loans and their inclusion as troubled debt restructurings are based on individual facts and circumstances. Loan modifications that are included as troubled debt restructurings may involve either an increase or reduction of the interest rate, extension of the term of the loan, or deferral of principal and/or interest payments, regardless of the period of the modification. All of the loans identified as troubled debt restructuring were modified due to financial stress of the borrower. In order to determine if a borrower is experiencing financial difficulty, an evaluation is performed to determine the probability that the borrower will be in payment default on any of its debt in the foreseeable future with the modification. This evaluation is performed under the Corporation's internal underwriting

policy.

When the Corporation modifies loans in a troubled debt restructuring, the Corporation evaluates any possible impairment similar to other impaired loans based on the present value of expected future cash flows, discounted at the contractual interest rate of the original loan or lease agreement, or use the current fair value of the collateral, less selling costs for collateral dependent loans. If the corporation determined that the value of the modified loan is less than the recorded investment in the loan, impairment is recognized through an allowance estimate or a charge-off to the allowance. In periods subsequent to modification, the Corporation evaluates all troubled debt restructuring, including those that have payment defaults, for possible impairment and recognize impairment through the allowance.

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As of December 31, 2013, the Corporation did not have any commitments to extend additional funds to borrowers with loans modified and included as a troubled debt restructuring.

During 2013, certain loans were modified in troubled debt restructurings, where economic concessions were granted to borrowers consisting of reductions in the interest rates, payment extensions, forgiveness of principal, and forbearances. Presented below, segregated by class of loans, are troubled debt restructurings that occurred during the year ended December 31, 2013 and 2012 (dollars in thousands):

<i>(dollars in thousands)</i>	2013			2012		
	Number of Loans	Post - Modification Outstanding Balance	Net Charge-offs Resulting from Modifications	Number of Loans	Post -Modification Outstanding Balance	Net Charge-offs Resulting from Modifications
Commercial:						
Commercial and industrial	-	\$-	\$-	1	\$8	\$-
Nonfarm nonresidential	-	-	-	1	361	-
Retail:						
Consumer	3	8	-	1	3	-
Single family residential	3	167	6	3	237	-
Total trouble debt restructurings	6	\$175	\$6	6	\$609	\$-

Loans retain their accrual status at the time of their modification. As a result, if a loan is on nonaccrual status at the time it is modified, it stays as no-accrual status, and if a loan is on accrual status at the time of the modification, it generally stays on accrual status. Commercial and consumer loans modified in a troubled debt restructuring are closely monitored for delinquency as an early indicator of possible future default. If loans modified in a troubled debt restructuring subsequently default, the Corporation evaluates the loan for possible further impairment. The allowance for loan losses may be increased, adjustments may be made in the allocation of the allowance, or partial charge-offs may be taken to further write-down the carrying value of the loan. The Corporation considers a loan in default when it is 90 days or more past due or transferred to nonaccrual.

As of December 31, 2013 and 2012, the Corporation did not have any loans that were modified in troubled debt restructurings during the past twelve months that have subsequently defaulted.

*Credit Quality Indicators.* As part of the on-going monitoring of the credit quality of the Corporation's loan portfolio, management tracks certain credit quality indicators including trends related to (i) the weighted-average risk grade of commercial loans, (ii) the level of classified commercial loans, (iii) net charge-offs, (iv) non-performing loans and (v) the general economic conditions in the State of Tennessee.

The Corporation uses a risk grading matrix to assign a risk grade to each of its commercial loans. Loans are graded on a scale of 1 – 8. A description of the general characteristics of the 8 risk grades is as follows:

**Risk Rating 1: Minimal Risk**

General Characteristics:

- Substantially risk free.
- Federal, state, or municipal subdivisions with acceptable investment grade credit rating.

- Large national, regional, or local entity with proven access to capital markets.
- Diversity in its line of business with stable and diversified sales base.
- Borrower is considered to be an industry leader with many consecutive years of strong profits and exhibits a financial condition, equity position, liquidity, and debt service capacity far exceeding industry norms.
- Borrower has an abundance of unpledged financeable assets coupled with superior cash generation capabilities.
- Industry conditions and trends are positive and strong.
- Borrower has strong management with evidence of management succession.
- Credit rating by Moody's, Standard & Poor, or other qualified rating agency that is grade A or higher.
- A cash secured loan with the cash on deposit in our bank or a guaranty from the Federal government also warrants this risk rating.

### **Risk Rating 2: Modest Risk**

#### General Characteristics:

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

### **Risk Rating 3: Average Risk**

#### General Characteristics:

- Borrower shows a stable earnings history and financial condition in line with industry norms with indications that these trends will continue.
- The credit extension is considered sound, however elements may be present which suggest the borrower may not be free from temporary impairments in the future.
- Liquidity and leverage is in line with industry norms.
- Good management with acceptable management succession.
-

Under most economic and business conditions has access to alternative financing but limited or no access to capital markets for short-term or capital needs.

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

**Risk Rating 4: Acceptable Risk**

General Characteristics:

- Credit is to a borrower with smaller margins of debt service coverage and with some elements of reduced financial strength.
- Borrower is generally in a lower average market position in its industry.
- Borrower shows satisfactory asset quality and liquidity, good debt capacity and coverage, and good management in critical positions.

- Management is of unquestioned character but management succession may be questionable.
- Borrower can obtain similar financing from other financial institutions.
- Interim losses or moderately declining earnings trends may occur, but the borrower has sufficient strength and financial flexibility to offset these issues.
- Credit may be to individuals with a moderately leveraged financial condition, but with satisfactory liquidity and income to cover debt repayment requirements.
- Business borrowers may have moderate leverage, but must have historically consistent cash flow to cover debt service and other operating needs.
- Business borrowers may also have erratic or cyclical operating performances but should demonstrate strong equity positions to support these profitability swings.
- Asset-based loans that have stabilized and proven performance with the financial capacity to provide for annual clean up may qualify for this rating.
- Borrower has no access to capital markets, but would be financeable by another financial institution or finance company.
- Credit extensions are generally secured by acceptable collateral.

#### **Risk Rating 5: Pass / Watch**

##### General Characteristics:

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

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

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

- Borrowers may exhibit declining earnings, strained cash flow, increasing leverage, or weakening market positions that indicate a trend toward an unacceptable risk.
- Borrower's liquidity, leverage, and earnings performance is below or trending below industry norms.
- Interim losses and other adverse trends may occur, but not to the level that would impair the bank's position. Borrower may be a newly formed company or in a new line of business or may be an established business with new or unproven management. Borrower should be adequately capitalized, but may not yet have achieved stabilized cash flow.
- Borrower generally has a small market position in its industry.
- Borrower may be engaged in an industry that is experiencing an economic downturn or is particularly susceptible to uncontrollable external factors.
- Management is of good character although some management weakness may exist, including lack of depth or succession.
- Borrowers generally have limited additional debt capacity and modest coverage, and average or below-average asset quality, margins, and market share.
- Borrower's ability to obtain financing from other financial institutions may be impaired.



•Credit to individuals with marginal financial condition and liquidity, but with income still sufficient to service the debt.

### **Risk Rating 6: Special Mention**

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

General Characteristics:

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

### **Risk Rating 7: Substandard**

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

General Characteristics:

- The primary source of repayment no longer provides satisfactory support and repayment is dependent on secondary sources.
- A substandard loan is inadequately protected by the current sound worth and paying capacity of the obligor or by the collateral pledged, if any.

- Normal repayment from the borrower is impaired although no loss of principal is envisioned.
- A partial loss of interest or principal will occur if the deficiencies are not corrected.
- Cash flow is generally not sufficient to fund anticipated cash needs.
- Financeable assets may not be sufficient to protect the bank's position.
- Adverse trends in operations that jeopardized debt repayment may require the borrower to undertake a significant reorganization of financing or the business.
- Borrower shows poor liquidity and high leverage impairing the repayment of the debt in accordance with agreed upon terms.
- Management lacks depth and succession; may be inexperienced or of questionable character.
- Borrower's market position in the industry is deteriorating.
- Borrower is not financeable by another bank or finance company.

**Risk Rating 8: Doubtful**

An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

## General Characteristics:

- Inadequate primary source of repayment. Assumes a less than satisfactory secondary source of repayment on a most-likely case basis. There may be an adequate secondary source of repayment on a best-case basis.
- Borrowers have the same weaknesses found in Substandard borrowers.
- Loss probability is extremely high but because of certain important and reasonably specific factors that may work to strengthen the loan, its classification as an estimated loss is deferred until a more exact status may be determined.
- Pending factors may include proposed merger or acquisition; liquidation procedures; capital injections; perfecting liens on additional collateral; and refinancing plans.
- Cash flow is insufficient to fund cash needs.
- Financeable assets are insufficient to protect the bank's position.
- Source of debt repayment is dependent on liquidation of assets with a probable loss.
- Borrower may no longer be a going concern, or may not exist as a going concern for the foreseeable future.
- No alternative financing sources exist.

The following table presents risk grades and classified loans by class for year ending December 31, 2013 and 2012 (dollars in thousands):

December 31, 2013 Commercial Loan Portfolio: Credit risk profile by internally assigned grade	Commercial and Industrial	Non-Farm, Non- Residential Real Estate Loans	Construction and Development	Commercial Loans Secured by Residential R/E	All Other Commercial Loans	Commercial Loan Totals
Pass	\$ 92,155	\$ 170,585	\$ 29,463	\$ 26,516	\$ 24,131	\$ 342,850
Special Mention	836	3,883	-	-	179	4,898
Substandard	635	1,745	475	424	1,023	4,302
Doubtful	1,076	-	-	-	1,249	2,325
TOTALS	\$ 94,702	\$ 176,213	\$ 29,938	\$ 26,940	\$ 26,582	\$ 354,375

Retail Loan Portfolio: Credit risk profiles based on delinquency status classification	Consumer Loans	Single-Family Residential**	All Other Retail Loans	Retail Loan Totals
Performing	\$ 10,9366	\$ 212,096	\$ 27,643	\$ 250,675
Nonperforming*	21	1,667	28	1,716
TOTALS	\$ 10,957	\$ 213,763	\$ 27,671	\$ 252,391

## December 31, 2012

Commercial Loan Portfolio: Credit risk profile by	Commercial and Industrial	Non-Farm, Non- Residential	Construction and Development	Commercial Loans Secured by	All Other Commercial Loans	Commercial Loan Totals
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internally assigned grade		Real Estate Loans		Residential R/E		
Pass	\$ 81,560	\$ 164,290	\$ 35,543	\$ 21,660	\$ 22,857	\$ 325,910
Special Mention	269	815	98	398	-	1,580
Substandard	726	2,460	682	1,925	187	5,980
Doubtful	1,076	-	-	-	1,379	2,455
TOTALS	\$ 83,631	\$ 167,565	\$ 36,323	\$ 23,983	\$ 24,423	\$ 335,925

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

\*Loans are classified as nonperforming loans and are automatically placed on nonaccrual status once they reach 90 days past due. For purposes of this table all loans graded substandard or below are including in nonperforming.

\*\*Single-family residential loans includes primary liens, closed-end secondary liens, residential construction loans, and home equity lines of credit.

#### NOTE 6 ALLOWANCE FOR LOAN AND LEASE LOSSES

*Allowance for Possible Loan Losses.* The allowance for possible loan losses is a reserve established through a provision for possible loan losses charged to expense, which represents management's best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The Corporation's allowance for possible loan loss methodology includes allowance allocations calculated in accordance with ASC Topic 310, "Receivables" and allowance allocations calculated in accordance with ASC Topic 450, "Contingencies." Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, specific homogeneous risk pools and specific loss allocations, with adjustments for current events and conditions. The Corporation's process for determining the appropriate level of the allowance for possible loan losses is designed to account for credit deterioration as it occurs. The provision for possible loan losses reflects loan quality trends, including the levels of and trends related to nonaccrual loans, past due loans, potential problem loans, criticized loans and net charge-offs or recoveries, among other factors. The provision for possible loan losses also reflects the totality of actions taken on all loans for a particular period. In other words, the amount of the provision reflects not only the necessary increases in the allowance for possible loan losses related to newly identified criticized loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools.

The level of the allowance reflects management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Corporation's control, including, among other things, the performance of the Corporation's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities

toward loan classifications.

The Corporation's allowance for possible loan losses consists of three elements: (i) specific valuation allowances determined in accordance with ASC Topic 310 based on probable losses on specific loans; (ii) historical valuation allowances determined in accordance with ASC Topic 450 based on historical loan loss experience for similar loans with similar characteristics and trends, adjusted, as necessary, to reflect the impact of current conditions; and (iii) general valuation allowances determined in accordance with ASC Topic 450 based on general economic conditions and other qualitative risk factors both internal and external to the Corporation.

The allowances established for probable losses on specific loans are based on a regular analysis and evaluation of problem loans. Commercial loans are classified based on an internal credit risk grading process that evaluates, among other things: (i) the obligor's ability to repay; (ii) the underlying collateral, if any; and (iii) the economic environment and industry in which the borrower operates. This analysis is performed at the relationship manager level for all commercial loans. When a loan has a calculated grade of 7 or higher, a special assets officer analyzes the loan to determine whether the loan is impaired and, if impaired, the need to specifically allocate a portion of the allowance for possible loan losses to the loan. Specific valuation allowances are determined by analyzing the borrower's ability to repay amounts owed, collateral deficiencies, the relative risk grade of the loan and economic conditions affecting the borrower's industry, among other things.

Historical valuation allowances are calculated based on the historical loss experience of specific types of loans and the internal risk grade of such loans at the time they were charged-off. The Corporation calculates historical loss ratios for pools of similar loans with similar characteristics based on the proportion of actual charge-offs experienced to the total population of loans in the pool. The historical loss ratios are periodically updated based on actual charge-off experience. A historical valuation allowance is established for each pool of similar loans based upon the product of the historical loss ratio and the total dollar amount of the loans in the pool. The Corporation's pools of similar loans include similarly risk-graded groups of commercial and industrial loans, commercial real estate loans, consumer real estate loans and consumer and other loans.

The components of the general valuation allowance include (i) the additional reserves allocated to specific loan portfolio segments as a result of applying an environmental risk adjustment factor to the base historical loss allocation and (ii) the additional reserves that are not allocated to specific loan portfolio segments including allocations for groups of similar loans with risk characteristics that exceed certain concentration limits established by management.

There is an inherent imprecision in calculating the specific portion of the allowance for loan and lease losses ("ALLL"). Therefore, a factor has been added to the allocation of each of the identified segments of the loan portfolio to account for the imprecision.

Included in the general valuation allowances are allocations for groups of similar loans with risk characteristics that exceed certain concentration limits established by management. Concentration risk limits have been established, among other things, for certain industry concentrations, large balance and highly leveraged credit relationships that exceed specified risk grades, and loans originated with policy exceptions that exceed specified risk grades.

The allowance for loan losses is maintained at a level considered adequate to provide for the losses that can be reasonably anticipated. Management's periodic evaluation of the adequacy of the allowance is based on the Corporation's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to change. The Corporation uses a rolling eight quarters historic loss period for all segments when estimating the historic charge off rates calculated in accordance with ASC Topic 450 and incorporates environmental factors for various components such as economic conditions, trends in delinquencies, loan review assessments, credit concentrations and level of underperforming ratios.

General valuation allowances are based on general economic conditions and other qualitative risk factors both internal and external to the Corporation. In general, such valuation allowances are determined by evaluating, among other things: (i) the experience, ability and effectiveness of the bank's lending management and staff; (ii) the effectiveness of the Corporation's loan policies, procedures and internal controls; (iii) changes in asset quality; (iv) changes in loan portfolio volume; (v) the composition and concentrations of credit; (vi) the impact of competition on

loan structuring and pricing; (vii) the effectiveness of the internal loan review function; (viii) the impact of environmental risks on portfolio risks; and (ix) the impact of changes to interest rates on portfolio risk. Management evaluates the degree of risk that each one of these components has on the quality of the loan portfolio on a quarterly basis. Each component is determined to have either a high, moderate or low degree of risk. The results are then input into a “general allocation matrix” to determine an appropriate general valuation allowance.

Included in the general valuation allowances are allocations for groups of similar loans with risk characteristics that exceed certain concentration limits established by management. Concentration risk limits have been established, among other things, for certain industry concentrations, large balance and highly leveraged credit relationships that exceed specified risk grades, and loans originated with policy exceptions that exceed specified risk grades.

Loans identified as losses by management and internal loan review are charged-off. Furthermore, consumer loan accounts are charged-off automatically based on regulatory requirements.



The following table summarizes the allocation in the allowance for loan losses by loan segment for the years ended December 31, 2013, 2012 and 2011 (dollars in thousands):

December 31, 2013	Commercial	Consumer		Totals
		Residential and Real Estate	Other Retail	
Beginning Balance	\$ 7,528	\$ 1,109	\$ 172	\$8,809
Less: Charge-offs	222	27	49	298
Add: Recoveries	53	2	29	84
Add: Provisions	-	-	-	-
Ending Balance	\$ 7,359	\$ 1,084	\$ 152	\$8,595

December 31, 2012	Commercial	Consumer		Totals
		Residential and Real Estate	Other Retail	
Beginning Balance	\$ 6,895	\$ 2,113	\$ 192	\$9,200
Less: Charge-offs	1,690	176	19	1,885
Add: Recoveries	364	2	8	374
Add: Provisions	1,959	(830)	(9)	1,120
Ending Balance	\$ 7,528	\$ 1,109	\$ 172	\$8,809

December 31, 2011	Commercial	Consumer		Totals
		Residential and Real Estate	Other Retail	
Beginning Balance	\$ 7,011	\$ 2,001	\$ 408	\$9,420
Less: Charge-offs	3,353	52	147	3,552
Add: Recoveries	103	-	104	207
Add: Provisions	3,134	164	(173)	3,125
Ending Balance	\$ 6,895	\$ 2,113	\$ 192	\$9,200

The following tables detail the amount of the ALLL allocated to each portfolio segment as of December 31, 2013, 2012 and 2011, disaggregated on the basis of the Corporation's impairment methodology (dollars in thousands):

December 31, 2013	Commercial	Consumer		Totals
		Residential and Real Estate	Other Retail	
Loans individually evaluated for impairment	\$ 342	\$ 118	\$ 11	\$471
Loans collectively evaluated for impairment	7,017	966	141	8,124
Ending Balance	\$ 7,359	\$ 1,084	\$ 152	\$8,595

December 31, 2012	Commercial	Residential Real Estate	Consumer	Totals
			and Other Retail	
Loans individually evaluated for impairment	\$ 221	\$ 82	\$ -	\$303
Loans collectively evaluated for impairment	7,307	1,027	172	8,506
Ending Balance	\$ 7,528	\$ 1,109	\$ 172	\$8,809

December 31, 2011	Commercial	Residential Real Estate	Consumer	Totals
			and Other Retail	
Loans individually evaluated for impairment	\$ 1,111	\$ 131	\$ -	\$1,242
Loans collectively evaluated for impairment	5,784	1,982	192	7,958
Ending Balance	\$ 6,895	\$ 2,113	\$ 192	\$9,200

The following table shows loans as of December 31, 2013, 2012 and 2011 related to each balance in the allowance for possible loan losses by portfolio segment and disaggregated on the basis of the Bank's impairment methodology (dollars in thousands):

December 31, 2013	Commercial	Residential & Real Estate	Consumer & Other Retail	Totals
Loans individually evaluated for impairment	\$ 8,227	\$ 987	\$ 11	\$ 9,225
Loans collectively evaluated for impairment	346,148	212,776	38,617	597,541
Ending Balance	\$ 354,375	\$ 213,763	\$ 38,628	\$ 606,766

December 31, 2012	Commercial	Residential & Real Estate	Consumer & Other Retail	Totals
Loans individually evaluated for impairment	\$ 7,627	\$ 1,015	\$ -	\$ 8,642
Loans collectively evaluated for impairment	328,298	195,334	34,885	558,517
Ending Balance	\$ 335,925	\$ 196,349	\$ 34,885	\$ 567,159

December 31, 2011	Commercial	Residential & Real Estate	Consumer & Other Retail	Totals
Loans individually evaluated for impairment	\$ 12,387	\$ 1,217	\$ -	\$ 13,604
Loans collectively evaluated for impairment	268,536	221,365	14,297	504,198
Ending Balance	\$ 280,923	\$ 222,582	\$ 14,297	\$ 517,802

## NOTE 7 PREMISES AND EQUIPMENT

The following table presents the Corporation's assets by category at December 31, 2013 and 2012 (dollars in thousands):

	2013	2012
Land	\$8,223	\$9,003
Premises	22,765	22,717
Furniture and equipment	9,367	9,401
Leasehold improvements	1,095	1,319
	41,450	42,440

Less allowance for depreciation and amortization	(16,582)	(16,023)
	\$24,868	\$26,417

**NOTE 8 RELATED PARTY TRANSACTIONS**

Certain related parties (primarily directors and senior officers of the Corporation or the Bank, including their affiliates, families and companies in which they hold 10% or more ownership) were customers of, and had loans and other transactions with, the Bank in the ordinary course of business. An analysis of the activity with respect to such loans for the years ended December 31, 2013 and 2012 is shown in the table below (dollars in thousands). These totals exclude loans made in the ordinary course of business to other companies with which neither the Corporation nor the Bank had a relationship other than the association of one of its directors in the capacity of officer or director. These loan transactions were made on substantially the same terms as those prevailing at the time for comparable loans to other persons. They did not involve more than the normal risk of collectability or present other unfavorable features. No related party loans were charged off in 2013 or 2012.

Activity for related party transactions during 2013 and 2012 is as follows (dollars in thousands):

	2013	2012
Related party extensions of credit, beginning of period	\$3,831	\$3,829
New loans	1,116	745
Repayments	(1,125)	(743)
Related party extension of credit, end of period	\$3,822	\$3,831

The aggregate balances of related party deposits at December 31, 2013 and 2012 were \$15,724 and \$15,984, respectively.

The aggregate balances of related party repurchase agreements at December 31, 2013 and 2012 were \$9,079 and \$8,694, respectively.

The Corporation and Bank utilize various services and purchased good provided by certain related parties. Significant services provided by a director during 2013 totaled \$38, which was for consulting services. For 2012, these services totaled \$1,105, which was for building contractor services.

## NOTE 9 LEASES

Real property for four of the Bank's office locations and certain equipment are leased under noncancelable operating leases expiring at various times through 2028. In most cases, the leases provide for one or more renewal options of five to ten years under the same or similar terms. In addition, various items of office equipment are leased under cancelable operating leases. Total rental expense incurred under all operating leases, including short-term leases with terms of less than one month, amounted to approximately \$18, \$12 and \$13 for equipment leases and approximately \$264, \$283 and \$236 for building leases in 2013, 2012 and 2011, respectively. Future minimum lease commitments as of December 31, 2013 under all noncancelable operating leases with initial terms of one year or more are shown in the following table (dollars in thousands):

Year	Lease Payments
2014	\$ 336
2015	347
2016	320
2017	290
2018	290
Thereafter	3,942
Total	\$ 5,525

## NOTE 10 FEDERAL AND STATE INCOME TAXES

The following table presents components of income tax expense attributable to continuing operations for the years ended December 31, 2013, 2012 and 2011 (dollars in thousands):

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	2013	2012	2011
	<i>Restated</i>	<i>Restated</i>	
Current	\$ 915	\$ 2,256	\$ 1,960
Deferred	1,785	784	(1,216)
Total provision for income taxes	2,700	3,040	744

	2013	2012	2011
	<i>Restated</i>	<i>Restated</i>	
Deferred Tax Effects of Principal Temporary Differences			
Allowance for possible loan losses	\$ 3,309	\$ 3,392	\$ 3,519
Deferred compensation	2,516	2,420	2,234
Write down of other real estate	314	1,152	1,621
Deferred gain on OREO sale	188	202	-
Amortization of core deposit intangible	(272 )	423	575
Recognition of nonaccrual loan income	111	152	66
Unrealized gains (losses) on available-for-sale securities	6,613	(2,212 )	(1,892)
Post retirement benefit obligation	890	2,857	1,643
Accelerated depreciation	(822 )	(630 )	(562 )
Amortization of goodwill	(2,591 )	(2,376 )	(2,152)
Alternative Minimum Tax	-	402	422
Dividend Income - F&M West	(372 )	(219 )	(241 )
Prepaid Expenses	(178 )	(185 )	-
Other	240	(370 )	(360 )
Net deferred tax asset	\$ 9,946	\$ 5,008	\$ 4,872

## Reconciliation of Total Income Taxes Reported with the Amount of Income Taxes Computed at the Federal Statutory Rate (34% Each Year)

	2013	2012	2011
	<i>Restated</i>	<i>Restated</i>	
Tax expense at statutory rate	\$4,191	\$4,236	\$2,632
Increase (decrease) in taxes resulting from:			
Tax exempt interest	(1,144 )	(1,275 )	(1,533 )
Nondeductible interest expense	18	29	45
Employee benefits	(196 )	(240 )	(244 )
Other nondeductible expenses (nontaxable income) - net	11	32	55
State income taxes net of federal tax benefit	-	41	(40 )
Dividend income exclusion	-	(1 )	(52 )
Other	(180 )	218	(119 )
Total provision for income taxes	\$2,700	\$3,040	\$745
Effective tax rate	21.9 %	24.4 %	9.6 %

The Corporation and one of its subsidiaries file consolidated income tax returns with the Internal Revenue Service and State of Tennessee. The Corporation is not subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2010. There was no valuation allowance for deferred tax assets at December 31, 2013 and 2012. Management believes it is more-likely-than-not that all of the deferred tax assets will be realized because they were supported by recoverable taxes paid in prior years.

**NOTE 11 BORROWED FUNDS**

The Bank is a party to the Blanket Agreement for Advances and Security Agreement (the “Blanket Agreement”) with the Federal Home Loan Bank of Cincinnati (the “FHLB”). Advances made to the Bank under the Blanket Agreement are collateralized by the FHLB stock and qualifying residential mortgage loans totaling 150% of the outstanding amount borrowed. These collateralization matters are outlined in the Blanket Agreement dated June 20, 2006 between the Bank and the FHLB. Outstanding advances at December 31, 2013 and 2012 were \$0 and \$10,100, respectively.

Stock held in the FHLB totaling \$3,009 at December 31, 2013 is carried at cost. The stock is restricted and can only be sold back to the FHLB at par.





The Bank has a Cash Management Advance Line of Credit Agreement (the “CMA”) dated June 21, 2010, with the Federal Home Loan Bank. The CMA is a component of the Blanket Agreement. The purpose of the CMA is to assist with short-term liquidity management. Under the terms of the CMA, the Bank may borrow a maximum of \$40 million selecting a variable rate of interest for up to 90 days or a fixed rate for a maximum of 30 days. There were no borrowings outstanding under the CMA as of December 31, 2013.

Short-term borrowings included the following at December 31 (dollars in thousands):

	2013	2012
Securities sold under repurchase agreements	\$ 18,095	\$ 17,068

Securities sold under agreements to repurchase consist of obligations of the Bank to other parties. The obligations are secured by investment securities and such collateral is held by in safekeeping by a third party. The maximum amount of outstanding agreements at any month end during 2013 and 2012 totaled \$22,359 and \$22,598, respectively, and the monthly average of such agreements totaled \$19,052 and \$18,657 for 2013 and 2012, respectively. The agreements at December 31, 2013, mature January 2, 2014.

## **NOTE 12 – SIGNIFICANT ESTIMATES, COMMITMENTS AND CONTINGENCIES**

Accounting principles generally accepted in the United States of America require disclosure of certain significant estimates and current vulnerabilities due to certain concentrations. Estimates related to the allowance for loan losses are reflected in the footnote regarding loans. Other significant estimates and concentrations not discussed in those footnotes include:

### **General Litigation**

The Corporation is subject to claims and lawsuits that arise primarily in the ordinary course of business. It is the opinion of management that the disposition or ultimate resolution of such claims and lawsuits will not have a material adverse effect on the consolidated financial position, results of operations and cash flows of the Corporation.

### **Pension and Other Postretirement Benefit Obligations**

The Corporation has a noncontributory defined benefit postretirement health care plan whereby it agrees to provide certain postretirement benefits to eligible employees. The benefit obligation is the actuarial present value of all benefits attributed to service rendered prior to the valuation date based on the projected unit credit cost method. It is reasonably possible that events could occur that would change the estimated amount of this liability materially in the near term.

### **Current Economic Conditions**

The current protracted economic decline continues to present financial institutions with circumstances and challenges, which in some cases have resulted in large and unanticipated declines in the fair values of investments and other assets, constraints on liquidity and capital and significant credit quality problems, including severe volatility in the valuation of real estate and other collateral supporting loans.

The accompanying financial statements have been prepared using values and information currently available to the Corporation.

Given the volatility of current economic conditions, the values of assets and liabilities recorded in the financial statements could change rapidly, resulting in material future adjustments in asset values, the allowance for loan losses and capital that could negatively impact the Corporation's ability to meet regulatory capital requirements and maintain sufficient liquidity. Furthermore, the Corporation's regulators could require material adjustments to asset values or the allowance for loan losses for regulatory capital purposes that could affect the Corporation's measurement of regulatory capital and compliance with the capital adequacy guidelines under the regulatory framework for prompt corrective action.

## **Commitments and Credit Risk**

The Corporation grants agribusiness, commercial and residential loans to customers throughout the state. The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the Bank has in those particular financial instruments.

### **Commitments to Originate Loans**

Commitments to originate loans are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since a portion of the commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Each customer's creditworthiness is evaluated on a case-by-case basis. The amount of collateral obtained, if deemed necessary, is based on management's credit evaluation of the counterparty. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, commercial real estate and residential real estate.

Mortgage loans in the process of origination represent amounts that the Corporation plans to fund within a normal period of 30 to 90 days, and which are intended for sale to investors in the secondary market. Total mortgage loans in process of origination were \$407 and \$9,488, at December 31, 2013 and 2012, respectively. Total mortgage loans held for sale amounted to \$327 and \$2,456, at December 31, 2013 and 2012, respectively.

### **Standby Letters of Credit**

Standby letters of credit are irrevocable conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. Financial standby letters of credit are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing and similar transactions. Performance standby letters of credit are issued to guarantee performance of certain customers under nonfinancial contractual obligations. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending loans to customers. Should the Corporation be obligated to perform under the standby letters of credit, the Corporation may seek recourse from the customer for reimbursement of amounts paid.

The Corporation had total outstanding standby letters of credit amounting to \$11,384 and \$9,070, at December 31, 2013 and 2012, respectively, with terms ranging from seven days to 23 years.

### **Lines of Credit**

Lines of credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Lines of credit generally have fixed expiration dates. Since a portion of the line may expire without being drawn upon, the total unused lines do not necessarily represent future cash requirements. Each customer's creditworthiness is evaluated on a case-by-case basis. The amount of collateral obtained, if deemed necessary, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, commercial real estate and residential real estate. Management uses the same credit policies in granting lines of credit as it does for on-balance-sheet instruments.

At December 31, 2013, the Corporation had granted unused lines of credit to borrowers aggregating approximately \$79,150 and \$44,318 for commercial lines and open-end consumer lines, respectively. At December 31, 2012, unused lines of credit to borrowers aggregated approximately \$64,455 for commercial lines and \$45,302 for open-end consumer lines.

**NOTE 13 – REGULATORY MATTERS**

The Corporation and the Bank are subject to federal regulatory risk-adjusted capital adequacy standards. Failure to meet capital adequacy requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that could have a material adverse effect on the operating results and financial condition of the Corporation and the Bank. The applicable regulations require the Bank to meet specific capital adequacy guidelines that involve quantitative measures of assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital classification is also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Corporation and the Bank to maintain minimum amounts and ratios of Total Capital and Tier I Capital to risk-weighted assets and of Tier I Capital to average assets. Actual capital amounts and ratios are presented in the table below (dollars in thousands). Management believes, as of December 31, 2013, that the Corporation and the Bank met all capital adequacy requirements to which they were subject.

(Dollars in Thousands)	Actual (Restated)		For Minimum Capital Adequacy Purposes (Restated)		For Minimum Regulatory Compliance Purposes (Restated)	
			Amount	Ratio	Amount	Ratio
<b>As of December 31, 2013 (Restated)</b>						
Total Capital (to Risk Weighted Assets) Consolidated	\$ 111,807	15.5 %	\$ 57,525	8.0 %	\$ -	-
Bank	108,923	15.1 %	57,642	8.0 %	72,052	10.0 %
Tier I Capital (to Risk Weighted Assets) Consolidated	103,212	14.4 %	28,763	4.0 %	-	-
Bank	100,328	13.9 %	28,821	4.0 %	43,231	6.0 %
Tier I Capital (to Average Assets) Consolidated	103,212	9.5 %	43,320	4.0 %	-	-
Bank	100,328	9.3 %	43,320	4.0 %	54,150	5.0 %
<b>As of December 31, 2012 (Restated)</b>						
Total Capital (to Risk Weighted Assets) Consolidated	\$ 110,624	15.8 %	\$ 55,987	8.0 %	\$ -	-
Bank	107,782	15.5 %	55,630	8.0 %	69,537	10.0 %
Tier I Capital (to Risk Weighted Assets) Consolidated	101,944	14.6 %	27,993	4.0 %	-	-
Bank	99,102	14.3 %	27,815	4.0 %	41,722	6.0 %
Tier I Capital (to Average Assets) Consolidated	101,944	9.7 %	42,101	4.0 %	-	-
Bank	99,102	9.4 %	42,101	4.0 %	52,626	5.0 %

The Corporation is subject to certain restrictions on the amount of dividends that it may declare without prior regulatory approval. At December 31, 2013, approximately \$16,553 of retained earnings were available for dividend declaration without prior approval.



**NOTE 14 – FAIR VALUE MEASUREMENT**

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. Fair value measurement must maximize the use of observable inputs and minimize the use of unobservable inputs. In estimating fair value, the Corporation utilizes valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. Such valuation techniques are consistently applied. Inputs to valuation techniques include the assumptions that market participants would use in pricing an asset or liability. Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 820, “Fair Value Measurements and Disclosures” (“ASC Topic 820”) establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

- *Level 1 Inputs* - Unadjusted quoted prices in active markets for identical assets or liabilities.

*Level 2 Inputs* - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, market consensus, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

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

**Recurring Measurements**

The following table summarizes financial assets measured at fair value on a recurring basis as of December 31, 2013 and 2012, and by the level within the fair value hierarchy utilized to measure fair value (dollars in thousands):

December 31, 2013

	Level 1	Level 2	Level 3	Total
Available-For-Sale Securities				
U.S. Government agencies	\$ -	\$ 105,072	\$ -	\$ 105,072
U.S. government sponsored agency mortgage backed securities	-	157,423	-	157,423
States and political subdivisions	-	46,337	-	46,337
Corporate bonds	-	20,882	-	20,882
<b>Total assets at fair value</b>	<b>\$ -</b>	<b>\$ 329,714</b>	<b>\$ -</b>	<b>\$ 329,714</b>

December 31, 2012

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

The following is a description of the valuation methodologies and inputs used for assets measured at fair value on a recurring basis and recognized in the accompanying balance sheets, as well as the general classification of such assets pursuant to the valuation hierarchy. There have been no significant changes in the valuation techniques during the year ended December 31, 2013.

### *Available-for-Sale Securities*

Where quoted market prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. If quoted market prices are not available, the Corporation obtains fair value measurements from an independent pricing service, such as Interactive Data, which utilizes pricing models to determine fair value measurement. The Corporation reviews the pricing quarterly to verify the reasonableness of the pricing. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other factors. U.S. government agencies, state and political subdivisions, U.S. government sponsored agency mortgage-backed securities and corporate bonds are classified as Level 2 inputs.



**Nonrecurring Measurements**

The following table summarizes financial assets measured at fair value on a nonrecurring basis as of December 31, 2013 and December 31, 2012, by the level within the fair value hierarchy utilized to measure fair value (dollars in thousands):

Assets measured at fair value on a nonrecurring basis as of December 31, 2013

	Level 1	Level 2	Level 3	Total
Impaired loans (collateral-dependent)	\$-	\$-	\$2,214	\$2,214
Other real estate owned	-	-	208	208

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

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

***Impaired Loans (Collateral-Dependent)***

The estimated fair value of collateral-dependent impaired loans is based on the appraised fair value of the collateral, less estimated cost to sell. Collateral-dependent impaired loans are classified within Level 3 of the fair value hierarchy.

The Corporation considers the appraisal or evaluation as the starting point for determining fair value and then considers other factors and events in the environment that may affect the fair value. Appraisals of the collateral underlying collateral-dependent loans are obtained when the loan is determined to be collateral-dependent and subsequently as deemed necessary by the Chief Credit Officer. Appraisals are reviewed for accuracy and consistency by the Chief Credit Officer. Appraisers are selected from the list of approved appraisers maintained by management. The appraised values are reduced by discounts to consider lack of marketability and estimated cost to sell if repayment or satisfaction of the loan is dependent on the sale of the collateral. These discounts and estimates are developed by the Chief Credit Officer by comparison to historical results. Fair value adjustments were approximately \$79 at December 31, 2013 and \$3,300 at December 31, 2012.

Loans considered impaired under ASC 310-35, "Impairment of a Loan," are loans for which, based on current information and events, it is probable that the creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans are subject to nonrecurring fair value adjustments to reflect

(1) subsequent partial write-downs that are based on the observable market price or current appraised value of the collateral or (2) the full charge-off of the loan carrying value.

### ***Other Real Estate Owned***

Other real estate owned (“OREO”) is initially recorded at fair value at the time of acquisition, as determined by independent appraisal or evaluation by the Corporation, less costs to sell when the real estate is acquired in settlement of loans. Quarterly evaluations of OREO are performed to determine if there has been any subsequent decline in the value of OREO properties. Estimated fair value of OREO is based on appraisals or evaluations, less costs to sell. OREO is classified within Level 3 of the fair value hierarchy. OREO assets are subject to nonrecurring fair value adjustments to reflect subsequent partial write-downs that are based on the observable market price or current appraised value of the collateral. Fair value adjustments were approximately \$395 at December 31, 2013 and \$1,200 at December 31, 2012.

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

**Unobservable (Level 3) Inputs**

The following table presents quantitative information about unobservable inputs used in nonrecurring Level 3 fair value measurements as of December 31, 2013 and 2012 (dollars in thousands):

<b>Quantitative Information about Level 3 Fair Value Measurements</b>				
December 31, 2013	Fair Value	Valuation Technique(s)	Unobservable Input	Range (Weighted Average)
Impaired loans (collateral-dependent)	\$2,214	Market comparable properties	Marketability discount	5.0% - 10.0% (7%)
Other real estate/assets owned	\$208	Market comparable properties	Marketability discount	5.0% - 10.0% (7%)

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

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

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

*Cash and due from banks* – The carrying amount approximates fair value.

*Interest bearing deposits in other banks* – The carrying amount approximates fair value.

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

*Securities held-to-maturity* – Fair values are based on quoted market prices, if available. If a quoted price is not available, fair value is estimated using quoted prices for similar securities. The fair value estimate is provided to management from a third party using modeling assumptions specific to each type of security that are reviewed and approved by management. Quarterly sampling of fair values provided by additional third parties supplement the fair value review process.

*Loans held for sale* – The fair value is predetermined at origination based on sale price.

*Loans (net of the allowance for loan losses)* – The fair value of fixed rate loans and variable rate mortgage loans is estimated by discounting the future cash flows using current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. For other variable rate loans, the carrying amount approximates fair value.

*Federal Home Loan Bank stock* – The carrying value of Federal Home Loan Bank (“FHLB”) stock approximates fair value based on the redemption provisions of the FHLB.

*Federal Reserve Bank stock* – The carrying value of Federal Reserve Bank stock approximates fair value based on the redemption provisions of the Federal Reserve Bank.

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

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

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

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

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

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

The following tables present estimated fair values of the Corporation's financial instruments as of December 31, 2013 and 2012, and indicate the levels within the fair value hierarchy of the valuation techniques (dollars in thousands):

**Fair Value Measurements at December 31, 2013 Using**

<b>Carrying Amount</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level</b>	<b>Significant Other Observable Inputs (Level</b>	<b>Significant Unobservable Inputs (Level</b>
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## 1)

Financial assets				
Cash and due from banks	\$20,391	\$20,391	\$ -	\$ -
Interest-bearing deposits in other banks	25,167	25,167	-	-
Federal funds sold	9,850	9,850	-	-
Federal Home Loan Bank and Federal Reserve Bank stock	3,879	-	3,879	-
Securities available-for-sale	329,714	-	329,714	-
Securities held-to-maturity	27,839	-	28,595	-
Loans held for sale	327	327	-	-
Loans, net	598,171	-	-	607,113
Accrued interest receivable	4,183	-	4,183	-
Financial liabilities				
Non-interest bearing deposits	179,823	179,823	-	-
Interest bearing deposits	777,514	-	778,682	-
Repurchase agreements	18,095	-	18,095	-
Accrued interest payable	663	-	663	-
Off-balance sheet credit related instruments:				
Commitments to extend credit and letters of credit		-	-	-

**Fair Value Measurements at December 31, 2012 Using**

	<b>Carrying Amount</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
Financial assets				
Cash and due from banks	\$23,443	\$23,443	\$ -	\$ -
Interest-bearing deposits in other banks	31,953	31,953	-	-
Federal funds sold	15,000	15,000	-	-
Federal Home Loan Bank and Federal Reserve Bank stock	3,879	-	3,879	-
Securities available-for-sale	345,718	-	345,718	-
Securities held-to-maturity	31,755	-	33,420	-
Loans held for sale	2,456	2,456	-	-
Loans, net	558,350	-	-	572,277
Accrued interest receivable	4,060	-	4,060	-
Financial liabilities				
Non-interest bearing deposits	169,136	169,136	-	-
Interest bearing deposits	763,713	-	766,043	-
Repurchase agreements	17,068	-	17,068	-
Advances from Federal Home Loan Bank	10,100	-	10,215	-
Accrued interest payable	754	-	754	-
Off-balance sheet credit related instruments:				
Commitments to extend credit and letters of credit		-	-	-

**NOTE 15 – QUARTERLY RESULTS OF OPERATIONS (Unaudited)**

The following table presents unaudited quarterly interim financial information for the Corporation for the years ended December 31, 2013 and 2012 (dollars in thousands):

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter (Restated)	Total (Restated)
2013 (Restated)					
Interest income	\$9,223	\$9,523	\$9,328	\$9,287	\$37,361
Interest expense	834	751	679	643	2,907
Net interest income	8,389	8,772	8,649	8,644	34,454
Provision for possible loan losses, net	-	-	-	-	-
Noninterest income	3,329	2,620	2,509	2,658	11,116

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Noninterest expenses	8,105	8,165	8,322	8,667	33,259
Income before income taxes	3,613	3,227	2,836	2,635	12,311
Income taxes	557	842	779	522	2,700
Net income	\$3,056	\$2,385	\$2,057	\$2,113	\$9,611
Basic earnings per share	0.59	0.46	0.40	0.42	1.88
Weighted average shares outstanding per quarter	5,178,759	5,133,051	5,086,469	5,046,833	5,110,849



2012 (Restated)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter (Restated)	Total (Restated)
Interest income	\$9,065	\$9,095	\$9,114	\$9,110	\$36,384
Interest expense	1,071	979	917	874	3,841
Net interest income	7,994	8,116	8,197	8,236	32,543
Provision for possible loan losses, net	600	520	-	-	1,120
Noninterest income	3,379	3,360	2,276	2,616	11,631
Noninterest expenses	7,754	8,424	8,145	6,287	30,610
Income before income taxes	3,019	2,532	2,328	4,565	12,444
Income taxes	690	451	373	1,526	3,040
Net income	\$2,329	\$2,081	\$1,955	\$3,039	\$9,404
Basic earnings per share	0.44	0.39	0.37	0.57	1.77
Weighted average shares outstanding per quarter	5,330,000	5,330,000	5,328,002	5,332,893	5,315,634

**NOTE 16 – DEPOSITS**

The Bank does not have any foreign offices and all deposits are serviced in its 16 domestic offices. Maturities of time deposits of \$100 or more at December 31, 2013 and 2012 are as follows (dollars in thousands):

	2013	2012
Under 3 months	\$31,514	\$28,504
3 to 12 months	\$63,429	64,639
Over 12 months	\$27,834	27,018
Total	\$122,777	\$120,161

The following table presents maturities of interest-bearing time deposits as of December 31, 2013:

2014	\$185,687
2015	\$25,422
2016	\$14,712
2017	\$7,120
2018	\$5,893
Thereafter	\$-
Total	\$238,834



**NOTE 17 – CONDENSED FINANCIAL INFORMATION OF THE CORPORATION**

The following tables present the condensed balance sheets, statements of income, comprehensive income, and cash flows of the Corporation as of December 31, 2013 and 2012 (dollars in thousands):

**CONDENSED BALANCE SHEETS**

	As of December 31,	
	2013	2012
	<i>Restated</i>	<i>Restated</i>
Cash	\$23	\$61
Investment in bank subsidiary	101,226	109,859
Investment in credit life insurance company	54	54
Investment in other securities	17	17
Dividends receivable from bank subsidiary	2,058	1,917
Cash surrender value - life insurance	4,409	4,395
Total assets	\$107,787	\$116,303
Liabilities		
Accrued liabilities	\$1,820	\$1,686
Dividends payable	1,858	1,917
Total liabilities	3,678	3,603
Shareholders' equity		
Common stock - \$10 par value, 8,000,000 shares authorized; 5,021,012 and 5,180,000 shares issued and outstanding, as of December 31, 2013 and December 31, 2012, respectively	50,210	51,800
Retained earnings	62,900	59,162
Accumulated other comprehensive income (loss)	(9,001 )	1,738
Total shareholders' equity	104,109	112,700
Total liabilities and shareholders' equity	\$107,787	\$116,303

**CONDENSED STATEMENTS OF INCOME**

	Years ended December		
	31,		
	2013	2012	2011
	<i>Restated</i>	<i>Restated</i>	
Operating income			
Dividends from bank subsidiary	\$7,663	\$7,289	\$6,974
Other dividend income	15	18	15
Other	65	135	130
Operating expenses	(238 )	(218 )	(199 )
Income before equity in undistributed net income of bank subsidiary	7,505	7,224	6,920
Equity in undistributed net income of bank subsidiary	2,106	2,180	76

Net Income \$9,611 \$ 9,404 \$6,996

**CONDENSED STATEMENT OF COMPREHENSIVE INCOME (LOSS)**

	Year Ended December 31,		
	2013	2012	2011
	<i>Restated</i>	<i>Restated</i>	
Net Income for common shareholders	\$9,611	\$ 9,404	\$6,996
Other Comprehensive Income (Loss)			
Unrealized appreciation (depreciation) on available-for-sale securities, net of tax expense (benefit) of (\$8,507), \$1,204, and \$2,960	(13,589)	1,923	4,728
Reclassification adjustment for realized gains included in net income, net of taxes of (\$319), (\$883), and (\$561), respectively	(510 )	(1,411 )	(897 )
Change in unfunded portion of postretirement benefit obligations, net of tax of \$2,102, (\$1,243) and \$1,214, respectively	3,360	(1,982 )	1,940
Other Comprehensive Income (Loss)	(10,739)	(1,470 )	5,771
Total Comprehensive Income (Loss)	\$(1,128 )	\$ 7,934	\$12,767

**CONDENSED STATEMENTS OF CASH FLOWS**

	Years Ended December 31,		
	2013	2012	2011
	<i>Restated</i>	<i>Restated</i>	
Operating activities			
Net income for the year	\$9,611	\$9,404	\$6,996
Adjustments to reconcile net income to net cash provided by operating activities			
Equity in undistributed net income of bank subsidiary	(2,106)	(2,180 )	(76 )
Increase in cash surrender value of life insurance contracts	(65 )	(135 )	(130 )
(Increase) decrease in other assets	(90 )	56	(1,972)
Decrease in payables	84	127	126
Total adjustments	(2,177)	(2,132 )	(2,052)
Net cash provided by operating activities	7,434	7,272	4,944
Investing activities			
Purchase of single premium life insurance policy	-	(310 )	-
Net cash used by investing activities	-	(310 )	-
Financing activities			
Payment to repurchase common stock	(3,722)	(3,400 )	(3,011)
Cash dividends paid	(3,800)	(3,944 )	(1,991)
Advance from subsidiary	50	-	-
Net cash used by financing activities	(7,472)	(7,344 )	(5,002)
Decrease in cash	(38 )	(382 )	(58 )
Cash at beginning of year	61	443	501
Cash at end of year	\$23	\$61	\$443

**NOTE 18 – EMPLOYEE BENEFIT PLANS**

The Bank contributes to a qualified profit-sharing plan covering employees who meet participation requirements. To be eligible to participate, employees must complete 1,000 hours of service within the twelve month time period following their date of hire. Employees must be age twenty or older. The amount of the contribution is at the discretion of the Bank's Board of Directors, up to the maximum deduction allowed for federal income tax purposes. Contributions to the plan, which amounted to approximately \$1,596, \$1,019 and \$874 in 2013, 2012 and 2011, respectively, are included in salaries and employee benefits expense.

The Bank formalized a nonqualified salary continuation plan for certain key officers. In connection with this plan, the value of the single premium universal life insurance policies (approximately \$975 at December 31, 2013 and approximately \$963 at December 31, 2012) purchased in 1993 to fund the plan and the related liability (approximately \$49 at December 31, 2013 and \$59 at December 31, 2012) were included in other assets and other liabilities, respectively. The principal cost of the plan is accrued over the anticipated remaining period of active employment, based on the present value of the expected retirement benefit.

The Corporation and Bank implemented a deferred compensation plan that permits directors to defer their director's fees and earn interest on the deferred amount in the amount of the wall street journal prime rate plus three percent. The agreements provide for a lump sum payment or 120 month payments of deferred fees plus accrued interest after retirement, separation from service, or death. The liability accrued for this plan totaled \$6,487 and \$6,226 at December 30, 2013 and 2012, respectively. The charge to expense for the agreements was \$722, \$853 and \$711 for the years ended December 31 2013, 2012 and 2011, respectively.

#### **NOTE 19 – POST RETIREMENT BENEFIT PLAN**

Effective July 1, 2013, the Corporation revised its retiree medical benefit plan for employees who were hired before March 27, 2007. Newly retiring employees will no longer be offered medical, dental or life insurance coverage. Instead, qualified retirees will receive a post retirement bonus. The Corporation will pay a post retirement bonus equal to \$20,000 to employees (i) who were hired prior to March 20, 2007; (ii) who retire on or after July 1, 2013; (iii) who are at least age 59 ½ at the time of retirement; and (iv) who have at least twenty-five years of service to the Corporation as of retirement. The bonus will be paid in a lump sum cash payment (subject to applicable tax withholding requirements) within 60 days after the employee's retirement, provided such retirement constitutes a "separation from service" under section 409A of the Internal Revenue Code. The Corporation still sponsors a defined benefit post-retirement health care plan for retirees who retired prior to July 1, 2007 which is a self-insured plan. Under this plan, premiums paid by retirees and spouses depend on date of retirement, age and coverage election.

The change to the Corporation's retiree medical benefit plan, as described above, resulted in a negative plan amendment of approximately \$3.2 million, which contributed to a large decrease in the benefit obligation at the end of 2013. The additional decrease in the benefit obligation was the result of a change in actuarial assumptions related to claims expense applied in 2013, which resulted in a \$2.0 million actuarial gain. The actuarial loss for 2012 is primarily due to a change in the discount rate assumption.

The Corporation funding policy is to make the minimal annual contribution that is required by applicable regulations, plus such amounts as the Corporation may determine to be appropriate from time to time. The Corporation expects to contribute \$145 to the plan in 2014.

The following table provides further information about the plan (dollars in thousands):

	Post-Retirement Benefits	
	2013	2012
	<i>Restated</i>	<i>Restated</i>
<b>Change in benefit obligation</b>		
Benefit obligation at beginning of year	\$7,421	\$4,572
Service cost	138	91
Interest cost	292	351
Plan participants' contribution	-	106
Expected benefits paid	(266 )	(314 )
Negative plan amendment	(3,220)	-
Actuarial (gain) loss	(2,000)	3,225
Amendments and other changes	(52 )	(610 )
Benefit obligation at end of year	\$2,313	\$7,421
<b>Change in fair value of assets</b>		
Fair value of plans assets at beginning of year	\$-	\$-
Employer contribution	266	208
Plan participants' contributions	-	106
Benefits paid	(266 )	(314 )
Fair value of plan assets at end of year	\$-	\$-
<b>Reconciliation of funded status</b>		
Projected benefit obligation, end of year	\$(2,313)	\$(7,421 )
Fair value of assets, end of year	-	-
Funded status, end of year	\$(2,313)	\$(7,421 )

Amounts recognized in accumulated other comprehensive income not yet recognized as components of net periodic benefit cost consist of:

	2013	
	<i>Restated</i>	
Unrecognized net actuarial (gain)/loss	\$ (2,490 )	\$2,920
Unrecognized prior service cost	(52 )	-
	\$ (2,542 )	\$2,920



Amounts recognized in statement of financial position are as follows:

	2013	2012
	<i>Restated</i>	<i>Restated</i>
Current Liability	\$ 183	\$ 266
Noncurrent liability	2,130	7,155
Total	\$ 2,313	\$ 7,421

A reconciliation of accumulated other comprehensive (income) loss is as follows:

	Post-Retirement Benefits		
	2013	2012	2011
	<i>Restated</i>	<i>Restated</i>	
Accumulated other comprehensive (income) loss beginning of year	\$2,920	\$ (305 )	\$(2,849)
Amortization of net actuarial gain (loss)	(190 )	-	205
Negative plan amendment gain	(3,220)	-	-
Actuarial loss (gain) incurred in current year	(2,000)	3,225	2,339
Prior service cost established in current year	(52 )	-	-
Other comprehensive (income) loss	(5,462)	3,225	2,544
Accumulated other comprehensive (income) loss (before tax effects)	\$(2,542)	\$ 2,920	\$(305 )

	Post-Retirement Benefits		
Components of net periodic benefit cost:	2013	2012	2011
Service cost	\$ 138	\$ 91	\$24
Interest cost	292	351	139
Recognized net actuarial (gain) loss	190	-	(205)
Net periodic benefit cost (income)	\$ 620	\$ 442	\$(42 )

The estimated net gain for the defined benefits postretirement plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year is \$188.

	Post-Retirement Benefits	
Weighted-average assumption used to determine benefit obligation:	2013	2012
Discount rate	5%	4%
Rate of compensation increase	NA	NA

	Post-Retirement Benefits	
Weighted-average assumptions used to determine benefit costs:	2013	2012

Discount rate 4% 8%

The following table gives the Health Care Cost Trend, which is applied to gross charges, net claims and retiree paid premiums to reflect the Corporation's past practice and stated ongoing intention to maintain relatively constant cost sharing between the Corporation and retirees (dollars in thousands):

Health care trend rate	2013	2012
Initial		
Pre-65	11 %	11 %
Post-65	7.50 %	8 %
Ultimate (pre and post-65)	5.00 %	5 %
Years to ultimate		
Pre-65	6	6
Post-65	5	6

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid, net of participant contributions (dollars in thousands):

FYE	Company Benefits
2014	\$ 183
2015	167
2016	178
2017	169
2018	191
2019-2023	935
	\$ 1,823

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects (dollars in thousands):

	1-Percentage-Point Increase	1-Percentage-Point Decrease
Effect on total of service and interest cost	\$ 29	\$ (16)
Effect on postretirement benefit obligation	212	(109)