KENTUCKY BANCSHARES INC /KY/
Form 10-Q
November 14, 2011
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2011

or

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

For the transition period from to

Commission File Number: 000-52598

KENTUCKY BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

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

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

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

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

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

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

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

Number of shares of Common Stock outstanding as of October 31, 2011: 2,718,805.

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Item 1 - Financial Statements

KENTUCKY BANCSHARES, INC.

CONSOLIDATED BALANCE SHEETS (unaudited)

(in thousands)

	9/30/2011	12/31/2010
Assets		
Cash and due from banks	$ 14,677	$ 12,517
Federal funds sold	143	5,108
Cash and cash equivalents	14,820	17,625
Securities available for sale	158,068	176,867
Mortgage loans held for sale	962	
Loans	408,202	411,830
Allowance for loan losses	(5,664)	(4,925)
Net loans	402,538	406,905
Federal Home Loan Bank stock	6,731	6,731
Real estate owned, net	10,268	8,424
Bank premises and equipment, net	16,863	17,308
Interest receivable	4,081	4,526
Mortgage servicing rights	921	958
Goodwill	13,117	13,117
Other intangible assets	825	1,009
Other assets	4,533	5,473
Total assets	$ 633,727	$ 658,943
Liabilities and Stockholders Equity		
Deposits		
Non-interest bearing	$ 130,414	$ 105,519
Time deposits, $100,000 and over	91,448	111,239
Other interest bearing	286,215	320,643
Total deposits	508,077	537,401
Repurchase agreements and other borrowings	4,905	7,179
Federal Funds Purchased	9,482	
Federal Home Loan Bank advances	30,814	43,206
Subordinated debentures	7,217	7,217
Interest payable	1,184	1,257
Other liabilities	3,943	1,640
Total liabilities	565,622	597,900
Stockholders equity		
Preferred stock, 300,000 shares authorized and unissued		
Common stock, no par value; 10,000,000 shares authorized; 2,722,481 and 2,738,039 shares issued and outstanding on September 30,2011 and December 31, 2010	12,558	12,498
Retained earnings	52,088	49,797
Accumulated other comprehensive income (loss)	3,459	(1,252)
Total stockholders equity	68,105	61,043

Total liabilities & stockholders equity	$	633,727	$	658,943

See Accompanying Notes

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KENTUCKY BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (unaudited)

(in thousands, except per share amounts)

	Nine Months Ending	
	9/30/2011	9/30/2010
INTEREST INCOME:		
Loans, including fees	$ 17,959	$ 17,936
Securities		
Taxable	2,105	2,190
Tax exempt	2,313	2,538
Other	228	260
Total interest income	22,605	22,924
INTEREST EXPENSE:		
Deposits	3,145	6,296
Repurchase agreements and other borrowings	62	114
Federal Home Loan Bank advances	1,020	1,424
Subordinated debentures	177	179
Total interest expense	4,404	8,013
Net interest income	18,201	14,911
Loan loss provision	1,900	1,950
Net interest income after provision	16,301	12,961
NON-INTEREST INCOME:		
Service charges	3,396	3,707
Loan service fee income	70	65
Trust department income	497	431
Securities available for sale gains (losses), net	490	1,267
Gain on sale of mortgage loans	533	650
Brokerage Income	114	140
Debit Card Interchange Income	1,239	1,066
Other	152	97
Total other income	6,491	7,423
NON-INTEREST EXPENSE:		
Salaries and employee benefits	8,914	7,574
Occupancy expenses	2,270	2,080
Repossession expenses (net)	656	947
FDIC Insurance	521	768
Legal and professional fees	601	586
Data processing	752	660
Debit Card Expenses	535	469
Amortization	184	191
Advertising and marketing	538	446
Taxes other than payroll, property and income	583	594
Telephone	346	272
Postage	224	246
Loan fees	123	139
Other	1,307	1,245
Total other expenses	17,554	16,217
Income before taxes	5,238	4,167

Income taxes		781		467
Net income	$	4,457	$	3,700
Other Comprehensive Income, net of tax:				
Change in Unrealized Gains on Securities		4,711		1,680
Comprehensive Income	$	9,168	$	5,380
Earnings per share				
Basic	$	1.65	$	1.35
Diluted		1.65		1.35
Dividends per share		0.66		0.63

See Accompanying Notes

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KENTUCKY BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (unaudited)

(in thousands, except per share amounts)

	Three Months Ending	
	9/30/2011	9/30/2010
INTEREST INCOME:		
Loans, including fees	$ 6,015	$ 5,909
Securities		
Taxable	597	610
Tax exempt	784	872
Other	70	85
Total interest income	7,466	7,476
INTEREST EXPENSE:		
Deposits	898	2,055
Repurchase agreements and other borrowings	19	36
Federal Home Loan Bank advances	324	420
Subordinated debentures	60	55
Total interest expense	1,301	2,566
Net interest income	6,165	4,910
Loan loss provision	450	700
Net interest income after provision	5,715	4,210
NON-INTEREST INCOME:		
Service charges	1,241	1,320
Loan service fee income	(16)	(5)
Trust department income	146	121
Securities available for sale gains (losses), net	266	1,053
Gain on sale of mortgage loans	250	341
Brokerage Income	42	69
Debit Card Interchange Income	420	367
Other	41	40
Total other income	2,390	3,306
NON-INTEREST EXPENSE:		
Salaries and employee benefits	3,038	2,631
Occupancy expenses	759	719
Repossession expenses (net)	362	319
FDIC Insurance	68	272
Legal and professional fees	234	236
Data processing	266	225
Debit Card Expenses	186	173
Amortization	60	63
Advertising and marketing	233	155
Taxes other than payroll, property and income	212	200
Telephone	75	102
Postage	75	86
Loan fees	63	58
Other	362	470
Total other expenses	5,993	5,709
Income before taxes	2,112	1,807

Income taxes		338		233
Net income	$	1,774	$	1,574
Other Comprehensive Income, net of tax:				
Change in Unrealized Gains on Securities		1,610		789
Comprehensive Income	$	3,384	$	2,363
Earnings per share				
Basic	$	0.67	$	0.57
Diluted		0.67		0.57
Dividends per share		0.22		0.21

See Accompanying Notes

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KENTUCKY BANCSHARES, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY (unaudited)

(in thousands, except share information)

	Common Stock(1) Shares	Common Stock(1) Amount	Retained Earnings	Accumulated Other Comprehensive Income/(Loss)	Total Stockholders Equity
Balances, January 1, 2011	2,738,039	$ 12,498	$ 49,797	$ (1,252)	$ 61,043
Common stock issued, including tax benefit, net	6,616				
Stock based compensation expense		64			64
Common stock purchased and retired	(22,174)	(4)	(362)		(366)
Net change in unrealized gain (loss) on securities available for sale, net of tax and reclassifications				4,711	4,711
Net income			4,457		4,457
Dividends declared - $0.66 per share			(1,804)		(1,804)
Balances, September 30, 2011	2,722,481	$ 12,558	$ 52,088	$ 3,459	$ 68,105

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

See Accompanying Notes

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KENTUCKY BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

(in thousands)

	Nine Months Ended	
	9/30/2011	**9/30/2010**
Cash Flows From Operating Activities		
Net Income	$ 4,457	$ 3,700
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,268	1,234
Securities amortization (accretion), net	142	695
Stock based compensation expense	64	83
Provision for loan losses	1,900	1,950
Securities gains, net	(490)	(1,267)
Originations of loans held for sale	(16,936)	(23,125)
Proceeds from sale of loans	16,507	23,817
Gains (losses) on sale of fixed assets	(54)	3
Losses (gains) on other real estate	47	39
Gain on sale of mortgage loans	(533)	(650)
Changes in:		
Interest receivable	445	(7)
Real estate owned, net	156	697
Other assets	781	382
Interest payable	(73)	238
Other liabilities	(35)	(2,042)
Net cash from operating activities	7,646	5,747
Cash Flows From Investing Activities		
Purchases of securities	(41,192)	(105,577)
Proceeds from principal payments, sales, maturities and calls of securities	67,476	100,618
Net change in loans	(2,834)	4,329
Purchases of bank premises and equipment	(598)	(975)
Proceeds from the sale of bank premises	200	3
Proceeds from the sale of other real estate	3,157	998
Net cash from investing activities	26,209	(604)
Cash Flows From Financing Activities:		
Net change in deposits	(29,324)	2,408
Net change in repurchase agreements and other borrowings	7,808	(1,189)
Advances from Federal Home Loan Bank	10,000	
Payments on Federal Home Loan Bank advances	(22,374)	(12,475)
Payments on note payable	(600)	(600)
Purchase of common stock	(366)	(10)
Dividends paid	(1,804)	(1,728)
Net cash from financing activities	(36,660)	(13,594)
Net change in cash and cash equivalents	(2,805)	(8,451)
Cash and cash equivalents at beginning of period	17,625	34,421
Cash and cash equivalents at end of period	$ 14,820	$ 25,970
Supplemental disclosures of cash flow information		
Cash paid during the year for:		

Interest expense	$	4,477	$	8,251
Income taxes		500		
Supplemental disclosures of non-cash investing activities				
Real estate acquired through foreclosure	$	5,301	$	3,494

See Accompanying Notes

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2010.

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

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

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

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

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

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Adoption of New Accounting Standards

ASU No. 2011-02 - Receivables (Topic 310) ***A Creditor s Determination of Whether a Restructuring Is a Troubled Debt Restructuring.*** This ASU was issued to improve financial reporting by creating greater consistency in the way GAAP is applied for various types of debt restructurings. The ASU clarifies which loan modifications constitute troubled debt restructurings (TDRs). It is intended to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a troubled debt restructuring, both for purposes of recording an impairment loss and for disclosure of troubled debt restructurings. Although, the ASU does not amend the accounting for troubled debt restructurings, it is expected that application of the clarifications contained in the ASU will result in more modifications being considered troubled debt restructurings.

In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude that both of the following exist: (*a*) the restructuring constitutes a concession; and (*b*) the debtor is experiencing financial difficulties. The provisions of this ASU clarify the guidance on a creditor s evaluation of whether it has granted a concession and whether a debtor is experiencing financial difficulties. With regard to determining whether a concession has been granted, the ASU clarifies that creditors are precluded from using the effective interest method to determine whether a concession has been granted. In the absence of using the effective interest method, a creditor must now focus on other considerations such as the value of the underlying collateral, evaluation of other collateral or guarantees, the debtor s ability to access other funds at market rates, interest rate increases and whether the restructuring results in a delay in payment that is insignificant. In addition, the ASU provides a not all inclusive list of six indicators for creditors to consider when determining if a debtor is experiencing financial difficulties which can be found in 310-40-15-20.

For public companies, the new guidance is effective for interim and annual periods beginning on or after June 15, 2011, and applies retrospectively to restructurings occurring on or after the beginning of the fiscal year of adoption. As a result of applying the amendments, an entity may identify receivables that are newly considered impaired. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively. For example, a December 31, year-end company public company will be required to adopt the provisions of the ASU on July 1, 2011. If the company entered into a loan modification between the dates of January 1 and September 30, the company would be required to apply the provisions contained in the ASU to that loan modification to determine if the modification is a TDR. Any impairment resulting from a receivable now considered a TDR, would be recognized in the period ending September 30, 2011. The Company has adopted the methodologies prescribed by this ASU during the third quarter of 2011, and it did not have a material effect on its financial position or results of operations.

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ASU No. 2011-03 Transfers and Servicing (Topic 860) - ***Reconsideration of Effective Control for Repurchase Agreements.*** The amendments in this ASU remove from the assessment of effective control the criteria relating to the transferor s ability to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee. The amendments in this ASU also eliminate the requirement to demonstrate that the transferor possesses adequate collateral to fund substantially all the cost of purchasing replacement financial assets. The guidance in this ASU is effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. The Company will adopt the methodologies prescribed by this ASU by the date required, and does not anticipate that the ASU will have a material effect on its financial position or results of operations.

ASU No. 2011-04 - Fair Value Measurement (Topic 820) - ***Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs***. The amendments in this ASU generally represent clarifications of Topic 820, but also include some instances where a particular principle or requirement for measuring fair value or disclosing information about fair value measurements has changed. This ASU results in common principles and requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. GAAP and IFRSs. The amendments in this ASU are to be applied prospectively. For public entities, the amendments are effective during interim and annual periods beginning after December 15, 2011. Early application by public entities is not permitted. The Company will adopt the methodologies prescribed by this ASU by the date required, and does not anticipate that the ASU will have a material effect on its financial position or results of operations.

ASU No. 2011-05 - Comprehensive Income (Topic 220) - ***Amendments to Topic 220, Comprehensive Income***. Under the amendments in this ASU, an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. This ASU eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders equity. The amendments in this ASU do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. The amendments in this ASU should be applied retrospectively. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted, because compliance with the amendments is already permitted. The amendments do not require any transition disclosures. The Company will adopt the methodologies prescribed by this ASU by the date required, and does not anticipate that the ASU will have a material effect on its financial position or results of operations.

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2. SECURITIES AVAILABLE FOR SALE

INVESTMENT SECURITIES

Period-end securities are as follows:

(in thousands)

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for Sale				
September 30, 2011				
U.S. government agencies	$ 18,156	$ 12	$ (2)	$ 18,166
States and political subdivisions	79,230	4,353	(34)	83,549
Mortgage-backed - residential	55,171	877		56,048
Equity securities	270	35		305
Total	$ 152,827	$ 5,277	$ (36)	$ 158,068
December 31, 2010				
U.S. government agencies	$ 43,238	$ 49	$ (309)	$ 42,978
States and political subdivisions	81,887	1,039	(1,773)	81,153
Mortgage-backed - residential	53,369	20	(948)	52,441
Equity securities	270	25		295
Total	$ 178,764	$ 1,133	$ (3,030)	$ 176,867

The amortized cost and fair value of securities at September 30, 2011 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	$ 85	$ 86
Due after one year through five years	10,299	10,344
Due after five years through ten years	31,720	33,040
Due after ten years	55,282	58,245
	97,386	101,715
Mortgage-backed - residential	55,171	56,048
Equity	270	305
Total	$ 152,827	$ 158,068

Proceeds from sales of securities during the first nine months of 2011 and 2010 were $26.1 million and $37.3 million. Gross gains of $490 thousand and $1.268 million 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 $167 thousand and $431 thousand, respectively.

Proceeds from sales of securities during the three months ending September 30, 2011 and September 30, 2010 were $4.9 million and $27.8 million. Gross gains of $266 thousand and $1.053 million, respectively, and no gross losses were realized on those sales. The tax provision related to these realized gains was $90 thousand and $358 thousand, respectively.

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Securities with unrealized losses at September 30, 2011 and at December 31, 2010 not recognized in income are as follows:

September 30, 2011

	Less than 12 Months		12 Months or More		Total	
Description of Securities	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**	**Fair Value**	**Unrealized Loss**
U.S. Government agencies	$ 2,998	$ (2)	$	$	$ 2,998	$ (2)
States and municipals	424	(19)	1,017	(15)	1,441	(34)
Mortgage-backed - residential						
Total temporarily impaired	$ 3,422	$ (21)	$ 1,017	$ (15)	$ 4,439	$ (36)

December 31, 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	$ 29,904	$ (309)	$	$	$ 29,904	$ (309)
States and municipals	45,084	(1,649)	1,939	(124)	47,023	(1,773)
Mortgage-backed - residential	48,421	(948)			48,421	(948)
Total temporarily impaired	$ 123,409	$ (2,906)	$ 1,939	$ (124)	$ 125,348	$ (3,030)

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

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

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3. LOANS

Loans at period-end are as follows:

(in thousands)

		9/30/11		12/31/10
Commercial	$	26,726	$	22,840
Real estate construction		14,636		13,518
Real estate mortgage:				
1-4 family residential		160,048		158,877
Multi-family residential		12,936		13,519
Non-farm & non-residential		97,339		105,580
Agricultural		78,167		78,375
Consumer		18,107		18,830
Other		243		291
Total	$	408,202	$	411,830

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

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

Three Months Ended September 30, 2011 (in thousands)										
		Beginning Balance		Charge-offs		Recoveries		Provision		Ending Balance
Commercial	$	205	$	2	$		$	(4)	$	199
Real estate Construction		674		19				94		749
Real estate mortgage:										
1-4 family residential		2,303		231		6		238		2,316

Multi-family residential	334	84		13	263
Non-farm & non-residential	696	4		(52)	640
Agricultural	683		2	19	704
Consumer	569	27	6	47	595
Other	26	194	119	123	74
Unallocated	152			(28)	124
	$ 5,642	$ 561	$ 133	$ 450	$ 5,664

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		Nine Months Ended September 30, 2010 (in thousands)
Balance at Beginning of Period	$	7,600
Amounts Charged-off:		
Commercial		19
Real estate Construction		547
Real estate mortgage:		
1-4 family residential		500
Multi-family residential		
Non-farm & non-residential		1,467
Agricultural		74
Consumer		814
Total Charged-off Loans		3,421
Recoveries on Amounts		
Previously Charged-off:		
Commercial		43
Real estate Construction		
Real estate mortgage:		
1-4 family residential		30
Multi-family residential		
Non-farm & non-residential		706
Agricultural		17
Consumer		447
Total Recoveries		1,243
Net Charge-offs		2,178
Provision for Loan Losses		1,950
Balance at End of Period	$	7,372

		Three Months Ended September 30, 2010 (in thousands)
Balance at Beginning of Period	$	6,461
Amounts Charged-off:		
Commercial		
Real Estate Construction		
Real Estate Mortgage:		
1-4 family residential		160
Multi-family residential		
Non-farm & non-residential		15
Agricultural		
Consumer		342
Total Charged-off Loans		517
Recoveries on Amounts		
Previously Charged-off:		
Commercial		
Real Estate Construction		
Real Estate Mortgage:		
1-4 family residential		8
Multi-family residential		
Non-farm & non-residential		563
Agricultural		
Consumer		157

Total Recoveries		728
Net Charge-offs		(211)
Provision for Loan Losses		700
Balance at End of Period	$	7,372

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The following tables present the balance in the allowance for loan losses and the recorded investment (excluding accrued interest receivable amounting to $2.9 million as of September 30, 2011 and $3.3 million at December 31, 2010) in loans by portfolio segment and based on impairment method as of September 30, 2011 and December 31 2010:

As of September 30, 2011 **(in thousands)**	**Individually Evaluated for Impairment**	**Collectively Evaluated for Impairment**	**Total**
Allowance for Loan Losses:			
Commercial	$	$ 199	$ 199
Real estate construction	321	428	749
Real estate mortgage:			
1-4 family residential	307	2,009	2,316
Multi-family residential		263	263
Non-farm & non-residential	30	610	640
Agricultural	428	276	704
Consumer		595	595
Other		74	74
Unallocated		124	124
	$ 1,086	$ 4,578	$ 5,664
Loans:			
Commercial	$	$ 26,726	$ 26,726
Real estate construction	4,088	10,548	14,636
Real estate mortgage:			
1-4 family residential	2,362	157,686	160,048
Multi-family residential		12,936	12,936
Non-farm & non-residential	4,284	93,055	97,339
Agricultural	5,761	72,406	78,167
Consumer		18,107	18,107
Other		243	243
	$ 16,495	$ 391,115	$ 408,202

As of December 31, 2010 **(in thousands)**	**Individually Evaluated for Impairment**	**Collectively Evaluated for Impairment**	**Total**
Allowance for Loan Losses:			
Commercial	$	$ 235	$ 235
Real estate construction	382	339	721
Real estate mortgage:			
1-4 family residential	272	1,555	1,827
Multi-family residential	12	136	148
Non-farm & non-residential	127	762	889
Agricultural	6	259	265
Consumer		582	582
Other		58	58
Unallocated		200	200
	$ 799	$ 4,126	$ 4,925
Loans:			
Commercial	$	$ 22,840	$ 22,840
Real estate construction	5,051	8,467	13,518
Real estate mortgage:			
1-4 family residential	2,773	156,104	158,877

Multi-family residential	1,148	12,371	13,519
Non-farm & non-residential	6,069	99,511	105,580
Agricultural	792	77,583	78,375
Consumer		18,830	18,830
Other		291	291
	$ 15,833	$ 395,997	$ 411,830

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

(in thousands)	September 30, 2011 Nine Month Average	September 30, 2011 Three Month Average
Commercial	$	$
Real Estate construction	5,265	4,047
Real estate mortgage:		
1-4 family residential	3,493	2,717
Multi-family residential	1,488	945
Non-farm & non-residential	5,477	4,846
Agricultural	4,565	5,596
Installment		
Other		
Total	$ 20,288	$ 18,151

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

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

The annual average of individually impaired loans as of December 31, 2010 was $11.7 million and $149 thousand was recognized during 2010 as interest income on a cash-basis.

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The following tables present loans individually evaluated for impairment by class of loans as of September 30, 2011 and December 31, 2010:

As of September 30, 2011 **(in thousands)**	**Unpaid Principal Balance**	**Recorded Investment**	**Allowance for Loan Losses Allocated**
With no related allowance recorded:			
Commercial	$	$	$
Real estate construction	1,600	1,053	
Real estate mortgage:			
1-4 family residential	847	847	
Multi-family residential			
Non-farm & non-residential	3,681	3,681	
Agricultural	818	818	
Consumer			
Total	6,946	6,399	
With an allowance recorded:			
Commercial			
Real estate construction	3,035	3,035	321
Real estate mortgage:			
1-4 family residential	1,560	1,515	307
Multi-family residential			
Non-farm & non-residential	603	603	30
Agricultural	4,943	4,943	428
Consumer			
Total	10,141	10,096	1,086
Total impaired loans	$ 17,087	$ 16,495	$ 1,086

As of December 31, 2010 **(in thousands)**	**Unpaid Principal Balance**	**Recorded Investment**	**Allowance for Loan Losses Allocated**
With no related allowance recorded:			
Commercial	$	$	$
Real estate construction	2,178	942	
Real estate mortgage:			
1-4 family residential	1,404	1,355	
Multi-family residential	1,381	45	
Non-farm & non-residential	4,464	4,435	
Agricultural	696	696	
Consumer			
Other			
Total	10,123	7,473	
With an allowance recorded:			
Commercial			
Real estate construction	4,109	4,109	382
Real estate mortgage:			
1-4 family residential	2,482	1,418	272
Multi-family residential	1,103	1,103	12
Non-farm & non-residential	1,884	1,634	127

Agricultural		96		96		6
Consumer						
Other						
Total		9,674		8,360		799
Total Impaired Loans	$	19,797	$	15,833	$	799

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The following tables present the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of September 30, 2011 and December 31, 2010:

As of September 30, 2011	**Nonaccrual**	**Loans Past Due Over 90 Days Still Accruing**	**Troubled Debt Restructurings**
(in thousands)			
Commercial	$	$ 196	$
Real estate construction	1,252		
Real estate mortgage:			
1-4 family residential	2,963	243	525
Multi-family residential			
Non-farm & non-residential	1,090	418	
Agricultural	757		585
Consumer	13	2	
Total	$ 6,075	$ 859	$ 1,110

As of December 31, 2010	**Nonaccrual**	**Loans Past Due Over 90 Days Still Accruing**	**Troubled Debt Restructurings**
(in thousands)			
Commercial	$ 18	$	$
Real estate construction	3,451		
Real estate mortgage:			
1-4 family residential	3,381	684	
Multi-family residential	2,484		
Non-farm & non-residential	2,115	3	
Agricultural	1,016		
Consumer	14	19	
Total	$ 12,479	$ 706	$

Nonaccrual loans secured by real estate make up 99.3% of the total nonaccruals at September 30, 2011.

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.

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

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

During the first nine months of 2011, $5.3 million of impaired loans were transferred to other real estate owned and $1.8 million recorded in charge offs which contributed to a reduction in nonaccrual loan balances.

The following tables present the aging of the recorded investment in past due and non-accrual loans as of September 30, 2011 and December 31, 2010 by class of loans:

As of September 30, 2011 (in thousands)	**30 59 Days Past Due**	**60 89 Days Past Due**	**Loans Past Due Over 90 Days Still Accruing**	**Non-accrual**	**Total Past Due & Non-accrual**	**Loans Not Past Due**
Commercial	$	$	$ 196	$	$ 196	$ 26,530
Real estate construction				1,252	1,252	13,384
Real estate mortgage:						
1-4 family residential	1,956	196	243	2,963	5,358	154,690
Multi-family residential	371				371	12,565
Non-farm & non-residential	236		418	1,090	1,744	95,595
Agricultural	560			757	1,317	76,850
Consumer	70	44	2	13	129	17,978
Other						243
Total	$ 3,193	$ 240	$ 859	$ 6,075	$ 10,367	$ 397,835

As of December 31, 2010 (in thousands)	**30 59 Days Past Due**	**60 89 Days Past Due**	**Loans Past Due Over 90 Days Still Accruing**	**Non-accrual**	**Total Past Due & Non-accrual**	**Loans Not Past Due**
Commercial	$ 246	$	$	$ 18	$ 264	$ 22,576
Real estate construction	192			3,452	3,644	9,874
Real estate mortgage:						
1-4 family residential	4,215	224	684	3,381	8,504	150,373
Multi-family residential	49			2,484	2,533	10,986
Non-farm & non-residential	121	113	3	2,114	2,351	103,229
Agricultural	1,101	141		1,016	2,258	76,117

Consumer	192	29	19	14	254	18,576
Other						291
Total	$ 6,116	$ 507	$ 706	$ 12,479	$ 19,808	$ 392,022

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Troubled Debt Restructurings:

The Company has allocated no specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of September 30, 2011 and December 31, 2010. The Company has not committed to lend additional amounts as of September 30, 2011 and December 31, 2010 to customers with outstanding loans that are classified as troubled debt restructurings.

During the nine months ending September 30, 2011, the terms of certain loans were modified as troubled debt restructurings. No loans were modified as troubled debt restructurings during the three months ending September, 30, 2011. The modification of the terms of such loans were to interest only payments for a 1 year term.

The following table presents loans by class modified as troubled debt restructurings that occurred during the period ending September 30, 2011:

	Number of Loans	**Pre-Modification Outstanding Recorded Investment**	**Post-Modification Outstanding Recorded Investment**
Troubled Debt Restructurings:			
Real estate mortgage:			
1-4 family residential	1	$ 474	$ 525
Agricultural	1	393	585
Total	2	$ 867	$ 1,110

The troubled debt restructurings described above increased the allowance for loan losses by $0 and resulted in charge offs of $0 during the period ending September 30, 2011.

For the nine months and three months ending September 30, 2011, no loans modified as troubled debt restructurings had defaulted on payment.

No other loans were modified during the nine months and three months ending September 30, 2011 that did not meet the definition of a troubled debt restructuring.

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Credit Quality Indicators:

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

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

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

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

As of September 30, 2011 and December 31, 2010, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

As of September 30, 2011 **(in thousands)**	**Pass**	**Special Mention**	**Substandard**	**Doubtful**
Commercial	$ 25,177	$ 1,280	$ 269	$
Real estate construction	7,915	2,434	4,287	
Real estate mortgage:				
1-4 family residential	140,988	8,766	10,220	74
Multi-family residential	9,842	2,991	103	
Non-farm & non-residential	90,833	2,107	4,399	
Agricultural	64,042	7,232	6,893	
Total	$ 338,797	$ 24,810	$ 26,171	$ 74

As of December 31, 2010 **(in thousands)**	**Pass**	**Special Mention**	**Substandard**	**Doubtful**
Commercial	$ 21,225	$ 1,310	$ 305	$
Real estate construction	3,412	3,620	6,486	
Real estate mortgage:				

1-4 family residential		138,066		11,029		9,721		60
Multi-family residential		10,872		44		2,603		
Non-farm & non-residential		98,032		1,071		6,478		
Agricultural		72,091		4,664		1,620		
Total	$	343,698	$	21,738	$	27,213	$	60

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For consumer loans, the Company evaluates the credit quality based on the aging of the recorded investment in loans, which was previously presented. Non-performing consumer loans are loans which are greater than 90 days past due or on non-accrual status, and total $15 thousand at September 30, 2011 and $33 thousand at December 31, 2010.

4. REAL ESTATE OWNED

Activity in real estate owned was as follows:

	Nine Months Ended 2011	2010
	(in thousands)	
Beginning of year	$ 8,424	$ 4,542
Additions	5,301	3,494
Sales	(3,815)	(979)
Additions to valuation allowance	(156)	(697)
Recovery from sale in valuation allowance	514	20
End of period	$ 10,268	$ 6,380

Activity in the valuation allowance was as follows:

	Nine Months Ended 2011	2010
	(in thousands)	
Beginning of year	$ 799	$ 12
Additions charged to expense	156	697
Recovery from sale	(514)	(20)
End of period	$ 441	$ 689

Expenses related to foreclosed assets include:

	2011	2010
Net loss (gain) on sales	$ 47	$ 39
Provision for unrealized losses	156	697
Operating expenses (receipts), net of rental income	500	249
End of period	$ 703	$ 985

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5. EARNINGS PER SHARE

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

The factors used in the earnings per share computation follow:

	Nine Months Ended September 30 2011 (in thousands)			
		2011		2010
Basic Earnings Per Share				
Net Income	$	4,457	$	3,700
Weighted average common shares outstanding		2,709		2,732
Basic earnings per share	$	1.65	$	1.35
Diluted Earnings Per Share				
Net Income	$	4,457	$	3,700
Weighted average common shares outstanding		2,709		2,732
Add dilutive effects of assumed vesting of stock grants		1		
Weighted average common and dilutive potential common shares outstanding		2,710		2,732
Diluted earnings per share	$	1.65	$	1.35

Three Months Ended

	Three Months Ended September 30 (in thousands)			
		2011		2010
Basic Earnings Per Share				
Net Income	$	1,774	$	1,574
Weighted average common shares outstanding		2,709		2,732
Basic earnings per share	$	0.67	$	0.57
Diluted Earnings Per Share				
Net Income	$	1,774	$	1,574
Weighted average common shares outstanding		2,709		2,732
Add dilutive effects of assumed vesting of stock grants		1		
Weighted average common and dilutive potential common shares outstanding		2,710		2,732
Diluted earnings per share	$	0.67	$	0.57

Stock options for 30,660 shares of common stock for the nine and three months ended September 30, 2011 and 33,240 shares of common stock for the nine and three months ended September 30, 2010 were excluded from diluted earnings per share because their impact was antidilutive. Restricted stock grants of 23,610 shares of common stock for the nine and three months ended September 30, 2011 and 21,705 shares of common stock for the nine and three months ended September 30, 2010 were excluded from diluted earnings per share because their impact was antidilutive.

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6. STOCK COMPENSATION

We have four share based compensation plans as described below.

Two Stock Option Plans

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

The combined summary of activity for 2011 in the expired Stock Option Plans follows:

	Shares		Weighted Average Exercise Price	Weighted Average Remaining Contractual Term		Aggregate Intrinsic Value
Outstanding, beginning of year	32,640	$	29.48			
Granted						
Forfeited or expired	(1,980)		26.50			
Exercised						
Outstanding, end of period	30,660	$	29.68	30.8 months	$	
Vested and expected to vest	30,660	$	29.68	30.8 months	$	
Exercisable, end of period	30,660	$	29.68	30.8 months	$	

As of September 30, 2011, 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, 2011 no additional options can be granted under either of these plans.

2005 Restricted Stock Grant Plan

On May 10, 2005, our stockholders approved a restricted stock grant plan. Total shares issuable under the plan are 50,000. There were 5,955 shares issued during 2011 and 4,020 shares issued during 2010. There were 295 shares forfeited during the first nine months of 2011 and 344 shares forfeited during the first nine months of 2010. As of September 30, 2011, the restricted stock grant plan allows for additional restricted stock share awards of up to 23,895 shares.

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

Nonvested Shares	Shares	Weighted-Average Grant-Date Fair Value	Fair Value Per Share
Nonvested at January 1, 2011	10,486	$ 231,659	$ 22.09
Granted	5,955	100,496	16.88
Vested	(3,379)	(83,424)	24.69
Forfeited	(295)	(5,494)	18.62
Nonvested at September 30, 2011	12,767	$ 243,237	19.05

As of September 30, 2011, there was $260,673 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, 2011 no awards have been granted under the plan and 150,000 shares are still available.

7. 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.

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

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

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

Other Real Estate Owned: Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned (OREO) are measured at 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.

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Assets and Liabilities Measured on a Recurring Basis

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

		Fair Value Measurements at September 30, 2011 Using:		
(In thousands) Description	Fair Value	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U. S. government agencies	$ 18,166	$	$ 18,166	$
States and municipals	83,549		83,549	
Mortgage-backed - residential	56,048		56,048	
Equity securities	305	305		
Total	$ 158,068	$ 305	$ 157,763	$

		Fair Value Measurements at December 31, 2010 Using:		
(In thousands) Description	Fair Value	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U. S. government agencies	$ 42,978	$	$ 42,978	$
States and municipals	81,153		81,153	
Mortgage-backed - residential	52,441		52,441	
Equity securities	295	295		
Total	$ 176,867	$ 295	$ 176,572	$

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

(In thousands) Description	Fair Value	Fair Value Measurements at September 30, 2011 Using: Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Other Significant Unobservable Inputs (Level 3)
Impaired loans:				
Real estate commercial	$	$	$	$
Real estate construction	2,714			2,714
Real Estate Mortgage:				
1-4 family residential	1,253			1,253
Multi-family residential				
Non-farm & non-residential	573			573
Agricultural	4,515			4,515
Total impaired loans	9,055			9,055
Other real estate owned:				
Residential	2,833			2,833
Commercial real estate	42			42
Total other real estate owned	2,875			2,875
Loan servicing rights	131			131

(In thousands) Description	Fair Value	Fair Value Measurements at December 31, 2010 Using: Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Other Significant Unobservable Inputs (Level 3)
Impaired loans:				
Real estate commercial	$	$	$	$
Real estate construction	3,727			3,727
Real Estate Mortgage:				
1-4 family residential	2,209			2,209
Multi-family residential	1,092			1,092
Non-farm & non-residential	1,757			1,757
Agricultural	90			90
Total impaired loans	8,875			8,875
Other real estate owned:				
Residential	3,365			3,365
Commercial real estate	1,668			1,668
Total other real estate owned:	5,033			5,033
Loan servicing rights	138			138

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Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of $9.1 million, which includes a valuation allowance of $1.1 million at September 30, 2011, resulting in an additional provision of $287 thousand for loan losses for the nine months ending September 30, 2011 and a reduction of $204 thousand for the loan loss provision for the three months ending September 30, 2011. The loan loss provision for the nine months ending September 30, 2011 is $1.9 million and $450 thousand for the three months ending September 30, 2011. The loan loss provision for the twelve months ending December 31, 2010 was $3.25 million.

Other real estate owned which is measured at fair value less costs to sell, had a net carrying amount of $2.9 million, which is made up of the outstanding balance of $3.3 million, net of a valuation allowance of $442 thousand at September 30, 2011. The write-down of Other Real Estate Owned properties totaled $156 thousand for the nine months ending September 30, 2011 and $88 thousand for the three months ending September 30, 2011. The write-down of Other Real Estate Owned properties totaled $807 thousand for the twelve months ending December 31, 2010.

Loan servicing rights, which are carried at lower of cost or fair value, were carried at their fair value of $131 thousand, which is made up of the outstanding balance of $225 thousand, net of a valuation allowance of $94 thousand at September 30, 2011, resulting in a recovery of $8 thousand for the nine months ending September 30, 2011 and a write-down of $33 thousand for the three months ending September 30, 2011. At December 31, 2010, loan servicing rights were carried at their fair value of $138 thousand, which is made up of the outstanding balance of $240 thousand, net of a valuation allowance of $102 thousand at December 31, 2010, resulting in a recovery of $36 thousand for the year ending December 31, 2010.

Fair Value of Financial Instruments

The fair values of the Company s financial instruments at September 30, 2011 and December 31, 2010 are as follows:

	September 30, 2011		December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
		(In Thousands)		
Financial assets				
Cash and cash equivalents	$ 14,820	$ 14,820	$ 17,624	$ 17,624
Securities	158,068	158,068	176,867	176,867
Loans, net	402,538	403,485	406,905	407,925
FHLB stock	6,731	N/A	6,731	N/A
Interest receivable	4,081	4,081	4,526	4,526
Financial liabilities				
Deposits	$ 508,077	$ 510,510	$ 537,401	$ 539,939
Federal funds purchased	9,482	9,482		
Securities sold under agreements to repurchase and other borrowings	4,905	4,907	7,179	7,178
FHLB advances	30,814	32,509	43,206	45,071
Subordinated debentures	7,217	6,424	7,217	6,151
Interest payable	1,184	1,184	1,257	1,257

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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 subsidiary s customers from other providers of financial and mortgage services; government legislation, regulation and monetary policy (which changes from time to time and over which we have no control); changes in interest rates (both generally and more specifically mortgage interest rates); material unforeseen changes in the liquidity, results of operations, or financial condition of our subsidiary s customers; adequacy of the allowance for losses on loans and the level of future provisions for losses on loans; and other risks detailed in our filings with the Securities and Exchange Commission, all of which are difficult to predict and many of which are beyond our control.

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

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Summary

The Company recorded net income of $4.5 million, or $1.65 basic earnings and diluted earnings per share for the first nine months ending September 30, 2011 compared to $3.7 million or $1.35 basic earnings and diluted earnings per share for the nine month period ending September 30, 2010. The first nine months earnings reflects an increase of 20.5% compared to the same time period in 2010, due primarily to an increase in net interest income of $3.3 million and a decrease in repossession expense of $291 thousand. These positive changes to net income during 2011 were partially offset by a decrease of $311 thousand in service charges, a decrease of $777 thousand in gains recognized on the sale of loans and an increase of $1.3 million in employee salaries and benefits. The earnings for the three months ending September 30, 2011 were $1.8 million, or $0.67 basic and diluted earnings per share compared to $1.6 million or $0.57 basic and diluted earnings per share for the three month period ending September 30, 2010. The earnings for the three month period in 2011 reflect a 12.7% increase compared to the same time period in 2010.

Return on average assets was 0.91% for the nine months ended September 30, 2011 and 0.70% for the nine month period ended September 30, 2010. Return on average assets was 1.09% for the three months ended September 30, 2011 and 0.91% for the three months ended September 30, 2010. Return on average equity was 9.3% for the nine month period ended September 30, 2011 and 7.9% for the same period in 2010. Return on average equity was 10.7% for the three months ended September 30, 2011 and 10.0% for the same time period in 2010. Gross Loans decreased $3.6 million from $411.8 million on December 31, 2010 to $408.2 million on September 30, 2011. The overall decrease is attributed mostly to a decrease of $8.2 million in non-farm and non-residential loans. Increases in the loan portfolio from December 31, 2010 to September 30, 2011 included an increase of $3.9 million in commercial loans, an increase of $1.1 million in real estate construction loans and an increase of $1.2 million in 1-4 family residential property loans.

Total deposits decreased from $537.4 million on December 31, 2010 to $508.1 million on September 30, 2011, a decrease of $29.3 million. The overall decrease is mostly attributed to a decrease of $27.8 million in pubic fund deposits from December 31, 2010 to September 30, 2011. Public fund deposits will typically be higher at the end of the calendar year due to tax monies collected and will decrease during the first half of the following year as those funds are dispersed. Non-interest bearing demand deposit accounts increased $24.9 million from December 31, 2010 to September 30, 2011. This increase is not all attributed to additional deposits being placed with the bank as part of the increase is from deposit accounts changing from time deposits to non-interest bearing demand deposit accounts. Time deposits $100 thousand and over decreased $19.8 million and other interest bearing deposit accounts decreased $34.4 million.

Net Interest Income

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

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Net interest income was $18.2 million for the nine months ended September 30, 2011 compared to $14.9 million for the nine months ended September 30, 2010, an increase of 22.1%. The interest spread of 4.06% for the first nine months of 2011 is up from 3.06% reported for the same period in 2010, an increase of 100 basis points. Rates have remained fairly low in the past year. The significant increase in the net interest spread is largely attributed to a decrease in the cost of certificate of deposit accounts. For the first nine months ending September 30, 2011, the cost of total deposits was 0.79% compared to 1.47% for the same time period in 2010. Increasing non-interest bearing deposit accounts has also helped to lower the cost of deposits. Net interest income was $6.2 million for the three months ending September 30, 2011 compared to $4.9 million for the three months ending September 30, 2010, an increase of 25.5%. The interest spread was 4.15% for the three month period ending September 30, 2011 compared to 3.07% for the three month period in 2010, an increase of 108 basis points.

For the first nine months, the yield on assets increased from 4.74% in 2010 to 5.06% in 2011. The year to date average balance of federal funds sold decreased $26.5 million for the first nine months in 2011 compared to 2010 due to an influx of short term deposits in 2010. This helped to increase the yield on earning assets in 2011 because of the low rates earned on federal funds sold. Also, the yield on loans increased 16 basis points in the first nine months of 2011 compared to 2010 from 5.71% to 5.87%. The cost of liabilities decreased from 1.68% in 2010 to 1.00% in 2011. Year to date average loans decreased $11.7 million, or 2.8% from September 30, 2010 to September 30, 2011. Loan interest income has increased $23 thousand for the first nine months of 2011 compared to the first nine months of 2010. Year to date average deposits decreased from September 30, 2010 to September 30, 2011, down $36.9 million or 6.5%. The decrease is primarily the result of a decrease in time deposits that matured during the fourth quarter of 2010. Year to date average interest bearing deposits decreased $53.4 million, or 11.6%, from September 30, 2010 to September 30, 2011. Deposit interest expense has decreased $3.2 million for the first nine months of 2011 compared to the same period in 2010. Year to date average borrowings decreased $12.8 million, or 19.7% from September 30, 2010 to September 30, 2011. The decrease is mostly attributed to paying off Federal Home Loan Bank advances when they come due and not replacing them. Interest expense on borrowed funds has decreased $458 thousand for the first nine months of 2011 compared to the same period in 2010.

The volume rate analysis for 2011 that follows indicates that $1.1 million of the decrease in interest income is attributable to the decrease in volume, while the change in rates contributed to an increase of $775 thousand in interest income. Even more affected by volume and rate changes was the liability side of the balance sheet. The average rate of the Company s total outstanding deposits and borrowing liabilities decreased from 1.68% in 2010 to 1.00% in 2011. Based on the volume rate analysis that follows, the lower level of interest rates contributed to a decrease of $2.2 million in interest expense, while the change in volume was responsible for a $1.4 million decrease in interest expense. As a result, the 2011 net interest income increase is mostly attributed to decreases in rates on deposits and an increase in rates on loans.

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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 2011. 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

	2011 vs. 2010		
(in thousands)	**Increase Volume**	**(Decrease) Rate**	**Due to Change in Net Change**
INTEREST INCOME			
Loans	$ (681)	$ 704	$ 23
Investment Securities	(395)	85	(310)
Other	(335)	303	(32)
Total Interest Income	(1,411)	1,092	(319)
INTEREST EXPENSE			
Deposits			
Demand	56	(81)	(25)
Savings	9	(22)	(13)
Negotiable Certificates of Deposit and Other Time Deposits	(1,104)	(2,009)	(3,113)
Securities sold under agreements to repurchase and other borrowings	(3)	(49)	(52)
Federal Home Loan Bank advances	(343)	(63)	(406)
Total Interest Expense	(1,385)	(2,224)	(3,609)
Net Interest Income	$ (26)	$ 3,316	$ 3,290

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Non-Interest Income

Non-interest income decreased $932 thousand for the nine months ended September 30, 2011 compared to the same period in 2010 to $6.5 million. The decrease was due primarily to a decrease of $777 thousand in gains recognized on sold securities, a decrease of $311 thousand in service charges and a decrease of $117 thousand in gains on sold loans. The decrease in service charges is largely attributed to a decrease of $264 thousand in overdraft income. Increases to non-interest income for the first nine months of 2011 compared to the first nine months of 2010 included an increase of $173 thousand in debit card interchange income, an increase in trust department income of $66 thousand and an increase of $55 thousand in other income. The increase in other income is attributed to the $54 thousand gain on the sale of bank premises that was recorded in May 2011 when the Company sold the former Nicholasville branch building. Non-interest income decreased $916 thousand for the three months ended September 30, 2011 compared to the three months ended September 30, 2010. The decrease was mostly the result of a decrease of $787 thousand in recognized gains on the sale of securities, a decrease of $91 thousand in gains on the sale of mortgage loans and a decrease in service charges of $79 thousand. The decrease in service charges includes a decrease of $34 thousand in overdraft income for the three months ending September 30, 2011 compared to the same time period one year ago. Increases to non-interest income for the three month period ending September 30, 2011 compared to the three months ending September 30, 2010 include an increase of $53 thousand in debit card interchange income and increase of $25 thousand in trust department income.

The gain on the sale of mortgage loans decreased from $650 thousand in the first nine months of 2010 to $533 thousand during the first nine months of 2011, a decrease of $117 thousand. For the three months ending September 30, 2011 compared to the same time period in 2010, the gain on the sale of mortgage loans decreased $91 thousand. The volume of loans originated to sell during the first nine months of 2011 decreased $6.2 million compared to the same time period in 2010. 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 $70 thousand for the nine months ending September 30, 2011 compared to $65 thousand for the nine months ending September 30, 2010, an increase of $5 thousand. For the three month period ending September 30, 2011, loan service fee income was a loss of $16 thousand compared to a loss of $5 thousand for the same time period one year ago. During the first nine months of 2011, the carrying value of the mortgage servicing right was written up a net amount of $8 thousand. Of this, a positive adjustment of $20 thousand was recorded in the first quarter of 2011, a positive adjustment of $21 thousand was recorded in the second quarter of 2011 and a write-down of $33 thousand was recorded during the third quarter of 2011. For the nine months ending September 30, 2010, the carrying value of the mortgage servicing right had a negative valuation adjustment in the amount of $2 thousand with a $24 thousand negative adjustment recorded during the third quarter of 2010.

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Non-Interest Expense

Total non-interest expenses increased $1.3 million for the nine month period ended September 30, 2011 compared to the same period in 2010. For the three month period ended September 30, 2011 compared to the three months ending September 30, 2010, total non-interest expense increased $284 thousand.

For the comparable nine month periods, salaries and benefits increased $1.3 million, an increase of 17.7%. The increase is attributed largely to additional employees being hired throughout 2010 and 2011. The number of full time equivalent employees at September 30, 2011 was 193 compared to 187 one year ago and 184 at December 31, 2010. In addition, $180 thousand was expensed during the first nine months of 2011 to accrue for unused vacation time that employees can carry over into future periods and unused major illness time that certain employees may be eligible to receive upon retirement. This accrual accounts for an increase of $100 thousand in employee benefits because the Company did not begin accruing for this liability until June 2010. In addition, during the first nine months of 2011, $900 thousand has been accrued for incentives compared to $450 thousand for the first nine months of 2010, an increase of $450 thousand. Salaries and employee benefits increased $407 thousand for the three month period ending September 30, 2011 compared to the same time period in 2010.

Occupancy expenses increased $190 thousand to $2.3 million for the first nine months of 2011 compared to the same time period in 2010. Occupancy expenses increased $40 thousand for the three month period ended September 30, 2011 compared to the same time period in 2010. The increase in year to date occupancy expense during 2011 is mostly the result of an increase in computer maintenance of $121 thousand.

Legal and professional fees increased $15 thousand for the first nine months ended September 30, 2011 compared to the same time period in 2010. Legal and professional fees decreased $2 thousand for the three month period ending September 30, 2011 compared to the same time period in 2010. The increase in year to date legal and professional fees is largely attributable to additional collection efforts for problem loans. Repossession expenses decreased $291 thousand for the first nine months ending September 30, 2011 compared to the same time period in 2010 and increased $44 thousand for the three months period ending September 30, 2011 compared to the same period one year ago. Repossession expenses are reported net of income earned on the repossessed properties. Repossession expenses were higher during the first nine months of 2010 when compared to the same time period in 2011 due to $697 thousand being expensed for the write-downs of other real estate owned properties in 2010 and $156 being expensed in 2011. In addition, the rents earned on other real estate properties, including new property added, increased $201 thousand to $411 thousand for the nine months ending September 30, 2011 compared to the same period last year as rental income was being generated for the full nine months in 2011. FDIC insurance expense decreased $247 thousand for the nine months ending September 30, 2011 and $204 thousand for the three months ending September 30, 2011, compared to the same time period in 2010. The decrease is mostly attributed to a change in the calculation the FDIC uses to assess insurance premiums.

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Income Taxes

The effective tax rate for the nine months ended September 30, 2011 was 14.9% compared to 11.2% in 2010. The effective tax rate for the three months ended September 30, 2011 was 16.0% compared to 12.9% for the three months ended September 30, 2010 These rates are less than the statutory rate as a result of the tax-free securities and loans and tax credits generated by certain investments held by the Company. The rates for 2011 are higher due to the higher level of income for 2011. Tax-exempt interest income decreased $277 thousand for the first nine months of 2011 compared to the first nine months of 2010.

As part of normal business, Kentucky Bank typically makes tax free loans to select municipalities in our market and invests in selected tax free securities, primarily in the Commonwealth of Kentucky. In making these investments, the Company considers the overall impact to managing our net interest margin, credit worthiness of the underlying issuer and the favorable impact on our tax position. For the nine months ended September 30, 2011, the Company averaged $77.7 million in tax free securities and $15.3 million in tax free loans. As of September 30, 2011, the weighted average remaining maturity for the tax free securities is 146 months, while the weighted average remaining maturity for the tax free loans is 163 months.

Liquidity and Funding

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

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

Cash and cash equivalents were $14.8 million as of September 30, 2011 compared to $17.6 million at December 31, 2010. The decrease in cash and cash equivalents is mainly attributable to a decrease in federal funds sold of $5.0 million resulting primarily from a decrease in short term deposits. In addition to cash and cash equivalents, the securities portfolio provides an important source of liquidity. Securities available for sale totaled $158.1 million at September 30, 2011 compared to $176.9 million at December 31, 2010. The available for sale securities are available to meet liquidity needs on a continuing basis. However, we expect our customers deposits to be adequate to meet our funding demands.

Generally, we rely upon net cash inflows from financing activities, supplemented by net cash inflows from operating activities, to provide cash used in our investing activities. As is typical of many financial institutions, significant financing activities include deposit gathering and the use of short-term borrowings, such as federal funds purchased and securities sold under repurchase agreements along with long-term debt. Our primary investing activities include purchasing investment securities and loan originations.

For the first nine months of 2011, deposits have decreased $29.3 million, mostly due to an expected decline in public fund deposit balances. The Company s investment portfolio has decreased $18.8 million and the Company s loan portfolio has decreased $3.6 million. In addition, the Company has paid down FHLB advances by $12.4 million during the first nine months of 2011. Federal Funds purchased have increased $9.5 million from $0 at December 31, 2010 to $9.5 million at September 30, 2011.

The Company has a promissory note payable that matures July 30, 2012, and has principal due at maturity and interest payable quarterly at prime, and is secured by 100% of the common stock of the bank. The 2011 loan agreement contains certain covenants and performance terms. The Bank was in compliance with its debt covenants at September 30, 2011.

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, 2011, we have sufficient collateral to borrow an additional $60 million from the Federal Home Loan Bank. In addition, as of September 30, 2011, $15 million is available in overnight borrowing through various correspondent banks and the Company has access to $214 million in brokered deposits. In light of this, management believes there is sufficient liquidity to meet all reasonable borrower, depositor and creditor needs in the present economic environment.

Capital Requirements

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

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the following table) of Total and Tier I capital (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, 2011 and December 31, 2010, 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.

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

[redacted]									
September 30, 2011									
[redacted]									
[redacted]									
Tier I Capital (to Risk-Weighted Assets)		57,926	12.8		18,082	4		N/A	N/A
[redacted]									
[redacted]									
Total Capital (to Risk-Weighted Assets)	$	64,867	14.4%	$	36,151	8%	$	45,189	10%
[redacted]									
Tier I Capital (to Average Assets)		59,201	9.4		25,293	4		31,616	5
[redacted]									
December 31, 2010									
[redacted]									
Total Capital (to Risk-Weighted Assets)	$	60,500	13.1%	$	36,823	8%		N/A	N/A
[redacted]									
Tier I Capital (to Average Assets)		55,489	8.5		26,218	4		N/A	N/A
[redacted]									
Bank Only									
[redacted]									
Tier I Capital (to Risk-Weighted Assets)		57,131	12.4		18,405	4		27,608	6
[redacted]									

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Non-Performing Assets

As of September 30, 2011, our non-performing assets totaled $18.3 million or 2.89% of assets compared to $21.6 million or 3.28% of assets at December 31, 2010 (See table below.) The Company experienced a decrease of $6.4 million in non-accrual loans from December 31, 2010 to September 30, 2011, primarily due to $5.3 million moving to other real estate. As of September 30, 2011, non-accrual loans include $1.2 million in loans secured by real estate construction, $726 thousand in loans secured by farmland, $3.0 million in loans secured by 1-4 family residential properties and $1.1 million in loans secured by non-farm & non-residential real estate. Real estate loans composed 99.6% of the non-performing loans as of September 30, 2011 and 99.3% as of December 31, 2010. Forgone interest income on non-accrual loans totaled $558 thousand for the first nine months of 2011 compared to forgone interest of $436 thousand for the same time period in 2010. Accruing loans that are contractually 90 days or more past due as of September 30, 2011 totaled $859 thousand compared to $706 thousand at December 31, 2010, an increase of $153 thousand. The total nonperforming loans decreased $5.2 million from December 31, 2010 to September 30, 2011, resulting in a decrease in the ratio of nonperforming loans to loans of 123 basis points to 1.97%. In addition, the amount the Company has booked as Other Real Estate has increased $1.8 million from December 31, 2010 to September 30, 2011. As of September 30, 2011, the amount recorded as Other Real Estate totaled $10.3 million compared to $8.4 million at December 31, 2010. The overall increase is largely attributed to two loan customers. One of those loan customers specialized in commercial & land development properties had an outstanding note totaling $1.6 million that was on non-accrual at December 31, 2010. In March 2011, $1.1 million of the outstanding loan balance was repossessed and recorded into Other Real Estate Owned leaving the remaining balance to be charged off in April. The loan balance which was charged off in April 2011 was fully reserved for at March 31, 2011. The other loan customer specialized in real estate construction and had an outstanding loan balance of $1.2 million classified as nonaccrual at December 31, 2010. In May 2011, the property used as collateral for the loan was repossessed for the full amount of the outstanding loan balance of $1.2 million and is currently held as Other Real Estate Owned. The allowance as a percentage of non-performing and restructured loans and Other Real Estate Owned increased from 23% at December 31, 2010 to 31% at September 30, 2011.

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Nonperforming Assets

	9/30/11	12/31/10
	(in thousands)	
Non-accrual Loans	$ 6,075	$ 12,479
Accruing Loans which are Contractually past due 90 days or more	859	706
Troubled Debt Restructurings	1,110	
Total Nonperforming Loans	8,044	13,185
Other Real Estate	10,268	8,424
Total Nonperforming Loans and Other Real Estate	$ 18,312	$ 21,609
Nonperforming Loans as a Percentage of Loans	1.97%	3.20%
Nonperforming Loans and Other Real Estate as a Percentage of Total Assets	2.89%	3.28%
Allowance as a Percentage of Period-end Loans	1.39%	1.20%
Allowance as a Percentage of Non-performing Loans and Other Real Estate	31%	23%

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

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

Provision for Loan Losses

The loan loss provision for the first nine months was $1.90 million for 2011 and $1.95 million for 2010. 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.

In the first quarter of 2011, a problem loan of $4.8 million was identified, and contributions were made to the allowance for loan losses during the first quarter of 2011. Due to additional data obtained in the second quarter of 2011, this loan now has an allocated allowance for loan loss of $420 thousand. During the second quarter of 2011, two loans were charged off with losses of $377 thousand. Based on additional information obtained (i.e., signed sales contract, a decrease in occupancy levels during the first quarter of 2011, etc.) these losses were $288 thousand greater than calculated at December 31, 2010.

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Nonperforming loans have decreased $5.1 million since December 31, 2010 to $8.0 million as of September 30, 2011. Other real estate increased $1.9 million over this same time period as some nonperforming loans moved to other real estate.

The September 30, 2011 unallocated allowance of $124 thousand is comparable to the December 31, 2010 balance of $200 thousand. This reduction relates similar to the reduction in nonperforming loans mentioned previously.

Net charge-offs for the nine month period ended September 30, 2011 were $1.2 million compared to net charge-offs of $2.2 million for the same period in 2010. 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. Many of the charged-off loans recorded in the first half of 2010 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)	
	2011	**2010**
Balance at Beginning of Period	$ 4,925	$ 7,600
Amounts Charged-off:		
Commercial	36	19
Real Estate Construction	143	547
1-4 family residential	442	500
Multi-family residential	178	
Non-farm & non-residential	333	1,467
Agricultural		74
Consumer and other	701	814
Total Charged-off Loans	1,833	3,421
Recoveries on Amounts		
Previously Charged-off:		
Commercial	74	43
Real Estate Construction		
1-4 family residential	11	30
Multi-family residential	144	
Non-farm & non-residential	14	706
Agricultural	14	17
Consumer and other	415	447
Total Recoveries	672	1,243
Net Charge-offs	1,161	2,178
Provision for Loan Losses	1,900	1,950
Balance at End of Period	5,664	7,372
Loans		
Average	408,922	420,621
At September 30	408,202	415,417
As a Percentage of Average Loans:		
Net Charge-offs for the period	0.28%	0.52%

Provision for Loan Losses for the period	0.46%	0.46%
Allowance as a Multiple of Net Charge-offs (annualized)	3.7	2.5

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Loan Losses

	Three Months Ended September 30 (in thousands)			
	2011		2010	
Balance at Beginning of Period	$	5,642	$	6,461
Amounts Charged-off:				
Commercial		2		
Real estate construction		19		
1-4 family residential		231		160
Multi-family residential		84		
Non-farm & non-residential		4		15
Real estate mortgage				
Agricultural				
Consumer and other		221		342
Total Charged-off Loans		561		517
Recoveries on Amounts				
Previously Charged-off:				
Commercial				
Real estate construction				
1-4 family residential		6		8
Multi-family residential				
Non-farm & non-residential				563
Real estate mortgage				
Agricultural		2		
Consumer and other		125		157
Total Recoveries		133		728
Net Charge-offs		428		(211)
Provision for Loan Losses	$	450	$	700
Balance at End of Period	$	5,664	$	7,372
Loans				
Average	$	409,178	$	417,701
At September 30		408,202		415,417
As a Percentage of Average Loans:				
Net Charge-offs for the period		0.10%		(0.05)%
Provision for Loan Losses for the period		0.11%		0.17%
Allowance as a Multiple of Net Charge-offs (annualized)		3.3		(8.7)

Item 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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

Using interest rate shock simulations, the following table depicts the change in net interest income resulting from 100 and 300 basis point changes in rates on the Company s interest earning assets and interest bearing liabilities. The projections are based on balance sheet growth assumptions and repricing opportunities for new, maturing and adjustable rate amounts. As of September 30, 2011, 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 lower in each rising rate shock simulation than and higher in each falling rate shock 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, 2011 is as follows:

PROJECTED NET INTEREST INCOME

(dollars in thousands)

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

The projected net interest income report summarizing the Company s 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%

Projections from September 30, 2011, year one reflected a decline in net interest income of 2.3% with a 100 basis point decline compared to the 1.3% decline in 2010. The 100 basis point increase in rates reflected a 0.3% decrease in net interest income in 2011 compared to an increase of 0.5% in 2010.

EVE applies discounting techniques to future cash flows to determine the present value of assets, liabilities, and therefore equity. Based upon applying these techniques to the September 30, 2011 balance sheet, a 100 basis point increase in rates results in a 5.7% decrease in EVE. A 100 basis point decrease in rates results in a 4.8% decrease in EVE. These are within the Board approved limits.

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Item 4 CONTROLS AND PROCEDURES

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

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

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

Part II - Other Information

Item 1. Legal Proceedings

We are not a party to any material legal proceedings.

Item 1A. Risk Factors

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

Our results of operations and financial condition may be negatively affected if we are unable to meet a debt covenant and, correspondingly, unable to obtain a waiver regarding the debt covenant from the lender. From time to time we may obtain financing from other lenders. The loan documents reflecting the financing often require us to meet various debt covenants. If we are unable to meet one or more of our debt covenants, then we will typically attempt to obtain a waiver from the lender. If the lender does not agree to a waiver, then we will be in default under our borrowing obligation. This default could affect our ability to fund various strategies that we may have implemented resulting in a negative impact in our results of operations and financial condition.

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Other than the additional risk factors mentioned above, there are no material changes from the risk factors set forth under Part I, Item 1A Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2010, which you are encouraged to carefully consider.

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

ISSUER PURCHASES OF EQUITY SECURITIES

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid Per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans Or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
7/1/11 7/31/11		$		118,961 shares
8/1/11 8/31/11	13,474	16.52	13,474	105,487 shares
9/1/11 9/30/11	300	18.27	300	105,187 shares
Total	13,774		13,774	105,187 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. On May 17, 2011, the Board of Directors approved and authorized the Company s repurchase of an additional 100,000 shares. Shares will be purchased from time to time in the open market depending on market prices and other considerations. Through September 30, 2011, 294,813 shares have been purchased.

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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.

101* The following financial information from Kentucky Bancshares, Inc. Quarterly Report on Form 10-Q for the period ended September 30, 2011, filed with the SEC on November 14, 2011, formatted in Extensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets at September 30, 2011 and December 31, 2010, (ii) Consolidated Statements of Income and Comprehensive Income for the three and nine months ended September 30, 2011 and September 30, 2010, (iii) Consolidated Statement of Stockholders Equity for the nine months ended September 30, 2011, (iv) Consolidated Statements of Cash Flows for the nine months ended September 30, 2011 and September 30, 2010 and (v) Notes to Consolidated Financial Statements.

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

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 11/14/11

/s/Louis Prichard
Louis Prichard, President and C.E.O.

Date 11/14/11

/s/Gregory J. Dawson
Gregory J. Dawson, Chief Financial Officer