KENTUCKY BANCSHARES INC /KY/
Form 10-Q
November 12, 2010

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

(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2010
or
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ____________________ to ____________________

Commission File Number: 000-52598

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes X No _____

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes _____ No _____

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of ?large accelerated filer,? ?accelerated filer? and ?smaller reporting company? in Rule 12b-2 of the Exchange Act.
Large accelerated filer ____
Accelerated filer ____
Non-accelerated filer X (Do not check if a smaller reporting company)
Smaller reporting company ____

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

Number of shares of Common Stock outstanding as of November 8, 2010: 2,739,319.

KENTUCKY BANCSHARES, INC.

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Item 1 – Financial Statements

KENTUCKY BANCSHARES, INC.

CONSOLIDATED BALANCE SHEETS (unaudited)

(in thousands)	9/30/2010	12/31/2009
Assets		
Cash and due from banks	$ 18,115	$ 12,387
Federal funds sold	7,855	22,034
Cash and cash equivalents	25,970	34,421
Securities available for sale	176,487	168,411
Mortgage loans held for sale	149	191
Loans	415,417	425,418
Allowance for loan losses	(7,372)	(7,600)
Net loans	408,045	417,818

Federal Home Loan Bank stock	6,731	6,731
Real estate owned, net	6,380	4,542
Bank premises and equipment, net	17,670	17,610
Interest receivable	4,627	4,620
Mortgage servicing rights	862	822
Goodwill	13,117	13,117
Other intangible assets	1,072	1,263
Other assets	4,997	5,685
Total assets	$ 666,107	$ 675,231
Liabilities and Stockholders' Equity		
Deposits		
Non-interest bearing	$ 112,890	$ 97,005
Time deposits, $100,000 and over	120,253	105,036
Other interest bearing	305,711	334,405
Total deposits	538,854	536,446
Repurchase agreements and other borrowings	6,437	8,226
Federal Home Loan Bank advances	43,567	56,096
Subordinated debentures	7,217	7,217
Interest payable	2,361	2,123
Other liabilities	2,981	4,158
Total liabilities	601,417	614,266
Stockholders' equity		
Preferred stock, 300,000 shares authorized and unissued	-	-
Common stock, no par value; 10,000,000 shares authorized; 2,742,506 and 2,739,511 shares issued and outstanding on September 30, 2010 and December 31, 2009	12,489	12,416
Retained earnings	49,185	47,213
Accumulated other comprehensive income	3,016	1,336
Total stockholders' equity	64,690	60,965
Total liabilities & stockholders' equity	$ 666,107	$ 675,231

See Accompanying Notes

KENTUCKY BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (unaudited)

(in thousands, except per share amounts)	Nine Months Ending	
	9/30/2010	9/30/2009
INTEREST INCOME:		
Loans, including fees	$ 17,936	$ 18,640
Securities available for sale	4,955	5,361
Other	33	15
Total interest income	22,924	24,016
INTEREST EXPENSE:		
Deposits	6,296	7,100
Other	1,717	2,566
Total interest expense	8,013	9,666
Net interest income	14,911	14,350
Loan loss provision	1,950	1,350
Net interest income after provision	12,961	13,000

NON-INTEREST INCOME:		
Service charges	3,707	3,918
Loan service fee income, net	65	69
Trust department income	431	377
Securities available for sale gains, net	1,267	351
Gain on sale of mortgage loans	650	1,026
Other	1,303	1,114
Total other income	7,423	6,855
NON-INTEREST EXPENSE:		
Salaries and employee benefits	7,574	8,618
Occupancy expenses	2,080	2,031
Repossession expenses, net	947	264
FDIC insurance	768	921
Legal and professional fees	586	300
Data processing	579	558
Debit card expenses	469	479
Amortization	191	195
Advertising and marketing	446	372
Taxes other than payroll, property and income	594	553
Other	1,983	1,862
Total other expenses	16,217	16,153
Income before taxes	4,167	3,702
Income taxes	467	277
Net income	$ 3,700	$ 3,425
Other Comprehensive Income, net of tax:		
Change in Unrealized Gains on Securities	1,680	4,109
Comprehensive Income	$ 5,380	$ 7,534
Earnings per share		
Basic	$ 1.35	$ 1.25
Diluted	1.35	1.25
Dividends per share	0.63	0.60

See Accompanying Notes

KENTUCKY BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (unaudited)

(in thousands, except per share amounts)	Three Months Ending	
	9/30/2010	9/30/2009
INTEREST INCOME:		
Loans, including fees	$ 5,909	$ 6,337
Securities available for sale	1,558	1,574
Other	9	1
Total interest income	7,476	7,912
INTEREST EXPENSE:		
Deposits	2,055	2,204
Other	511	783
Total interest expense	2,566	2,987

Net interest income	4,910	4,925
Loan loss provision	700	450
Net interest income after provision	4,210	4,475
NON-INTEREST INCOME:		
Service charges	1,320	1,396
Loan service fee income, net	(5)	19
Trust department income	121	142
Securities available for sale gains (losses), net	1,053	148
Gain on sale of mortgage loans	341	215
Other	476	370
Total other income	3,306	2,290
NON-INTEREST EXPENSE:		
Salaries and employee benefits	2,631	2,632
Occupancy expenses	719	738
Repossession expenses, net	319	66
FDIC insurance	272	210
Legal and professional fees	236	118
Data processing	191	178
Debit card expenses	173	186
Amortization	63	64
Advertising and marketing	155	119
Taxes other than payroll, property and income	200	187
Other	750	806
Total other expenses	5,709	5,304
Income before taxes	1,807	1,461
Income taxes	233	108
Net income	$ 1,574	$ 1,353
Other Comprehensive Income (Loss), net of tax:		
Change in Unrealized Gains on Securities	789	3,290
Comprehensive Income	$ 2,363	$ 4,643
Earnings per share		
Basic	$ 0.57	$ 0.49
Diluted	0.57	0.49
Dividends per share	0.21	0.20

See Accompanying Notes

KENTUCKY BANCSHARES, INC.

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

	--Common Stock(1)--		Retained	Accumulated Other Comprehensive	S
	Shares	Amount	Earnings	Income	
Balances, January 1, 2010	2,739,511	$ 12,416	$ 47,213	$ 1,336	
Common stock issued, including tax					

benefit, net	3,646	-	-	-
Stock based compensation expense	-	83	-	-
Common stock purchased and retired	(651)	(10)	-	-
Net change in unrealized gain (loss) on securities available for sale, net of tax	-	-	-	1,680
Net income	-	-	3,700	-
Dividends declared - $0.63 per share	-	-	(1,728)	-
Balances, September 30, 2010	2,742,506	$ 12,489	$ 49,185	$ 3,016

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

See Accompanying Notes

KENTUCKY BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

(in thousands)	Nine Months Ended	
	9/30/2010	9/30/2009
Cash Flows From Operating Activities		
Net Income	$ 3,700	$ 3,425
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,234	1,128
Securities amortization, net	695	1,156
Stock based compensation expense	83	86
Provision for loan losses	1,950	1,350
Securities gains, net	(1,267)	(351)
Originations of loans held for sale	(23,125)	(45,213)
Proceeds from sale of loans	23,817	46,239
Gains on sale of fixed assets	3	-
Losses (gains on) other real estate, net	39	(78)
Gain on sale of mortgage loans	(650)	(1,026)
Changes in:		
Interest receivable	(7)	78
Real estate owned, net	700	1,137
Other assets	382	(2,947)
Interest payable	238	(286)
Other liabilities	(2,042)	(797)
Net cash from operating activities	5,750	3,901
Cash Flows From Investing Activities		

Purchases of securities	(105,577)	(60,799)
Proceeds from sales of securities	37,345	20,646
Proceeds from principal payments, maturities and calls of securities	63,273	48,850
Net change in loans	5,324	(5,181)
Purchases of bank premises and equipment	(975)	(555)
Proceeds from the sale of bank premises	3	-
Net cash from investing activities	(607)	2,961
Cash Flows From Financing Activities:		
Net change in deposits	2,408	(24,225)
Net change in repurchase agreements and other borrowings	(1,189)	7,657
Advances from Federal Home Loan Bank	-	10,000
Payments on Federal Home Loan Bank advances	(12,475)	(23,817)
Payments on note payable	(600)	(200)
Purchase of common stock	(10)	(150)
Dividends paid	(1,728)	(1,647)
Net cash from financing activities	(13,594)	(32,382)
Net change in cash and cash equivalents	(8,451)	(25,520)
Cash and cash equivalents at beginning of period	34,421	37,106
Cash and cash equivalents at end of period	$ 25,970	$ 11,586
Supplemental disclosures of cash flow information		
Cash paid during the year for:		
Interest expense	$ 8,251	$ 9,952
Income taxes	-	400
Supplemental disclosures of non-cash investing activities		
Real estate acquired through foreclosure	$ 3,494`	$ 4,109

See Accompanying Notes

KENTUCKY BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

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

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

Estimates in the Financial Statements: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The allowance for loan losses, mortgage servicing rights, real estate owned, goodwill and fair value of financial instruments are particularly subject to change.

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

Adoption of New Accounting Standards

Accounting Standards Codification (?ASC?) Topic 820, ?Fair Value Measurements and Disclosures?. The Financial Accounting Standards Board issued new accounting guidance under Accounting Standards Update (ASU) No. 2010-06 that requires new disclosures and clarifies existing disclosure requirements about fair value measurement as set forth in ASC Subtopic 820-10. The objective of the new guidance is to improve these disclosures and increase transparency in financial reporting. Specifically, the new guidance requires:

A reporting entity to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers; and

In the reconciliation for fair value measurements using significant unobservable inputs, a reporting entity should present separately information about purchases, sales, issuances, and settlements.

In addition, the guidance clarifies the requirements of the following existing disclosures:

For purposes of reporting fair value measurement for each class of assets and liabilities, a reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities; and

A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements.

ASU 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Early application is permitted. Additional disclosures have been made.

ASC Topic 860, ?Transfers and Servicing?. Effective January 1, 2010, the Company adopted new accounting guidance under ASC Topic 860 that requires more information about transfers of financial assets, including securitization transactions, and where entities have continuing exposure to the risks related to transferred financial assets. The guidance eliminates the concept of a ?qualifying special-purpose entity,? changes the requirements for derecognizing financial assets, and requires additional disclosures about continuing involvements with transferred financial assets including information about gains and losses resulting from transfers during the period. The adoption of this accounting guidance did not have a material impact on the Company?s consolidated financial position or results of operations.

ASC Topic 810, ?Consolidation?. Effective January 1, 2010, the Company adopted new accounting guidance under ASC Topic 810 that amends prior guidance to change how a reporting entity determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether a reporting entity is required to consolidate another entity is based on, among other things, the other entity?s purpose and design and the reporting entity?s ability to direct the activities of the other entity that most significantly impact the other entity?s economic performance. The new guidance requires a number of new disclosures about an entity?s involvement with variable interest entities and any significant changes in risk exposure due to that involvement. A reporting entity will also be required to disclose how its involvement with a variable interest entity affects the reporting entity?s financial statements. The adoption of this accounting guidance did not have a material impact on the Company?s consolidated financial position or results of operations.

2. SECURITIES AVAILABLE FOR SALE

INVESTMENT SECURITIES

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for Sale				
September 30, 2010				
U.S. government agencies	$ 54,758	$ 206	$ (14)	$ 54,950
States and political subdivisions	83,523	4,026	(100)	87,449
Mortgage-backed - residential	33,367	443	(23)	33,787
Equity securities	270	31	-	301
Total	$ 171,918	$ 4,706	$ (137)	$ 176,487

December 31, 2009				
U.S. government agencies	$ 45,168	$ 13	$ (448)	$ 44,733
States and political subdivisions	78,794	1,691	(362)	80,123
Mortgage-backed - residential	42,155	1,259	(151)	43,263
Equity securities	270	22	-	292
Total	$ 166,387	$ 2,985	$ (961)	$ 168,411

The amortized cost and fair value of securities at September 30, 2010, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity are shown separately.

(in thousands)	Amortized Cost	Fair Value
Due in one year or less	$ 1,513	$ 1,631
Due after one year through five years	40,808	41,087
Due after five years through ten years	39,402	41,005
Due after ten years	56,558	58,676
	138,281	142,399
Mortgage-backed - residential	33,367	33,787
Equity	270	301
Total	$ 171,918	$ 176,487

Proceeds from sales of securities during the first nine months of 2010 and 2009 were $37.3 million and $20.6 million. Gross gains of $1.268 million and $352 thousand and gross losses of $1 thousand and $1 thousand were realized on those sales, respectively. The tax provision related to these realized gains and losses was $431 thousand and $120 thousand, respectively. Proceeds from sales of securities during the third quarter of 2010 and 2009 were $27.8 million and $3.1 million. Gross gains of $1.053 million and $149 thousand and gross losses of $0 and $1 thousand were realized on those sales, respectively. The tax provision related to these realized gains and losses was $358 thousand and $51 thousand, respectively.

Securities with unrealized losses at September 30, 2010 and at December 31, 2009 not recognized in income are as follows:

September 30, 2010

	Less than 12 Months		12 Months or More		Total	
Description of Securities	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Government agencies	$ 5,031	$ (14)	$ -	$ -	$ 5,031	$ (14)
States and municipals	3,992	(99)	226	(1)	4,218	(100)
Mortgage-backed - residential	3,062	(23)	-	-	3,062	(23)
Total temporarily impaired	$12,085	$ (136)	$ 226	$ (1)	$12,311	$ (137)

December 31, 2009

	Less than 12 Months		12 Months or More		Total	
Description of Securities	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss

U.S. Government agencies	$35,216	$ (448)	$ -	$ -	$35,216	$ (448)
States and municipals	25,126	(348)	870	(14)	25,996	(362)
Mortgage-backed - residential	11,930	(151)	-	-	11,930	(151)
Total temporarily impaired	$72,272	$ (947)	$ 870	$ (14)	$73,142	$ (961)

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

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

3. LOANS

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

	9/30/10	12/31/09
Commercial	$ 24,409	$ 21,933
Real estate construction	13,855	16,865
Real estate mortgage	279,420	287,444
Agricultural	80,295	80,619
Consumer	17,127	18,277
Other	311	280
Total	$ 415,417	$ 425,418

Activity in the allowance for loan losses for the nine month periods indicated was as follows:
(in thousands)

	9/30/10	9/30/09
Beginning balance	$ 7,600	$ 5,465
Charge-offs	(3,421)	(1,602)
Recoveries	1,243	1,125
Provision for loan losses	1,950	1,350
Ending balance	$ 7,372	$ 6,338

Individually impaired loans were as follows:
(in thousands)

	9/30/10	12/31/09
Period-end loans with no allocated		

allowance for loan losses	$ 20,448	$ 19,206
Period-end loans with allocated allowance for loan losses	11,378	14,266
Total	$ 31,826	$ 33,472
Amount of the allowance for loan losses allocated	$ 3,709	$ 4,064

	Nine Months Ended 9/30/10	9/30/09
Average of individually impaired loans during the period	$ 12,822	$ 13,013
Cash-basis interest income recognized	135	1

Nonperforming loans were as follows:
(in thousands)

	9/30/10	12/31/09
Loans past due over 90 days still on accrual	$ 628	$ 2,526
Nonaccrual loans	15,680	12,038

Nonaccrual loans are included in impaired loans. A loan is impaired when full payment under the contractual terms is not expected.

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

During the first nine months of 2010, $3.5 million of impaired loans was transferred to real estate owned and $3.4 million recorded in chargeoffs. The increase in nonaccrual loans was primarily from various smaller balance loans being added during the first quarter of 2010. During the third quarter, the non-accrual loan portfolio increased largely due to one loan which was placed on non-accrual in the amount of $2.2 million. However, also during the third quarter, the Company received a principal payment of $2.9 million of which $2.3 million reduced non-accrual loan balances and $555 thousand was a recovery for the amount previously charged off.

The Company has no troubled debt restructurings as of September 30, 2010 and December 31, 2009.

4. EARNINGS PER SHARE

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

The factors used in the earnings per share computation follow:

	Nine Months Ended September 30 2010	2009
	(in thousands)	
Basic Earnings Per Share		
Net Income	$ 3,700	$ 3,425

Weighted average common shares outstanding	2,732	2,736
Basic earnings per share	$ 1.35	$ 1.25
Diluted Earnings Per Share		
Net Income	$ 3,700	$ 3,425
Weighted average common shares outstanding	2,732	2,736
Add dilutive effects of assumed exercise of stock options	-	-
Weighted average common and dilutive potential common shares outstanding	2,732	2,736
Diluted earnings per share	$ 1.35	$ 1.25

	Three Months Ended September 30 2010 (in thousands)	2009
Basic Earnings Per Share		
Net Income	$ 1,574	$ 1,353
Weighted average common shares outstanding	2,732	2,732
Basic earnings per share	$ 0.57	$ 0.49
Diluted Earnings Per Share		
Net Income	$ 1,574	$ 1,353
Weighted average common shares outstanding	2,732	2,732
Add dilutive effects of assumed exercise of stock options	-	-
Weighted average common and dilutive potential common shares outstanding	2,732	2,732
Diluted earnings per share	$ 0.57	$ 0.49

Stock options for 33,240 shares of common stock for the nine and three months ended September 30, 2010 and 37,844 shares of common stock for the nine and three months ended September 30, 2009 was excluded from diluted earnings per share because their impact was antidilutive. Stock grants of 21,705 shares of common stock for the nine and three months ended September 30, 2010 and 17,655 shares of common stock for the nine and three months ended September 30, 2009 was excluded from diluted earnings per share because their impact was antidilutive.

5. STOCK COMPENSATION

We have four share based compensation plans as described below.

Two Stock Option Plans

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

The combined summary of activity for 2010 in the expired Stock Option Plans follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding, beginning of year	36,250	$29.42		
Granted	-	-		
Forfeited or expired	(3,010)	28.15		
Exercised	-	-		
Outstanding, end of period	33,240	$29.53	41.4 months	$ -
Vested and expected to vest	33,240	$29.53	41.4 months	$ -
Exercisable, end of period	33,240	$29.53	41.4 months	$ -

As of September 30, 2010, there was $0 of total unrecognized compensation cost related to nonvested stock options granted under either Plan. Since both Stock Option Plans have expired, as of September 30, 2010 no additional options can be granted under either of these plans.

2005 Restricted Stock Grant Plan

On May 10, 2005, our stockholders approved a restricted stock grant plan. Total shares issuable under the plan are 50,000. There were 4,020 shares issued during 2010 and 4,150 shares issued during 2009. There were 344 shares forfeited during the first nine months of 2010 and 288 shares forfeited during the first nine months of 2009. As of September 30, 2010, the restricted stock grant plan allows for additional restricted stock share awards of up to 30,171 shares.

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

Nonvested Shares	Shares	Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 2010	10,122	$ 261,033
Granted	4,020	65,928
Vested	(2,808)	(75,926)
Forfeited	(344)	(8,473)
Nonvested at September 30, 2010	10,990	$ 242,562

As of September 30, 2010, there was $209,106 of total unrecognized compensation cost related to nonvested shares granted under the restricted stock grant plan. The cost is expected to be recognized over a weighted-average period of 5 years.

2009 Stock Award Plan

On May 13, 2009, our stockholders approved a stock award plan that provides for the granting of both incentive and nonqualified stock options and other share based awards. Total shares issuable under the plan are 150,000. As of September 30, 2010 no awards have been granted under the plan and 150,000 shares are still available.

6. FAIR VALUE MEASUREMENTS

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

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

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

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

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

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

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

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

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

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

Assets and Liabilities Measured on a Recurring Basis

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

(In thousands) Fair Value Measurements at September 30, 2010 Using:

Description	Carrying Value	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U. S. government agencies	$ 54,950	$ -	$ 54,950	$ -
States and municipals	87,449	-	87,449	-
Mortgage-backed - residential	33,787	-	33,787	-
Equity securities	301	301	-	-
Total	$176,487	$ 301	$176,186	$ -

(In thousands) Fair Value Measurements at December 31, 2009 Using:

Description	Carrying Value	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U. S. government agencies	$ 44,733	$ -	$ 44,733	$ -
States and municipals	80,123	-	80,123	-
Mortgage-backed - residential	43,263	-	43,263	-
Equity securities	292	292	-	-
Total	$168,411	$ 292	$168,119	$ -

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

(In thousands) Fair Value Measurements at September 30, 2010 Using:

Description	Carrying Value	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans				
Real estate construction	$ 1,102	$ -	$ -	$ 1,102
Real estate mortgage	6,567	-	-	6,567
Total	7,669	-	-	7,669

Other real estate owned				
Real estate construction	2,684	-	-	2,684
Real estate mortgage	1,472	-	-	1,472
Total	4,156	-	-	4,156
Mortgage servicing rights	166	-	-	166

(In thousands) Fair Value Measurements at December 31, 2009 Using:

Description	Carrying Value	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans	$10,202	$ -	$ -	$ 10,202
Other real estate Owned	68	-	-	68
Mortgage servicing rights	626	-	-	626

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of $7.7 million, with a valuation allowance of $3.7 million at September 30, 2010, resulting in an additional provision of $1.95 million for loan losses for the nine months ending September 30, 2010. The provision for the three months ending September 30, 2010 is $700 thousand.

Other real estate owned which is measured at fair value less costs to sell, had a net carrying amount of $4.2 million, which is made up of the outstanding balance of $4.7 million, net of a valuation allowance of $586 thousand at September 30, 2010, resulting in a write-down of $660 thousand for the nine months ending September 30, 2010. The write-down for the three months ending September 30, 2010 is $187 thousand.

Fair Value of Financial Instruments

The fair values of the Company?s financial instruments at September 30, 2010 and December 31, 2009 are as follows:

	September 30, 2010		December 31, 2009	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(In Thousands)			
Financial assets				
Cash and cash equivalents	$ 25,970	$ 25,970	$ 34,421	$ 34,421
Securities	176,487	176,487	168,411	168,411
Mortgage loans held for sale	149	153	191	192
Loans, net	408,045	407,583	417,818	417,759
FHLB stock	6,731	N/A	6,731	N/A
Interest receivable	4,627	4,627	4,620	4,620
Financial liabilities				
Deposits	$ 538,854	$ 542,945	$ 536,446	$ 541,691
Securities sold under agreements to repurchase and other borrowings	6,437	6,455	8,226	8,252

FHLB advances	43,567	46,069	56,096	57,633
Subordinated debentures	7,217	4,558	7,217	6,029
Interest payable	2,361	2,361	2,123	2,123

The methods and assumptions, not previously presented, used to estimate fair value are described as follows: Carrying amount is the estimated fair value for cash and cash equivalents, interest bearing deposits, accrued interest receivable and payable, demand deposits, short-term debt, and variable rate loans or deposits that reprice frequently and fully. The methods for determining the fair values for securities were described previously. For fixed rate loans or deposits and for variable rate loans or deposits with infrequent repricing or repricing limits, fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk (including consideration of widening credit spreads). Fair value of debt is based on current rates for similar financing. It was not practicable to determine the fair value of FHLB stock due to restrictions placed on its transferability. The fair value of off-balance sheet items is not considered material.

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

Forward-Looking Statements

This discussion contains forward-looking statements under the Private Securities Litigation Reform Act of 1995 that involve risks and uncertainties. These statements are not historical facts, but rather statements based on our current expectations regarding our business strategies and their intended results and our future performance. Forward-looking statements are preceded by terms such as ?expects,? ?believes,? ?anticipates,? ?intends? and similar expressions.

Although we believe that the assumptions underlying the forward-looking statements contained herein are reasonable, any of the assumptions could be inaccurate, and therefore, there can be no assurance that the forward-looking statements included herein will prove to be accurate. Factors that could cause actual results to differ from the results discussed in the forward-looking statements include, but are not limited to: economic conditions (both generally and more specifically in the markets, including the tobacco market and the thoroughbred horse industry, in which we and our bank operate); competition for our customers from other providers of financial and mortgage services; government legislation, regulation and monetary policy (which changes from time to time and over which we have no control); changes in interest rates (both generally and more specifically mortgage interest rates); material unforeseen changes in the liquidity, results of operations, or financial condition of our customers; and other risks detailed in our filings with the Securities and Exchange Commission, all of which are difficult to predict and many of which are beyond our control. We undertake no obligation to republish revised forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Summary

The Company recorded net income of $3.7 million, or $1.35 basic earnings and diluted earnings per share for the first nine months ending September 30, 2010 compared to $3.4 million, or $1.25 basic earnings and diluted earnings per share for the nine month period ending September 30, 2009. The first nine months earnings reflects an increase of 8.0% compared to the same time period in 2009, due primarily to an increase in net interest income of $561 thousand, an increase in the gain of sold securities of $916 thousand and a decrease in salaries and employee benefits of $1.0 million. Employee benefits were higher in 2009 due to $860 thousand being expensed for final costs associated with the settlement of the defined benefit plan that was terminated as of December 31, 2008. Salaries and employee benefit expense has decreased in 2010 also due to the voluntary separation offers that were offered to certain employees during the third and fourth quarters of 2009. These positive changes to net income during 2010 were partially offset by a decrease in the gain on sold loans of $376 thousand and an increase in repossession expenses of $683 thousand. The earnings for the three months ended September 30, 2010 were $1.6 million, or $0.57 basic and diluted earnings per share for the three month period ending September 30, 2010 compared to $1.4 million, or $0.49 basic and diluted earnings per share for the three month period ending September 30, 2009. This three month period earnings reflects a 16% increase compared to the same time period in 2009.

Return on average assets was 0.70% for the nine months ended September 30, 2010 and 0.68% for the nine month period ended September 30, 2009. Return on average assets was 0.91% for the three months ended September 30, 2010 and 0.82% for the three months ended September 30, 2009. Return on average equity was 7.9% for the nine month period ended September 30, 2010 and 7.8% for the same period in 2009. Return on average equity was 10.0% for the three months ended September 30, 2010 and 9.1% for the same time period in 2009.

Gross Loans decreased $10.0 million from $425.4 million on December 31, 2009 to $415.4 million on September 30, 2010. The overall decrease is attributed to decreases in real estate construction loans, real estate mortgage loans, agricultural and consumer loans. Decreases to these sectors of the loan portfolio were partially offset by an increase of $2.5 million in commercial loans.

Total deposits increased from $536.4 million on December 31, 2009 to $538.8 million on September 30, 2010, an increase of $2.4 million. This increase is primarily the result of an increase in non-interest bearing deposit accounts of $15.9 million and an increase in interest bearing time deposit accounts over $100 thousand of $15.2 million. Other interest bearing deposits decreased $28.7 million from $334.4 million at December 31, 2009 to $305.7 million at September 30, 2010. Deposits are up largely due to temporary cash influxes in our existing deposit base. Of this increase, $7 million is expected to be withdrawn during the fourth quarter of 2010.

Net Interest Income

Net interest income was $14.9 million for the nine months ended September 30, 2010 compared to $14.4 million for the nine months ended September 30, 2009, an increase of 3.9%. The interest spread of 3.06% for the first nine months of 2010 is up from 3.04% reported for the same period in 2009, an increase of 2 basis points. Net interest income was $4.9 million for the three month period ending September 30, 2010 compared to $4.9 million for the three month period ending September 30, 2009, a decrease of 0.3% or $15 thousand. The interest spread was 3.07% for three month period ending September 30, 2010 compared to 3.23% for the three month period in 2009, a decrease of 16 basis points. Rates have remained fairly low in the past year. In addition to lower rates and tightening margins, the net interest spread for 2010 is affected by an increase in ?lost? loan interest during 2010 that can be attributed to an increase in non-performing loans in our loan portfolio.

For the first nine months, the yield on assets decreased from 5.17% in 2009 to 4.74% in 2010. The cost of liabilities decreased from 2.13% in 2009 to 1.68% in 2010. Year to date average loans increased $1.0 million, or 0.23% from September 30, 2009 to September 30, 2010. Loan interest income has decreased $704 thousand for the first nine months of 2010 compared to the first nine months of 2009. Year to date average deposits increased from September 30, 2009 to September 30, 2010, up $52.3 million or 10.0%. The increase is primarily the result of an increase in non-interest bearing deposits and time deposits with balances greater than $100 thousand. Deposit interest expense has decreased $804 thousand for the first nine months of 2010 compared to the same period in 2009. Year to date average borrowings decreased $22.7 million, or 25.94% from September 30, 2009 to September 30, 2010. The decrease is primarily the result of paying off FHLB advances when they come due and not replacing them because of the influx in deposits. Interest expense on borrowed funds has decreased $849 thousand for the first nine months of 2010 compared to the same period in 2009.

The volume rate analysis for 2010 that follows indicates that $1.2 million of the decrease in interest income is attributable to the decrease in rates, while the change in volume contributed to an increase of $130 thousand in interest income. The rate decrease also caused a decrease in the cost of interest bearing liabilities. The average rate of these liabilities decreased from 2.13% in 2009 to 1.68% in 2010. Based on the volume rate analysis that follows, the lower level of interest rates contributed to a decrease of $1.7 million in interest expense, while the change in volume was responsible for a $26 thousand increase in interest expense. As a result, the 2010 net interest income increase is mostly attributed to decreases in rates.

In addition to the negative impact on net interest income that may result from the decreasing rate environment that began in 2007 and continued into 2010 competitive pressures on interest rates will continue and are likely to result in continued downward pressure on net interest margins.

The accompanying analysis of changes in net interest income in the following table shows the relationships of the volume and rate portions of these changes in 2010. Changes in interest income and expenses due to both rate and volume are allocated on a pro rata basis.

Changes in Interest Income and Expense

	Nine Months Ended September 30, 2010 2010 vs. 2009 Increase (Decrease) Due to Change in		
	Volume	Rate	Net Change
INTEREST INCOME			
Loans	$ 72	$ (776)	$ (704)
Investment Securities	31	(437)	(406)
Federal Funds Sold and Securities Purchased under Agreements to Resell	24	(3)	21
Deposits with Banks	3	(6)	(3)
Total Interest Income	130	(1,222)	(1,092)
INTEREST EXPENSE			
Deposits			
Demand	86	182	268
Savings	(28)	(173)	(201)
Negotiable Certificates of Deposit and Other Time Deposits	566	(1,437)	(871)
Securities sold under agreements to repurchase and other borrowings	(160)	(18)	(178)

Federal Home Loan			
Bank advances	(438)	(233)	(671)
Total Interest Expense	26	(1,679)	(1,653)
Net Interest Income	$ 104	$ 457	$ 561

Non-Interest Income

Non-interest income increased $568 thousand for the nine months ended September 30, 2010 compared to the same period in 2009 to $7.4 million, due primarily to an increase in the gain on sold securities of $916 thousand which increased from $351 thousand for the first nine months in 2009 to $1.267 million for the first nine months of 2010. The gain on securities were primarily used to offset the additions to the loan loss reserve. The gain on the sale of securities was partially offset by a decrease in service charges of $211 thousand and the gain on the sale of mortgage loans of $376 thousand. Other non-interest income increased $189 thousand for the nine months ended September 30, 2010 compared to the same period one year ago. The decrease in service charges was primarily the result of a decrease in fees collected for title insurance of $69 thousand and a decline in overdraft income of $152 thousand. Other non-interest income increased mostly due to an increase in debit card interchange income of $137 thousand compared to the same period one year ago and an increase in brokerage income of $50 thousand. Non-interest income increased $1.016 million for the three months ended September 30, 2010 compared to the three months ended September 30, 2009. The increase was primarily due to an increase in the gains of sold securities of $905 thousand and in the gains on sold mortgage loans of $126 thousand. These positive variances to non-interest income were partially offset by a decrease in service charges of $76 thousand, a decrease in loan service fee income of $24 thousand and a decrease in trust commissions of $21 thousand.

The gain on the sale of mortgage loans decreased from $1.026 million in the first nine months of 2009 to $650 thousand during the first nine months of 2010. For the three months ended September 30, 2010 compared to the same time period in 2009, the gain on the sale of mortgage loans increased $126 thousand. The volume of loans sold during the first nine months of 2010 decreased $22.1 million compared to the same time period in 2009. The volume of mortgage loan originations and sales is generally inverse to rate changes. A change in the mortgage loan rate environment can have a significant impact on the related gain on sale of mortgage loans. Loan service fee income was $65 thousand for the nine months ending September 30, 2010 compared to $69 thousand for the nine months ending September 30, 2009, a decrease of $4 thousand. During the third quarter of 2010, $24 thousand was expensed for the write-down of the mortgage servicing right due to impairment which is reflected in the loan service fee income. A positive adjustment of $24 thousand was made during the second quarter of 2010.

Non-Interest Expense

Total non-interest expenses increased $64 thousand for the nine month period ended September 30, 2010 compared to the same period in 2009. For the three month period ended September 30, 2010 compared to the three months ending September 30, 2009, total non-interest expense increased $405 thousand.

For the comparable nine month periods, salaries and benefits decreased $1.0 million, a decrease of 12.1%. The decrease in salaries & benefits is primarily attributed to our terminating the defined benefit plan offered to our employees as of December 31, 2008. During the second quarter of 2009, the Company recognized $860 thousand for the final expenses related to settling the plan. In addition, we have recognized savings during 2010 related to having fewer full time equivalent employees compared to the same period one year ago. The reduced staff is the result of our offering voluntary separation options to certain employees during the third and fourth quarters of 2009. The number of full time equivalent employees increased from 186 at September 30, 2009 to 187 at September 30, 2010. However, the number of full time equivalent employees reached 194 at June 30, 2009 and has since declined to 187 full time equivalent employees at September 30, 2010 resulting in a decline in the year to date salary and employee benefits expense in 2010. Salaries and employee benefits decreased $1 thousand for the three month period ending September 30, 2010 compared to the same time period in 2009.

Occupancy expenses increased $49 thousand to $2.1 million for the first nine months of 2010 compared to the same time period in 2009. Occupancy expenses decreased $19 thousand for the three month period ended September 30, 2010 compared to the same time period in 2009. The increase in year to date occupancy expense during 2010 is primarily the result of an increase in depreciation expense of $91 thousand, an increase in taxes on premises and equipment of $28 thousand offset by a decrease in computer maintenance of $39 thousand and a decrease in building repairs and maintenance of $43 thousand.

Legal and professional fees increased $286 thousand for the first nine months ended September 30, 2010 compared to the same time period in 2009. Legal and professional fees increased $118 thousand for the three month period ending September 30, 2010 compared to the same time period in 2009. The increase is primarily from additional collection efforts for problem loans. Repossession expenses increased $683 thousand for the first nine months ended September 30, 2010 compared to the same time period in 2009. The increase is primarily attributable to write-downs of other real estate owned. Repossession expenses increased $253 thousand for the three month period ending September 30, 2010 compared to the same three months ending September 30, 2009. Repossession expenses are reported net of income earned on the repossessed properties. These increases were partially offset by a decrease in the cost of FDIC insurance premiums of $153 thousand for the nine months ending September 30, 2010 compared to the nine months ending September 30, 2009. FDIC insurance expense increased $62 thousand for the three months ending September 30, 2010 compared to the same time period one year ago. Due to the downturn in the financial industry and related bank failures, the FDIC increased the FDIC insurance premiums in 2009. The decrease in FDIC insurance expense in 2010 compared to 2009 is attributed to the one-time special assessment the FDIC assessed on all FDIC insured banks in May of 2009, which cost the Company $296 thousand in 2009.

In February 2009, the FDIC adopted a long-term deposit insurance fund (?DIF?) restoration plan as well as an additional emergency assessment for 2009. The restoration plan increases base assessment rates for banks in all risk categories with the goal of raising the DIF reserve ratio from its current 0.40% to 1.15% within seven years. Banks in the best risk category, which include our subsidiary bank, paid initial base rates ranging from 12 to 16 basis points of assessable deposits beginning April 1, 2009, up from the initial base rate range of 12 to 14 basis points. Additionally, the FDIC approved an interim rule imposing a special emergency assessment to all financial institutions of five basis points as of June 30, 2009. The special assessment amounted to $296 thousand and was paid on September 30, 2009. The FDIC is also permitted to impose an emergency special assessment after June 30, 2009 of up to 10 basis points if necessary to maintain public confidence in federal deposit insurance. On November 12, 2009, the FDIC adopted a final rule requiring insured depository institutions to prepay their estimated quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011, and 2012. The prepaid amount will be amortized over the prepayment period. The Company?s prepayment was $3.1 million.

Financing Corporation (?FICO?) assessment costs were $44 thousand for the nine months ended September 30, 2010 and $40 thousand for 2009. FICO is a mixed-ownership government corporation established by the Competitive

Equality Banking Act of 1987 possessing assessment powers in addition to the FDIC. The FDIC acts as a collection agent for FICO, whose sole purpose is to function as a financing vehicle for the now defunct Federal Savings & Loan Insurance Corporation.

Income Taxes

The effective tax rate for the nine months ended September 30, 2010 was 11.2% compared to 7.5% in 2009. The effective tax rate for the three months ended September 30, 2010 was 12.9% compared to 7.3% for the three months ended September 30, 2009. These rates are less than the statutory rate as a result of the tax-free securities and loans held by the Company. The rates for 2010 are higher due to the higher level of income for 2010 and also tax credits for investments the Company held related to historic and low income housing that expired at the end of 2009. Nontaxable interest income increased $656 thousand for the first nine months of 2010 compared to the same time period in 2009.

Liquidity and Funding

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

Cash and cash equivalents were $26.0 million as of September 30, 2010 compared to $34.4 million at December 31, 2009. The decrease in cash and cash equivalents is mainly attributable to a decrease in federal funds sold resulting primarily from an increase in our security portfolio and an increase in our ?due from? accounts with correspondent banks. In addition to cash and cash equivalents, the securities portfolio provides an important source of liquidity. Securities available for sale totaled $176.5 million at September 30, 2010 compared to $168.4 million at December 31, 2009. The available for sale securities are available to meet liquidity needs on a continuing basis. We expect our customers? deposits to be adequate to meet our funding demands.
Generally, we rely upon net cash inflows from financing activities, supplemented by net cash inflows from operating activities, to provide cash used in our investing activities. As is typical of many financial institutions, significant financing activities include deposit gathering and the use of short-term borrowings, such as federal funds purchased and securities sold under repurchase agreements along with long-term debt. Our primary investing activities include purchasing investment securities and loan originations.

For the first nine months of 2010, deposits have increased $2.4 million. With loan demand being slow, the Company has been able to increase its investment portfolio by $8 million. In addition, the Company has paid down FHLB advances by $12.5 million and will continue to pay those down as they mature.

Management is aware of the challenge of funding sustained loan growth. Therefore, in addition to deposits, other sources of funds, such as Federal Home Loan Bank (FHLB) advances, may be used. We rely on FHLB advances for both liquidity and asset/liability management purposes. These advances are used primarily to fund long-term fixed rate residential mortgage loans. As of September 30, 2010, over $33 million is available in overnight borrowing through various correspondent banks. In light of this, management believes there is sufficient liquidity to meet all reasonable borrower, depositor and creditor needs in the present economic environment.

Capital Requirements

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

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the following table) of Total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital to average assets (as defined). Management believes, as of September 30, 2010 and December 31, 2009, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

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

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

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisio	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
			(Dollars in Thousands)			
September 30, 2010						
Consolidated						
Total Capital (to Risk-Weighted Assets)	$ 60,600	13.2%	$ 36,739	8%	$ 45,924	N/A
Tier I Capital (to Risk-Weighted Assets)	54,824	11.9	18,370	4	27,554	N/A
Tier I Capital (to Average Assets)	54,824	8.1	26,987	4	33,734	N/A
Bank Only						
Total Capital (to Risk-Weighted Assets)	$ 62,433	13.6%	$ 36,728	8%	$ 45,910	10%
Tier I Capital (to Risk-Weighted Assets)	56,659	12.3	18,364	4	27,546	6
Tier I Capital (to Average Assets)	56,659	8.4	26,978	4	33,722	5
December 31, 2009						
Consolidated						
Total Capital (to Risk-Weighted Assets)	$ 58,398	12.6%	$ 36,957	8%	$ 46,196	N/A
Tier I Capital (to Risk-Weighted Assets)	52,593	11.4	18,478	4	27,718	N/A
Tier I Capital (to Average Assets)	52,593	8.0	26,201	4	32,752	N/A

Bank Only						
Total Capital (to Risk-Weighted Assets)	$ 60,675	13.1%	$ 36,941	8%	$ 46,177	10%
Tier I Capital (to Risk-Weighted Assets)	54,869	11.9	18,471	4	27,706	6
Tier I Capital (to Average Assets)	54,869	8.4	26,200	4	32,750	5

Non-Performing Assets

As of September 30, 2010, our non-performing assets totaled $22.7 million or 3.41% of assets compared to $19.1 million or 2.83% of assets at December 31, 2009. (See table below) We experienced an increase of $3.6 million in non-accrual loans from December 31, 2009 to September 30, 2010, largely due to an increase in non-accrual loans secured by real estate of $3.7 million. As of September 30, 2010, non-accrual loans include $2.5 million in loans secured by non-farm and non-residential real estate, $4.2 million in loans secured by real estate construction, $4.7 million in loans secured by 1-4 family residential real estate, $3.3 million in loans secured by multi-family real estate properties and $800 thousand in loans secured by farmland. Real estate loans composed 99.7% of the non-performing loans as of September 30, 2010 and 98% as of December 31, 2009. Forgone interest income on the non-accrual loans was $436 thousand for the first nine months of 2010 compared to $394 thousand for the same time period in 2009. Accruing loans that are contractually 90 days or more past due as of September 30, 2010 totaled $628 thousand compared to $2.5 million at December 31, 2009, a decrease of $1.9 million. The decrease is primarily due to one loan amounting to $1.4 million being paid off during the period and other loans being reclassified as non-accrual. The total nonperforming loans increased $1.7 million from December 31, 2009 to September 30, 2010, resulting in an increase in the ratio of nonperforming loans to loans of 51 basis points to 3.93%. In addition, the amount the Company has booked as ?Other Real Estate? has increased $1.9 million from December 31, 2009 to September 30, 2010. As of September 30, 2010 the amount booked as ?Other Real Estate? totaled $6.4 million compared to $4.5 million at December 31, 2009. The increase is largely attributed to two loan customers who specialized in commercial & land development properties that totaled $2.4 million that was previously on non-accrual. The allowance as a percentage of non-performing and restructured loans and Other Real Estate decreased from 40% at December 31, 2009 to 32% at September 30, 2010. The decrease is largely attributed to the addition of $1.8 million made to the allowance for loan losses in the fourth quarter of 2009 for loans that were charged off in the first quarter of 2010.

Nonperforming Assets

	9/30/10	12/31/09
	(in thousands)	
Non-accrual Loans	$ 15,680	$ 12,038
Accruing Loans which are Contractually past due 90 days or more	628	2,526
Total Nonperforming and Restructured	16,308	14,564
Other Real Estate	6,380	4,542
Total Nonperforming and Restructured Loans and Other Real Estate	$ 22,688	$ 19,106
Nonperforming and Restructured Loans as a Percentage of Loans	3.93%	3.42%
Nonperforming and Restructured Loans and Other Real Estate as a Percentage of Total Assets	3.41%	2.83%
Allowance as a Percentage of		

Period-end Loans	1.77%	1.79%
Allowance as a Percentage of Non-performing and Restructured Loans and Other Real Estate	32%	40%

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

Provision for Loan Losses

The loan loss provision for the first nine months was $1.95 million for 2010 and $1.35 million for 2009. The loan loss provision for the three months ended September 30, 2010 was $700 thousand and $450 thousand for the same period in 2009. Management evaluates the loan portfolio by reviewing the historical loss rate for each respective loan type and assigns risk multiples to certain categories to account for qualitative factors including current economic conditions. The average loss rates are reviewed for trends in the analysis, as well as comparisons to peer group loss rates. Management makes allocations within the allowance for loan losses for specifically classified loans regardless of loan amount, collateral or loan type. Loan categories are evaluated utilizing subjective factors in addition to the historical loss calculations to determine a loss allocation for each of those types. As this analysis, or any similar analysis, is an imprecise measure of loss, the allowance is subject to ongoing adjustments. Therefore, management will often take into account other significant factors that may be necessary or prudent in order to reflect probable incurred losses in the total loan portfolio.

Net charge-offs for the nine month period ended September 30, 2010 were $2.2 million compared to net charge-offs of $477 thousand for the same period in 2009. Net charge-offs for the three month period ended September 30, 2010 were positive and equated to a net recovery of $211 thousand compared to net charge-offs of $485 thousand during the same period in 2009. Based on our internal loan review as of December 31, 2009, an addition of $1.8 million was made to the allowance for loan losses in the fourth quarter of 2009. Three borrowers that total $1.8 million were charged off in the first quarter of 2010 and were directly related to the additional provision in the fourth quarter of 2009. Future levels of charge-offs will be determined by the particular facts and circumstances surrounding individual loans. Based on the above information, Management believes the current loan loss allowance is sufficient to meet probable incurred loan losses.

Loan Losses	Nine Months Ended September 30 (in thousands)	
	2010	2009
Balance at Beginning of Period	$ 7,600	$ 5,465
Amounts Charged-off:		
Commercial	19	289
Real Estate Construction	547	39
Real Estate Mortgage	1,967	221
Agricultural	74	6
Consumer	814	1,047
Total Charged-off Loans	3,421	1,602
Recoveries on Amounts Previously Charged-off:		
Commercial	43	2

Real Estate Construction	-	35
Real Estate Mortgage	736	393
Agricultural	11	-
Consumer	453	695
Total Recoveries	1,243	1,125
Net Charge-offs	2,178	477
Provision for Loan Losses	1,950	1,350
Balance at End of Period	7,372	6,338
Loans		
Average	420,621	420,364
At September 30	415,417	427,921
As a Percentage of Average Loans:		
Net Charge-offs for the period	0.52%	0.11%
Provision for Loan Losses for the period	0.46%	0.32%
Allowance as a Multiple of Net Charge-offs (annualized)	2.5	10.0

	Three Months Ended September 30 (in thousands)	
	2010	2009
Balance at Beginning of Period	$ 6,461	$ 6,373
Amounts Charged-off:		
Commercial	-	222
Real Estate Construction	-	-
Real Estate Mortgage	175	139
Agricultural	-	-
Consumer	342	423
Total Charged-off Loans	517	784
Recoveries on Amounts Previously Charged-off:		
Commercial	-	-
Real Estate Construction	-	-
Real Estate Mortgage	564	6
Agricultural	1	-
Consumer	163	293
Total Recoveries	728	299
Net Charge-offs (Recoveries)	(211)	485
Provision for Loan Losses	700	450
Balance at End of Period	7,372	6,338
Loans		
Average	417,701	424,342
At September 30	415,417	427,921
As a Percentage of Average Loans:		
Net Charge-offs for the period	(0.05)%	0.11%
Provision for Loan Losses for the period	0.17%	0.11%
Allowance as a Multiple of Net Charge-offs (annualized)	(8.7)	3.3

Item 3 ? QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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

Using interest rate shock simulations, the following table depicts the change in net interest income resulting from 100 and 300 basis point changes in rates on the Company?s interest earning assets and interest bearing liabilities. The projections are based on balance sheet growth assumptions and repricing opportunities for new, maturing and adjustable rate amounts. As of September 30, 2010, the projected percentage changes are within the Board approved limits. Although management does analyze and monitor the projected percentage change in a declining interest rate environment, due to the current rate environment many of the current deposit rates cannot decline an additional 100 basis points. Therefore, management places more emphasis in the rising rate environment scenarios. This period?s volatility is higher in each rate shock simulation both in a falling and rising rate environment when compared to the same period a year ago. The projected net interest income report summarizing our interest rate sensitivity as of September 30, 2010 is as follows:

PROJECTED NET INTEREST INCOME
(dollars in thousands)

Change in basis points:	- 300	- 100	Level Rates	+ 100	+ 300
Year One (10/10 - 9/11)					
Net interest income	$22,784	$23,550	$23,853	$23,967	$24,268
Net interest income dollar change	(1,069)	(303)	N/A	114	415
Net interest income percentage change	-4.5%	-1.3%	N/A	0.5%	1.7%
Board approved limit	>-10.0%	>-4.0%	N/A	>-4.0%	>-10.0%

The projected net interest income report summarizing the Company's interest rate sensitivity as September 30, 2009 is as follows:

PROJECTED NET INTEREST INCOME
(dollars in thousands)

Change in basis points:	- 300	- 100	Level Rates	+ 100	+ 300
Year One (10/09 - 9/10)					
Net interest income	$20,843	$21,447	$21,938	$22,122	$22,280
Net interest income dollar change	(1,095)	(491)	N/A	184	342
Net interest income percentage change	-5.0%	-2.2%	N/A	0.8%	1.6%
Board approved limit	>-10.0%	>-4.0%	N/A	>-4.0%	>-10.0%

Projections from September 30, 2010, year one reflected a decline in net interest income of 1.3% with a 100 basis point decline compared to the 2.2% decline in 2009. The 100 basis point increase in rates reflected a 0.5% increase in net interest income in 2010 compared to 0.8% in 2009.

EVE applies discounting techniques to future cash flows to determine the present value of assets, liabilities, and therefore equity. Based on applying these techniques to the September 30, 2010 balance sheet, a 100 basis point increase in rates results in a 4.0% decrease in EVE. A 100 basis point decrease in rates results in a 0.4% decrease in EVE. These are within the Board approved limits.

Item 4 ? CONTROLS AND PROCEDURES

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

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

Part II – Other Information

Item 1. Legal Proceedings

We are not a party to any material legal proceedings.

Item 1A. Risk Factors

A wide range of regulatory initiatives directed at the financial services industry have been proposed in recent months. One of those initiatives, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the ?Dodd-Frank Act?), was signed into law by President Obama on July 21, 2010. The Dodd-Frank Act represents a comprehensive overhaul of the financial services industry within the United States, establishes the new federal Bureau of Consumer Financial Protection (the ?BCFP?), and will require the BCFP and other federal agencies to implement many new rules. At this time, it is difficult to predict the extent to which the Dodd-Frank Act or the resulting regulations will impact the Company?s business. However, compliance with these new laws and regulations will result in additional costs, which may adversely impact the Company?s results of operations, financial condition or liquidity, any of which may impact the market price of the Company?s common stock.

Other than the additional risk factor mentioned above, there are no material changes from the risk factors set forth under Part I, Item 1A ?Risk Factors? in our Annual Report on Form 10-K for the year ended December 31, 2009.

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

ISSUER PURCHASES OF EQUITY SECURITIES

(a) Total	(b)	(c) Total Number of Shares (or Units)	(d) Maximum Number (or Approximate

Period	Number of Shares (or Units) Purchased	Average Price Paid Per Share (or Unit)	Purchased as Part of Publicly Announced Plans Or Programs	Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans of Programs
7/1/10 ? 7/31/10	-	$ -	-	31,548 shares
8/1/10 ? 8/31/10	-	-	-	31,548 shares
9/1/10 ? 9/30/10	-	-	-	31,548 shares
Total	-	-	-	31,548 shares

On October 25, 2000, we announced that our Board of Directors approved a stock repurchase program and authorized the Company to purchase up to 100,000 shares of its outstanding common stock. On November 11, 2002, the Board of Directors approved and authorized the Company?s repurchase of an additional 100,000 shares. On May 20, 2008, the Board of Directors approved and authorized the Company to purchase an additional 100,000 shares. Shares will be purchased from time to time in the open market depending on market prices and other considerations. Through September 30, 2010, 268,452 shares have been purchased.

Item 6. Exhibits

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

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

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

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

KENTUCKY BANCSHARES, INC.

Date ____11/12/10________ __/s/Louis Prichard________________
Louis Prichard, President and C.E.O.

Date ____11/12/10________ __/s/Gregory J. Dawson_____________
Gregory J. Dawson, Chief Financial Officer

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