KENTUCKY BANCSHARES INC /KY/
Form 10-K
March 28, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2013

or

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: 33-96358

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**

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

Title of each class	**Name on each exchange on which registered**
Common Stock, no par value per share	OTC QB

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports to Section 13 or Section 15(d) of the Exchange Act. Yes o No x

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 (229.405 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. 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 definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer o

Non-accelerated filer x 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

Aggregate market value of voting stock held by non-affiliates as of June 30, 2013 was approximately $40.8 million. For purposes of this calculation, it is assumed that the Bank s Trust Department, directors, executive officers and beneficial owners of more than 5% of the registrant s outstanding voting stock are affiliates.

Number of shares of Common Stock outstanding as of March 20, 2014: 2,721,114.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant s definitive Proxy Statement for its Annual Meeting of Stockholders to be held on May 21, 2014 are incorporated by reference into Items 10, 11, 12, 13 and 14 of Part III.

PART I

Item 1. Business

General

Kentucky Bancshares, Inc. (Company, Kentucky, we, our and us) is a bank holding company headquartered in Paris, Kentucky. The Compa was organized in 1981 and is registered under the Bank Holding Company Act of 1956, as amended (BHCA).

The Company conducts its business in the Commonwealth of Kentucky through one banking subsidiary, Kentucky Bank.

Kentucky Bank is a commercial bank and trust company organized under the laws of Kentucky. Kentucky Bank has its main office in Paris (Bourbon County), with additional offices in Paris, Cynthiana (Harrison County), Georgetown (Scott County), Lexington (Fayette), Morehead (Rowan County), Nicholasville (Jessamine County), Sandy Hook (Elliott County), Versailles (Woodford County), Wilmore (Jessamine County) and Winchester (Clark County). The deposits of Kentucky Bank are insured up to prescribed limits by the Deposit Insurance Fund (DIF) of the Federal Deposit Insurance Corporation (FDIC).

The Company had total assets of $770.6 million, total deposits of $617.4 million and stockholders equity of $67.7 million as of December 31, 2013. The Company s principal executive office is located at 339 Main Street, Paris, Kentucky 40361, and the telephone number at that address is (859) 987-1795.

Business Strategy

The Company s current business strategy is to operate a well-capitalized, profitable and independent community bank with a significant presence in Central and Eastern Kentucky. Management believes the optimum way to grow the Company is by attracting new loan and deposit customers within its existing markets through its product offerings and premier customer service. Management continues to consider opportunities for branch expansion and will also consider acquisition opportunities that help advance its strategic objectives.

Lending

Kentucky Bank is engaged in general full-service commercial and consumer banking. A significant part of Kentucky Bank s operating activities include originating loans, approximately 86% of which are secured by real estate at December 31, 2013. Kentucky Bank makes commercial, agricultural and real estate loans to its commercial customers, with emphasis on small-to-medium-sized industrial, service and agricultural businesses. It also makes residential mortgage, installment and other loans to its individual and other non-commercial customers.

Loan Rates: Kentucky Bank offers variable and fixed rate loans. Loan rates on variable rate loans generally adjust upward or downward based on changes in the loan s index. Rate adjustments on variable rate loans are made from 1 day to 5 years. Variable rate loans may contain provisions that cap the amount of interest rate increases or decreases over the life of the loan. In addition to the lifetime caps and floors on rate adjustments, loans secured by residential real estate may contain provisions that limit annual increases at a maximum of 200 basis points. There is usually no annual limit applied to loans secured by commercial real estate.

Credit Risk: Commercial lending and real estate construction lending, generally include a higher degree of credit risk than other loans, such as residential mortgage loans. Commercial loans, like other loans, are evaluated at the time of approval to determine the adequacy of repayment sources and collateral requirements. Collateral requirements vary to some degree among borrowers and depend on the borrower s financial strength, the terms and amount of the loan, and collateral available to secure the loan. Credit risk results from the decreased ability or willingness to pay by a borrower. Credit risk also results when a liquidation of collateral occurs and there is a shortfall in collateral value as compared to a loan s outstanding balance. For construction loans, inaccurate initial estimates of a project s costs and the property s completed value could weaken the Company s position and lead to the property having a value that is insufficient to satisfy full payment of the amount of funds advanced for the property. Secured and unsecured consumer loans generally are made for automobiles, boats, and other motor vehicles. In most cases, loans are restricted to Kentucky Bank s general market area.

Other Products: Kentucky Bank offers its customers a variety of other services, including checking, savings, money market accounts, certificates of deposits, safe deposit facilities, credit cards and other consumer-oriented financial services. Kentucky Bank has Internet banking, including bill payment available to its customers at www.kybank.com. Through its Wealth Management Department, Kentucky Bank provides brokerage services, annuities, life and long term care insurance, personal trust and agency services (including management agency services).

Competition and Market Served

Competition: The banking business is highly competitive. Competition arises from a number of sources, including other bank holding companies and commercial banks, consumer finance companies, thrift institutions, other financial institutions and financial intermediaries. In addition to commercial banks, savings and loan associations, savings banks and credit unions actively compete to provide a wide variety of banking services. Mortgage banking firms, finance companies, insurance companies, brokerage companies, financial affiliates of industrial companies and government agencies provide additional competition for loans and for many other financial services. Kentucky Bank also currently competes for interest-bearing funds with a number of other financial intermediaries, including brokerage firms and mutual funds, which offer a diverse range of investment alternatives. Some of the Company s competitors are not subject to the same degree of regulatory review and restrictions that apply to the Company and its subsidiary bank. In addition, the Company must compete with much larger financial institutions that have greater financial resources than the Company.

Market Served. We primarily conduct our business in the Commonwealth of Kentucky. Our primary market areas consist of Bourbon, Clark, Elliott, Fayette, Harrison, Jessamine, Rowan, Scott, Woodford and surrounding counties in Kentucky. In October 2013, we filed a branch application for Richmond, Kentucky with the FDIC and received regulatory approval. The branch opened in the first quarter of 2014. Per capita personal income for Kentucky increased from $33,989 in 2011 to $35,643 in 2012, according to the Bureau of Labor Statistics. The Bureau of Labor Statistics reports that the unemployment rate in Kentucky has shown some improvement. The unemployment rate in Kentucky is 8.0% for December of 2013, compared to 8.1% for December of 2012.

Supervision and Regulation

Governing Regulatory Institutions: As a bank holding company, the Company is subject to the regulation and supervision of the Federal Reserve Board. The Company s subsidiary is subject to supervision and regulation by applicable state and federal banking agencies, including the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Kentucky Department of Financial Institutions. Kentucky Bank is also subject to various requirements and restrictions under federal and state law, including requirements to maintain reserves against deposits, restrictions on the types and amounts of loans that may be granted and the interest that may be charged thereon, and limitations on the types of investments that may be made and the types of services that may be offered. In addition to the impact of regulation, Kentucky Bank is affected significantly by the actions of the Federal Reserve Board as it attempts to control the money supply and credit availability in order to influence the economy.

Laws Protecting Deposits: There are a number of obligations and restrictions imposed on bank holding companies and their depository institution subsidiaries by federal law and regulatory policy. These obligations and restrictions are designed to reduce potential loss exposure to the depositors of such depository institutions and to the FDIC insured funds in the event the depository institution becomes in danger of default or is in default. For example, under a policy of the Federal Reserve Board with respect to bank holding company operations, a bank holding company is required to serve as a source of financial strength to its subsidiary depository institutions and commit resources to support such institutions in circumstances where it might not do so absent such policy. In addition, the cross-guarantee provisions of federal law require insured depository institutions under common control to reimburse the FDIC for any loss suffered or reasonably anticipated as a result of the default of a commonly controlled insured depository institution or for any assistance provided by the FDIC to a commonly controlled insured depository institution in danger of default.

The federal banking agencies also have broad powers under current federal law to take prompt corrective action to resolve problems of insured depository institutions. The extent of these powers depends upon whether the institutions in question are well capitalized , adequately capitalized , undercapitalized , significantly undercapitalized or critically undercapitalized , as such terms are defined under uniform regulation defining such capital levels issued by each of the federal banking agencies.

Deposit Insurance: The Company is subject to several deposit insurance assessments, which are described below:

FDIC Assessments. The Company s subsidiary bank is a member of the FDIC, and its deposits are insured by the FDIC s Deposit Insurance Fund up to the amount permitted by law. The Company s subsidiary bank is thus subject to FDIC deposit insurance assessments. The FDIC utilizes a risk-based assessment system that imposes insurance premiums based upon a risk matrix that takes into account a bank s capital level and supervisory rating.

In February 2009, the FDIC adopted a long-term DIF restoration plan as well as an additional emergency assessment for 2009. The restoration plan increased base assessment rates for banks in all risk categories in order to raise the DIF reserve ratio from its then current 0.40% to 1.15% within a certain number of years. Beginning April 1, 2009, the FDIC established an initial base assessment rate for each bank ranging from 12 to 45 basis points, depending upon a particular bank s risk category. Banks in the best risk category, which include the Company s subsidiary bank, were assessed initial base rates ranging from 12 to 16 basis points of assessable deposits.

The FDIC then adjusted the initial base rate assessment higher or lower to obtain the total base assessment rate based upon a bank s level of unsecured debt, secured liabilities, and brokered deposits. The total base assessment rate ranges between 7 and 77.5 basis points and is applied to a bank s assessable deposits when computing the FDIC insurance assessment amount.

On February 7, 2011, the FDIC amended its regulations to implement revisions to the Federal Deposit Insurance Act made by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) by modifying the definition of an institution s deposit insurance assessment base and to change the assessment rate adjustments. Under Dodd-Frank, the assessment base must, with some possible exceptions, equal average consolidated total assets minus average tangible equity. Previously, the assessment base was based on deposits. Dodd-Frank also requires the FDIC to adopt a DIF restoration plan to ensure that the reserve ratio increases to 1.35% from 1.15% of insured deposits by 2020.

Financing Corporation (FICO) Assessments. FICO assessment costs were $41 thousand in 2013, $40 thousand in 2012 and $47 thousand for 2011. FICO is a mixed-ownership government corporation established by the Competitive Equality Banking Act of 1987 possessing assessment powers in addition to the FDIC. The FDIC acts as a collection agent for FICO, whose sole purpose is to function as a financing vehicle for the now defunct Federal Savings & Loan Insurance Corporation. Outstanding FICO bonds, which are 30-year noncallable bonds, mature in 2017 through 2019.

Temporary Liquidity Guarantee Program (TLGP). The Company s participation in the FDIC s Transaction Account Guarantee Program initiated during the fourth quarter of 2008 also contributed to an increase in deposit insurance premiums. The TLGP consists of two separate programs implemented by the FDIC in October 2008. This includes the Debt Guarantee Program (DGP) and the Transaction Account Guarantee Program (TAGP). These programs were initially provided at no cost to participants during the first 30 days. Eligible institutions that do not opt out of either of these programs become participants by default and will incur the fees assessed for taking part.

Under the DGP, the FDIC will guarantee senior unsecured debt issued on or after October 14, 2008 through June 30, 2009 up to certain limits by participating entities. The FDIC will provide guarantee coverage for debt issued between those dates until the earlier of the maturity date of the debt or June 30, 2012. The Company chose to opt out of the DGP.

Under the TAGP, the FDIC guaranteed 100% of certain noninterest bearing transaction accounts up to any amount to participating FDIC insured institutions. This unlimited coverage expired December 31, 2012. The Company opted to participate in the TAGP; as such, it incurred an additional quarterly-assessed fee on balances in noninterest bearing transaction accounts exceeding the recently increased $250 thousand deposit limit that became effective on November 13, 2008. The previous deposit insurance limit amount was $100 thousand.

Dodd-Frank Wall Street Reform and Consumer Protection Act: Dodd-Frank was signed into law by the President on July 21, 2010, and represents a significant change in the American financial regulatory environment affecting all Federal financial regulatory agencies and affecting almost every aspect of the nation s financial services industry. Dodd-Frank includes, among others, the following:

- the creation of a Financial Stability Oversight Counsel to identify emerging systemic risks and improve interagency cooperation;
- the establishment of the same or strengthened capital and liquidity requirements for bank holding companies that apply to insured depository institutions;
- restrictions in proprietary trading and investing in or sponsoring of any hedge fund or private equity fund;
- the establishment of minimum credit risk retention requirements relating to securitizations;
- the establishment of detailed asset-level and data-level disclosure requirements relating to loan brokers and originators;
- codification and expansion of the source of strength doctrine as a statutory requirement. The source of strength doctrine represents the long held policy view by the Federal Reserve that a bank holding company should serve as a source of financial strength for its subsidiary banks;
- a permanent increase of the previously implemented temporary increase of FDIC deposit insurance to $250,000;
- authorization for financial institutions to pay interest on business checking accounts;
- changes in the calculation of FDIC deposit insurance assessments, such that the assessment base will no longer be the institution s deposit base, but instead, will be its average consolidated total assets less its average tangible equity;
- expanded restrictions on transactions with affiliates and insiders under Section 23A and 23B of the Federal Reserve Act and lending limits for derivative transactions, repurchase agreements and securities lending and borrowing transactions;

- provisions for new disclosure and other requirements regarding corporate governance and executive compensation;

- the creation of a Consumer Financial Protection Bureau, which is authorized to promulgate consumer protection regulations relating to bank and non-bank financial products and examine and enforce these regulations on institutions with more than $10 billion in assets.

Many of the requirements of Dodd-Frank will be implemented over time and most will be subject to regulations to be implemented or which will not become fully effective for several years.

Volcker Rule: On December 10, 2013, in implementing section 619 of the Dodd-Frank Act, the final Volcker Rule was approved by the OCC, the Federal Reserve, the FDIC, the SEC, and the Commodities Futures Trading Commission (CFTC). The Volcker Rule attempts to reduce risk and banking system instability by restricting U.S. banks from investing in or engaging in proprietary trading and speculation and imposing a strict framework to justify exemptions for underwriting, market making and hedging activities. U.S. banks will be restricted from investing in funds with collateral comprised of less than 100% loans that are not registered with the SEC and from engaging in hedging activities that do not hedge a specific identified risk. The Company does not believe the Volcker Rule will have a significant effect on operations.

Consumer Regulations: In addition to the laws and regulations discussed above, Kentucky Bank is also subject to certain consumer laws and regulations that are designed to protect consumers in transactions with banks. While the list set forth herein is not exhaustive, these laws and regulations include the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Real Estate Settlement Procedures Act, the Fair Housing Act and the Fair and Accurate Transactions Act, among others. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with clients when taking deposits or making loans. These laws also limit Kentucky Bank s ability to share information with affiliated and unaffiliated entities. The bank must comply with the applicable provisions of these consumer protection laws and regulations as part of its ongoing business operations.

Dividend Restrictions: There are various legal and regulatory limits on the extent to which the Company s subsidiary bank may pay dividends or otherwise supply funds to the Company. In addition, federal and state regulatory agencies also have the authority to prevent a bank or bank holding company from paying a dividend or engaging in any other activity that, in the opinion of the agency, would constitute an unsafe or unsound practice. Dividends paid by the subsidiary bank have provided substantially all of the Company s operating funds, and this may reasonably be expected to continue for the foreseeable future.

Employees

At December 31, 2013, the number of full time equivalent employees of the Company was 208.

Nature of Company s Business

The business of the Company is not seasonal. The Company s business does not depend upon a single customer, or a few customers, the loss of any one or more of which would have material adverse effect on the Company. No material portion of the Company s business is subject to renegotiation of profits or termination of contracts or subcontracts at the election of any governmental entity.

Available Information

The Company files annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports with the Securities and Exchange Commission (SEC) pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934. The public may read and copy any material the Company files with the SEC at the SEC s Public Reference Room at 100 F Street, NE, Washington, DC 20549 and may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC on its website at www.sec.gov. The Company s website is located at www.kybank.com.

Item 1A. Risk Factors

There are factors, many beyond our control, which may significantly affect the Company s financial position and results of operations. Some of these factors are described below in the sections titled financial risk, business risk and operational risk. These risks are not totally independent of each other; some factors affect more than one type of risk. These include regulatory, economic, and competitive environments. As part of the annual internal audit plan, our risk management department meets with management to assess these risks throughout the Company. Many risks are further addressed in other sections of this Form 10-K document. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair the Company s business operations. This report is qualified in its entirety by these risk factors.

Industry Risk

Industry risk includes risks that affect the entire banking service industry.

Significant decline in general economic conditions will negatively affect the financial results of our banking operations. Our success depends on general economic conditions both locally, nationally, and to a lesser extent, internationally. Economic conditions in the United States and abroad deteriorated significantly in the latter part of 2008 and such weakened conditions continued through 2013. While economic conditions have improved in some areas, business activity remains low, particularly in real estate. Further, the March 2011 earthquake in Japan and resulting devastation has affected and may continue to affect the ability of our customers, who work for or contract with the Toyota car manufacturing facility located in Georgetown, Kentucky, to repay mortgage or commercial business loans. Many businesses are still in serious difficulty due to reduced consumer spending and continued liquidity challenges in the market. The housing market is still depressed as reflected by a high level of foreclosures and continued unemployment. These factors have affected the performance of mortgage loans and resulted in financial institutions, including government-sponsored entities, in making significant write-downs of asset values of mortgage-backed securities, credit default swaps and other derivative and cash securities. Some financial institutions have failed. Many financial institutions and institutional investors have tightened the availability of credit to borrowers and other financial institutions, which, in turn, results in more loan defaults and decreased business activity. Consumer confidence regarding the economy is low and the financial markets reflect this lack of confidence. Most of our customers are in the Central Kentucky area, and have been directly affected by this recession. Local economic conditions have affected the demand of customers for loans, the ability of some borrowers to repay these loans and the value of the collateral securing these loans. Loan growth is critical to our profitability. We do not expect significant improvement in the economy in the near future, and future declines in the economy will likely make the credit market crisis worse.

The exercise of regulatory power may have negative impact on our results of operations and financial condition. We are subject to extensive regulation, supervision and examination by federal and state banking authorities. Any change in applicable regulations or federal or state legislation could have a substantial impact on our operations. Additional legislation and regulations may be enacted or adopted in the future that could significantly affect our powers, authority and operations, which have a material adverse effect on the financial condition and results of operations. For example, in response to the economic downturn and financial crisis, the U.S. government has enacted legislation by passing the Emergency Economic Stabilization Act of 2008 (EESA) followed by the American Recovery and Reinvestment Act of 2009 (the Recovery Act), and Dodd-Frank in 2010. These Acts have enabled, and will enable the U.S. Treasury, the FDIC and the Federal Reserve Board to develop programs, such as the Capital Purchase Program, the Financial Stability Plan and the foreclosure prevention program, to improve funding to consumers, increase interbank lending and reduce home foreclosures. The U.S. government continues to closely evaluate the economy, the effect of its legislation and resulting programs and initiatives on the economy. We expect that the U.S. government will continue to refine these programs and develop new programs. Our business, financial condition, results of operations, liquidity and access to capital and credit will likely be negatively affected if the economy worsens or the financial markets do not stabilize.

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 has required and continues to 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. See previous discussion under Regulation and Supervision for more information on the Dodd-Frank Act.

Higher FDIC Deposit Insurance Premiums and Assessments Could Adversely Affect Our Financial Condition. FDIC insurance premiums increased substantially in 2009 and 2010 but decreased in 2011 and 2012. The Company may have to pay significantly higher FDIC premiums in the future. Market developments have significantly depleted the insurance fund of the FDIC and reduced the ratio of reserves to insured deposits. Under the Federal Deposit Insurance Act, as amended by Dodd-Frank, the FDIC must establish and implement a plan to restore the Deposit Insurance Fund s designated reserve ratio to 1.35% of insured deposits by 2020. The FDIC must continue to assess and consider the appropriate level of the designated reserve ratio annually by considering each of the following: risk of loss to the insurance fund; economic conditions affecting the banking industry; the prevention of sharp swings in the assessment rates; and any other factors the FDIC deems important. In December 2010 the FDIC announced that it had established the long-term reserve ratio at 2.0%.

As a result of Dodd-Frank, the FDIC has revised its DIF restoration plan by changing the calculation of FDIC deposit insurance assessments; the assessment base will no longer be the institution s deposit base, but instead, will be its average consolidated total assets less its average tangible equity. These changes may result in higher insurance premiums and could significantly increase the Company s non-interest expense in future periods. Any increase in assessments could adversely impact the Company s future earnings and liquidity.

The effect of changes to banking capital standards could negatively impact the Company s regulatory capital and liquidity. In December 2010 and revised in June 2011, the Basel Committee on Banking Supervision issued final rules related to global regulatory standards on bank capital adequacy and liquidity. The new rules present details of the Basel III framework, which includes increased capital requirements and limits the types of instruments that can be included in Tier 1 capital. Basel III implementation in the U.S. will require that regulations and guidelines be issued by U.S. banking regulators, which may significantly differ from the recommendations published by the Basel Committee.

The Company cannot predict at this time the precise content of capital and liquidity guidelines or regulations that may be adopted by regulatory agencies having authority over us and our subsidiary, or the impact that any changes in regulation would have on the Company. However, we expect that the new standards will generally require the Company or our banking subsidiary to maintain more capital, with common equity as a more predominant component, or manage the configuration of our assets and liabilities in order to comply with new liquidity requirements, which could significantly impact our return on equity, financial condition, operations, capital position and ability to pursue business opportunities.

Increased competition from other providers may adversely affect our financial condition and results of operations. We face vigorous competition from banks and other financial institutions. This competition may reduce or limit our margins on banking services, reduce market share and adversely affect results of operations and financial condition.

Many other banks and financial institutions have substantially greater resources and lending limits, larger branch systems and a wider array of banking services. Additionally, we encounter competition from both de novo and smaller community banks entering the markets we are currently in. We also compete with other providers of financial services, such as money market mutual funds, brokerage firms, consumer finance companies and insurance companies.

Financial Risk

Financial risk components include, but are not limited to, credit risk, interest rate risk, goodwill impairment, market risk and liquidity risk. We have adopted various policies to minimize potential adverse effects of interest rate, market and liquidity risks. However, even with these policies in place, a change in interest rates could negatively impact our results of operations or financial position.

Defaults in the repayment of loans may negatively impact our business. Credit risk is most closely associated with lending activities at financial institutions. Credit risk is the risk to earnings and capital when a customer fails to meet the terms of any contract or otherwise fails to perform as agreed. Credit risk arises from all activities where the Company is dependent on issuer, borrower, or counterparty performance, not just traditional lending activities. For example, the investment security portfolio has inherent credit risk as do counterparties in derivative contracts. Credit risk encompasses a broad range of financial institution activities and includes items reflected both on and off the balance sheet.

Management makes various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of its borrowers and the value of real estate and other assets serving as collateral for repayment of many of the loans. In determining the size of the allowance for loan losses, management considers, among other factors, the Company s loan loss experience and an evaluation of economic conditions. If these assumptions prove to be incorrect, the current allowance may not be sufficient to cover future loan losses and adjustments may be necessary to allow for different economic conditions or adverse developments in the loan portfolio. Material additions to the Company s allowance would materially decrease our net income.

Fluctuations in interest rates may negatively impact our banking business. Interest rate risk focuses on the impact to earnings and capital arising from movements in interest rates. Interest rate risk focuses on the value implications for accrual portfolios (e.g., available-for-sale portfolios) and includes the potential impact to the Company s accrual earnings as well as the economic perspective of the market value of portfolio equity. The interest rate risk is comprised of repricing risk, basis risk, yield curve risk and options risk. Repricing risk represents the risk associated with the differences in timing of cash flows and rate changes with our products. Basis risk represents the risk associated with changing rate relationships among varying yield curves. Yield curve risk is associated with changing rate relationships over the maturity structure. Options risk is associated with interest-related options, which are embedded in our products.

Changes in market multiples may negatively affect the value of Goodwill. Goodwill resulting from business combinations prior to January 1, 2009 represents the excess of the purchase price over the fair value of the net assets of businesses acquired. Goodwill resulting from business combinations after January 1, 2009, is generally determined as the excess of the fair value of the consideration transferred, plus the fair value of any noncontrolling interests in the acquiree, over the fair value of the net assets acquired and liabilities assumed as of the acquisition date. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually. The Company has selected December 31 as the date to perform the annual impairment test. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Goodwill is the only intangible asset with an indefinite life on our balance sheet. At a minimum, management is required to assess goodwill and other intangible assets annually for impairment. This assessment involves estimating cash flows for future periods, preparing analyses of market multiples for similar operations, and estimating the fair value of the reporting unit to which the goodwill is allocated. If these variables change negatively, the Company would be required to take a charge against earnings to write down the asset to the lower fair value.

Changes in market factors may negatively affect the value of our investment assets. Market risk focuses on the impact to earnings and capital arising from changes in market factors (e.g., interest rates, market liquidity, volatilities, etc.) that affect the value of traded instruments. Market risk includes items reflected both on and off the balance sheet. Market risk focuses primarily on mark-to-market portfolios (e.g., accounts revalued for financial statement presentation).

Our inability to maintain appropriate levels of liquidity may have a negative impact on our results of operations and financial condition. Liquidity risk focuses on the impact to earnings and capital resulting from our inability to meet our obligations as they become due in the normal course of business without incurring significant losses. It also includes the management of unplanned decreases or changes in funding sources as well as managing changes in market conditions, which could affect the ability to liquidate assets in the normal course of business without incurring significant losses. Liquidity risk includes items both on and off the balance sheet.

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.

Business Risk

Business risk is composed mainly of legal (compliance) risk, strategic risk and reputation risk.

Our results of operations and financial condition are susceptible to legal or compliance risks. Legal or compliance risk is the risk to earnings or capital arising from the impact of unenforceable contracts, lawsuits, adverse judgments, violations or nonconformance with laws, rules, regulations, prescribed practices, or ethical standards. The risk also arises in situations where laws or rules governing certain products or activities of our customers may be ambiguous or untested. This risk is not limited to the traditional thinking that legal/compliance risk is only associated with consumer protection laws. It includes the exposure to litigation from all aspects of both traditional and nontraditional financial institution activities.

Incorrect strategic decisions may have a negative impact on our results of operations and financial condition.

Adverse publicity may have a negative impact on our business. Reputation risk is the risk to earnings and capital arising from negative public opinion. This affects the ability to establish new relationships or services or to continue servicing existing relationships. Examiners will assess reputation risk by recognizing the potential effect the public s opinion could have on our franchise value.

Operational Risk

An inability to process transactions may have a negative impact on our business. Operational risk is present on a daily basis through our processing of transactions and is pervasive in all products and services provided to our customers. It can be defined as the impact to earnings and capital from problems encountered in processing transactions. Operational risk is a function of internal controls, operating processes, management information systems, and employee integrity.

Technology Risk

Systems failure, interruption or breach of security may have a negative impact on our business. Communications and information systems are essential to the conduct of Kentucky Bank s business, as such systems are used to manage customer relationships, deposits, loans, general ledger accounts, financial reporting and regulatory compliance. While Kentucky Bank has established policies and procedures to prevent or limit the impact of systems failures, interruptions, and security breaches, there can be no assurance that such events will not occur or that they will be adequately addressed if they do. In addition, any compromise of Kentucky Bank s information security systems could deter customers from using Kentucky Bank s web site and its internet banking service, both of which involve the transmission of confidential information. Although Kentucky Bank relies on commonly used security and processing systems to provide the security and authentication necessary to ensure the secure transmission and processing of data, these precautions may not protect our systems from all compromises or breaches of security.

The business continuity of third-party providers may have a negative impact on our technology operations. Kentucky Bank outsources certain of its data processing to third-party providers. If third-party providers encounter difficulties, or if the Bank has difficulty communicating with them, Kentucky Bank s ability to adequately process and account for customer transactions could be affected, and its business operations could be adversely impacted. Threats to information security also exist in the processing of customer information through various other vendors and their personnel.

We and our subsidiary bank have addressed technology risks through the use of logon and user access controls, transaction limits, firewalls, antivirus software, intrusion protection monitoring and third party vulnerability scans. Systems failure or interruption has been addressed by adopting a disaster recovery and contingency plan. In addition, for all third-party providers of data processing services, we obtain and review audit reports prepared by independent registered public accounting firms regarding their financial condition and the effectiveness of their internal controls.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

The Company s corporate headquarters is located at 339 Main Street, Paris, KY 40361, which it owns. The main banking office of Kentucky Bank is located at 401 Main Street, Paris, Kentucky 40361. In addition, Kentucky Bank serves customer needs at 12 other locations. All locations offer a full range of banking services. Kentucky Bank owns all of the properties at which it conducts its business. The Company owns approximately 100,000 square feet of office space and leases approximately 9,600 square feet of office space.

Note 6 to the Company s audited and consolidated financial statements included in Item 8 (2013 Consolidated Financial Statements and Notes) contains additional information relating to amounts invested in premises and equipment.

Kentucky Bank Banking Offices

401 Main Street, Paris, KY 40361

2021 South Main Street, Paris, KY 40361

24 West Lexington Avenue, Winchester, KY 40391

1975 By Pass Road, Winchester, KY 40391

144 South KY 7, Sandy Hook, KY 41171

360 East Vine Street, Suite 100, Lexington, KY 40507

939 US Hwy 27 South, Cynthiana, KY 41031

920 North Main Street, Nicholasville, KY 40356

108 East Main Street, Wilmore, KY 40390

400 West First Street, Morehead, KY 40351

1500 Flemingsburg Road, Morehead, KY 40351

260 Blossom Park Drive, Georgetown, KY 40324

103 West Showalter Drive, Georgetown, KY 40324

520 Marsailles Road, Versailles, KY 40383

Item 3. Legal Proceedings

The Company and its subsidiary are from time to time involved in routine legal proceedings occurring in the ordinary course of business that, in the aggregate, management believes will not have a material impact on the Company s financial condition and results of operation. Further, we maintain liability insurance to cover some, but not all, of the potential liabilities normally incident to the ordinary course of our businesses as well as other insurance coverage s customary in our business, with coverage limits as we deem prudent.

Kentucky Bancshares, Inc. (the Company) terminated the Kentucky Bancshares, Inc. Retirement Plan and Trust (the Plan) in a standard termination, with a termination date of December 31, 2008. Prior to such termination, the Pension Protection Act of 2006 (PPA) had amended Internal Revenue Code (IRC) Section 417(e)(3) in part by changing the definition of applicable interest rate in a manner that in most cases (when combined with other changes to IRC Section 417(e)(3)) would result in a decrease in the value of a participant s or beneficiary s plan benefits under pension plans such as the Company s Plan with the new definition applicable (for most plans, including the Plan) to lump sums with annuity starting dates in or after the 2008 plan year. The Plan had determined in mid-2008 to comply with IRC Section 417(e)(3), as amended by PPA, by using the assumptions governing minimum lump sums, rather than by using the pre-PPA minimum lump sum assumptions, and operated the Plan in compliance with that decision. As permitted by the IRC, the Plan was amended on February 24, 2009 (after the termination of the Plan on December 31, 2008) to formalize that decision in accordance with Section 1107 of PPA.

The Internal Revenue Service issued a favorable determination as to the Plan termination in July 2010. Subsequent to Plan termination and distributions to Plan participants, the Plan was selected for audit by the PBGC. The PBGC asserted that the February, 2009 amendment to the Plan violated PBGC Regulation Section 4041.8(a) because the amendment served to lower benefits to Plan beneficiaries. The PBGC filed a Complaint in May 2013 in United States District Court (Eastern District of Kentucky) to require the Company to make additional distributions to Plan beneficiaries. On March 17, 2014, the United States District Court (Eastern District of Kentucky) issued an Opinion and Order entering judgment in favor of the PBGC and ruling that the Company must comply with the PBGC s determination respecting the Plan. The Company is appraising its options with respect to this judgment, including an appeal of the decision. However, in light of the court s opinion, the Company has now accrued approximately $1.6 million as of December 31, 2013 for this matter. After taking into account income tax adjustments and indemnification undertakings from professionals who assisted the Company in the termination of the Plan, the impact is an approximate $470,000 decrease to the net income disclosed on Form 8-K filed by the Company on January 31, 2014. Moreover, in the event the subject court decision is not overturned, the Company believes it has claims for further contribution towards payment of this liability from professionals who assisted the Company in the termination of the Plan.

PART II

Item 5. Market for Common Equity and Related Stockholder Matters

Market Information

There is no established public trading market for the Company s Common Stock. The Company s Common Stock is not listed on any national securities exchange. However, it is traded on the OTC Bulletin Board under the symbol KTYB.OB . Trading in the Common Stock has been infrequent, with retail brokerage firms making the market. The following table sets forth the high and low closing sales prices of the Common Stock from the OTC Bulletin Board and the dividends declared thereon, for the periods indicated below:

		High	Low	Dividend
2013	Quarter 4	$ 26.25	$ 24.15	$ 0.24
	Quarter 3	27.67	24.75	0.24
	Quarter 2	25.00	23.03	0.24
	Quarter 1	24.50	18.50	0.24
2012	Quarter 4	$ 21.10	$ 17.96	$ 0.23
	Quarter 3	23.00	20.27	0.23
	Quarter 2	23.90	20.20	0.23
	Quarter 1	23.49	19.05	0.23

Note 16 to the Company s 2013 Consolidated Financial Statements and Notes included Item 8 contains additional information relating to amounts available to be paid as dividends.

Holders

As of December 31, 2013 the Company had 2,717,434 shares of Common Stock outstanding and approximately 517 holders of record of its Common Stock.

Dividends

During 2013 and 2012, the Corporation declared quarterly cash dividends aggregating $0.96 and $0.92 per share, respectively.

Purchases of Equity Securities by the Issuer and Affiliates Purchasers

The table below lists 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 Unit) that May Yet Be Purchased Under the Plans or Programs
10/1/13 - 10/31/13					91,024shares
11/1/13 - 11/30/13	790	$	24.15	790	90,234 shares
12/1/13 - 12/31/13	2,510	$	25.00	2,510	87,724 shares
Total	3,300			3,300	87,724 shares

On October 25, 2000, the Company announced that its Board of Directors approved a stock repurchase program. The Company was authorized 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 purchase of 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 December 31, 2013, 312,276 shares have been purchased, with the most recent share repurchase under the Board-approved stock repurchase program having occurred on February 28, 2014.

Securities Authorized for Issuance under Equity Compensation Plans

The following table sets forth certain information regarding Company compensations plans under which equity securities of the company are authorized for issuance.

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted average exercise price of outstanding options warrants and rights	No. of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column 1)
Plans Approved By Stockholders:			
1993 Nonemployee Directors Stock Ownership Incentive Plan	4,000	30.96	
1999 Employee Stock Option Plan	15,100	31.64	
2005 Restricted Stock Grant Plan			12,470
2009 Stock Award Plan			149,100

Performance Graph

The information included under the caption Performance Graph in this Item 5 of this Form 10-K is not deemed to be soliciting material or to be filed with the SEC or subject to Regulation 14A or 14C under the Securities Exchange Act of 1934 or to the liabilities of Section 18 of the Securities Exchange Act of 1934, and will not be deemed to be incorporated by reference into any filings we make under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent we specifically incorporate it by reference into such a filing.

The following graph compares the change in the cumulative total stockholder return on our common stock with the cumulative total return of listed NASDAQ banks and the Russell Microcap Index from 2008 through 2013. This comparison assumes $100 invested on December 31, 2008 in (a) our common stock,(b) NASDAQ Bank and (c) the Russell Microcap Index.

Item 6. Selected Financial Data (in thousands except per share data)

The following selected financial data should be read in conjunction with the Company s Consolidated Financial Statements and the accompanying notes presented in Item 8.

	At or For the Year Ended December 31				
	2013	2012	2011	2010	2009
CONDENSED STATEMENT OF INCOME:					
Total Interest Income	$ 28,168	$ 28,233	$ 29,889	$ 30,276	$ 31,929
Total Interest Expense	3,456	3,716	5,565	10,067	12,509
Net Interest Income	24,712	24,517	24,324	20,209	19,420
Provision for Losses	1,050	2,050	2,450	3,250	3,450
Net Interest Income After Provision for Losses	23,662	22,467	21,874	16,959	15,970
Noninterest Income	10,222	11,870	9,347	10,566	10,214
Noninterest Expense	27,203	25,686	24,615	22,021	21,152
Income Before Income Tax Expense	6,681	8,651	6,606	5,504	5,032
Income Tax Expense	859	1,643	919	565	184
Net Income	5,822	7,008	5,687	4,939	4,848
SHARE DATA:					
Basic Earnings per Share (EPS)	$ 2.15	$ 2.59	$ 2.09	$ 1.81	$ 1.77
Diluted EPS	2.15	2.59	2.09	1.81	1.77
Cash Dividends Declared	0.96	0.92	0.88	0.84	0.80
Book Value	24.90	27.21	25.38	22.29	22.25
Average Common Shares-Basic	2,705	2,705	2,719	2,732	2,737
Average Common Shares-Diluted	2,709	2,708	2,720	2,732	2,737
SELECTED BALANCE SHEET DATA:					
Loans, net	$ 463,214	$ 423,928	$ 406,025	$ 406,905	$ 417,818
Investment Securities	230,396	192,780	180,419	176,867	168,411
Total Assets	770,579	701,010	659,453	658,943	675,231
Deposits	617,400	590,425	542,924	537,401	536,446
Securities sold under agreements to repurchase and other borrowings	12,867	4,315	4,524	7,179	8,226
Federal Home Loan Bank advances	57,847	17,449	30,326	43,206	56,096
Stockholders Equity	67,672	74,009	68,953	61,043	60,966
PERFORMANCE RATIOS: (Average Balances)					
Return on Assets	0.80%	1.03%	0.87%	0.71%	0.72%
Return on Stockholders Equity	8.12%	9.70%	8.74%	7.84%	8.10%
Net Interest Margin (1)	3.85%	4.19%	4.35%	3.43%	3.36%
Equity to Assets (annual average)	9.84%	10.60%	9.97%	9.07%	8.92%
SELECTED STATISTICAL DATA:					
Dividend Payout Ratio	41.53%	35.71%	42.24%	46.62%	45.28%
Number of Employees (at period end)	208	193	194	184	182
ALLOWANCE COVERAGE RATIOS:					
Allowance to Total Loans	1.16%	1.41%	1.42%	1.20%	1.79%

Net Charge-offs as a Percentage of Average Loans	0.37%	0.44%	0.38%	1.42%	0.31%

(1) Tax equivalent

Item 7. Management s Discussion and Analysis

This section presents an analysis of the consolidated financial condition of the Company and its wholly-owned subsidiary, Kentucky Bank, at December 31, 2013, 2012 and 2011, and the consolidated results of operations for each of the years in the three year period ended December 31, 2013. The following discussion and analysis of financial condition and results of operations should be read in conjunction with the 2013 Consolidated Financial Statements and Notes included in Item 8. When necessary, reclassifications have been made to prior years data throughout the following discussion and analysis for purposes of comparability with 2013 data.

Critical Accounting Policies

Overview. The accounting and reporting policies of the Company and its subsidiary are in accordance with accounting principles generally accepted in the United States and conform to general practices within the banking industry. Significant accounting policies are listed in Note 1 of the Company s 2013 Consolidated Financial Statements and Notes included in Item 8. Critical accounting and reporting policies include accounting for loans and the allowance for loan losses, goodwill and fair value. Different assumptions in the application of these policies could result in material changes in the consolidated financial position or consolidated results of operations.

Loan Values and Allowance for Loan Losses. Loans are stated at the amount of unpaid principal, reduced by an allowance for loan losses. Interest on loans is recognized on the accrual basis, except for those loans on the nonaccrual status. Interest income received on such loans is accounted for on the cash basis or cost recovery method. The allowance for loan losses is a valuation allowance for probable incurred credit losses. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. The accounting policies relating to the allowance for loan losses involve the use of estimates and require significant judgments to be made by management. The loan portfolio also represents the largest asset group on the consolidated balance sheets. Additional information related to the allowance for loan losses that describes the methodology and risk factors can be found under the captions *Asset Quality* and *Loan Losses* in this management s discussion and analysis of financial condition and results of operation, as well as Notes 1 and 4 of the Company s 2013 Consolidated Financial Statements and Notes.

Goodwill. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually. The Company has selected December 31 as the date to perform the annual impairment test. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Goodwill is the only intangible asset with an indefinite life on our balance sheet.

Fair Values. Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in the description of each asset and liability category in Note 17 of the Company s 2013 Consolidated Financial Statements and Notes. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

Forward-Looking Statements

This discussion contains forward-looking statements under the Private Securities Litigation Reform Act of 1995 that involve risks and uncertainties. Although the Company believes 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, the thoroughbred horse industry and the automobile industry relating to Toyota vehicles, in which the Company and its bank operate); competition for the Company 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 the Company has 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 the Company s customers; and other risks detailed in the Company s filings with the Securities and Exchange Commission, all of which are difficult to predict and many of which are beyond the control of the Company. The Company undertakes 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.

Overview

We conduct our business through our one bank subsidiary, Kentucky Bank. Kentucky Bank is engaged in general full-service commercial and consumer banking. A significant part of Kentucky Bank s operating activities include originating loans, approximately 86% of which are secured by real estate at December 31, 2013. Kentucky Bank makes commercial, agricultural and real estate loans to its commercial customers, with emphasis on small-to-medium-sized industrial, service and agricultural businesses. It also makes residential mortgages, installment and other loans to its individual and other non-commercial customers. Kentucky Bank s primary market is Bourbon, Clark, Elliott, Fayette, Harrison, Jessamine, Rowan, Scott, Woodford and surrounding counties in Kentucky.

Net income for the year ended December 31, 2013 was $5.8 million, or $2.15 per common share compared to $7.0 million, or $2.59 for 2012 and $5.7 million, or $2.09 for 2011. Earnings per share assuming dilution were $2.15, $2.59 and $2.09 for 2013, 2012 and 2011, respectively. For 2013, net income decreased $1.2 million, or 16.9%. Net interest income increased $195 thousand, the loan loss provision decreased $1.0 million, total other income decreased $1.6 million, while total other expenses increased $1.5 million and income tax expense decreased $785 thousand.

For 2012, net income increased $1.3 million, or 23.2%. Net interest income increased $193 thousand, the loan loss provision decreased $400 thousand, total other income increased $2.5 million, while total other expenses increased $1.1 million and income tax expense increased $724 thousand.

Return on average equity was 8.1% in 2013 compared to 9.7% in 2012 and 8.7% in 2011. Return on average assets was 0.80% in 2013 compared to 1.03% in 2012 and 0.87% in 2011.

Non-performing loans as a percentage of loans (including held for sale) were 2.22%, 3.51% and 1.83% as of December 31, 2013, 2012 and 2011, respectively.

RESULTS OF OPERATIONS

Net Interest Income

Net interest income, the Company s largest source of revenue, on a tax equivalent basis increased from $25.9 million in 2011 to $26.2 million in 2012, and to $26.3 million in 2013. The taxable equivalent adjustment (nontaxable interest income on state and municipal obligations net of the related non-deductible portion of interest expense) is based on our Federal income tax rate of 34%.

Average earning assets and interest bearing liabilities both increased from 2012 to 2013. Average earning assets increased $57.4 million, or 9.2%. Average investment securities increased $32.4 million primarily due to increased deposits. Average loans increased $26.5 million as a result of improved economic conditions and increased demand over 2012. Average interest bearing liabilities increased $39.5 million, or 8.6% during this same period. This change was primarily from an increase of $18.7 million in NOW and money market accounts, an increase of $11.2 million in savings deposits and an increase of $5.7 million in Federal Home Loan Bank advances. The Company continues to actively pursue quality loans and fund these primarily with deposits and Federal Home Loan Bank advances.

The bank prime rates have declined since 2006. Bank prime rates decreased 100 basis points in 2007, and another 400 basis points in 2008, and have remained unchanged since then. The tax equivalent yield on earning assets decreased from 4.78% in 2012 to 4.36% in 2013.

The volume rate analysis for 2013 that follows indicates that $2.3 million of the decrease in interest income is attributable to the decrease in rates, while the change in volume contributed to an increase of $2.2 million in interest income. Further, decreases in rates caused a decrease in the cost of interest bearing liabilities. The average rate of these liabilities decreased from 0.81% in 2012 to 0.69% in 2013. Based on the volume rate analysis that follows, the lower level of interest rates contributed to a decrease of $577 thousand in interest expense and a change in volume contributed to a $317 thousand increase in interest expense. In summary, the increase in the Company s 2013 net interest income is attributed mostly to an increase in volume in the loan and security portfolios and decreases in rates in time deposits and Federal Home Loan Bank advances.

The volume rate analysis for 2012 that follows indicates that $2.6 million of the decrease in interest income is attributable to the decrease in rates, while the change in rates volume contributed to an increase of $960 thousand in interest income. Further, decreases in rates and volume caused a decrease in the cost of interest bearing liabilities. The average rate of these liabilities decreased from 1.22% in 2011 to 0.81 in 2012. Based on the volume rate analysis that follows, the lower level of interest rates contributed to a decrease of $1.4 million in interest expense and a change in volume contributed to a $439 thousand decrease in interest expense. As a result, the increase in the Company s 2012 net interest income is attributed mostly to decreases in rates in time deposits and increases in non-interest bearing deposit accounts.

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 2013 vs. 2012 and 2012 vs. 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

	(in thousands)					
	2013 vs. 2012 Increase (Decrease) Due to Change in			2012 vs. 2011 Increase (Decrease) Due to Change in		
	Volume	**Rate**	**Net Change**	**Volume**	**Rate**	**Net Change**
INTEREST INCOME						
Loans	$ 1,431	$ (1,857)	$ (426)	$ 574	$ (1,258)	$ (684)
Investment Securities	790	(429)	361	369	(1,356)	(987)
Federal Funds Sold and Securities Purchased under Agreements to Resell				(3)	(2)	(5)
Deposits with Banks	(3)	3		19		19
Total Interest Income	2,218	(2,283)	(65)	959	(2,616)	(1,657)
INTEREST EXPENSE						
Deposits						
Demand	45	(82)	(37)	111	(301)	(190)
Savings	17	(5)	12	14	(12)	2
Negotiable Certificates of Deposit and Other Time Deposits	(22)	(175)	(197)	(311)	(921)	(1,232)
Securities sold under agreements to repurchase and other borrowings	118	(96)	22	(40)	14	(26)
Federal Home Loan Bank advances	159	(219)	(60)	(213)	(191)	(404)
Total Interest Expense	317	(577)	(260)	(439)	(1,411)	(1,850)
Net Interest Income	$ 1,901	$ (1,706)	$ 195	$ 1,398	$ (1,205)	$ 193

Average Consolidated Balance Sheets and Net Interest Analysis ($ in thousands)

	2013			2012			2011		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
ASSETS									
Interest-Earning Assets									
Securities Available for Sale (1)									
U.S. Treasury and Federal Agency Securities	$ 131,538	$ 2,145	1.63 %	$ 100,359	$ 1,527	1.52%	$ 86,706	$ 2,254	2.60%
State and Municipal obligations	81,471	2,771	3.40%	80,219	3,007	3.75%	82,137	3,279	3.99%
Other Securities	7,001	288	4.11%	7,001	308	4.40%	7,000	296	4.23%
Total Investment Securities	220,010	5,204	2.37%	187,579	4,842	2.58%	175,843	5,829	3.31%
Tax Equivalent Adjustment		1,556	0.71%		1,640	0.87%		1,596	0.91%
Tax Equivalent Total		6,760	3.07%		6,482	3.46%		7,425	4.22%
Federal Funds Sold and Agreements to Repurchase	290			389			4,783	5	0.10%
Interest-Bearing Deposits with Banks	17,238	29	0.17%	18,749	30	0.16%	6,753	11	0.16%
Loans, Net of Deferred Loan Fees (2)									
Commercial	48,877	2,380	4.87%	48,006	2,550	5.31%	46,852	2,567	5.48%
Real Estate Mortgage	378,468	19,191	5.07%	352,674	19,407	5.50%	342,979	20,007	5.83%
Installment	17,244	1,364	7.91%	17,369	1,403	8.08%	18,304	1,470	8.03%
Total Loans	444,589	22,935	5.16%	418,049	23,360	5.59%	408,135	24,044	5.89%
Total Interest-Earning Assets	682,127	29,725	4.36%	624,766	29,872	4.78%	595,514	31,485	5.29%
Allowance for Loan Losses	(5,838)			(5,949)			(5,483)		
Cash and Due From Banks	7,127			6,898			10,479		
Premises and Equipment	16,922			16,667			16,992		
Other Assets	28,871			39,261			35,198		
Total Assets	$ 729,209			$ 681,643			$ 652,700		
LIABILITIES									
Interest-Bearing Deposits									
Negotiable Order of Withdrawal (NOW) and Money Market Investment Accounts	$ 195,302	$ 418	0.21%	$ 176,654	$ 455	0.26%	$ 147,484	$ 645	0.44%
Savings	58,799	89	0.15%	47,577	77	0.16%	39,456	75	0.19%
Certificates of Deposit and Other Deposits	193,038	1,775	0.92%	195,207	1,972	1.01%	218,199	3,204	1.47%
Total Interest-Bearing Deposits	447,139	2,282	0.51%	419,438	2,504	0.60%	405,139	3,924	0.97%
Securities sold under agreements to repurchase and other borrowings	18,340	311	1.70%	12,218	288	2.36%	13,950	314	2.25%
Federal Home Loan Bank advances	35,435	863	2.44%	29,728	923	3.10%	36,052	1,327	3.68%
Total Interest-Bearing Liabilities	500,914	3,456	0.69%	461,384	3,715	0.81%	455,141	5,565	1.22%
Noninterest-Bearing Earning Demand Deposits	151,127			141,448			128,643		
Other Liabilities	5,442			6,552			3,830		
Total Liabilities	657,483			609,384			587,614		
STOCKHOLDERS EQUITY	71,726			72,259			65,086		
Total Liabilities and Stockholders Equity	$ 729,209			$ 681,643			$ 652,700		
Average Equity to Average Total Assets	9.84%			10.60%			9.97%		
Net Interest Income		24,713			24,517			24,324	
Net Interest Income (tax equivalent) (3)		26,269			26,157			25,920	
Net Interest Spread (tax equivalent) (3)			3.67%			3.97%			4.07%
Net Interest Margin (tax equivalent) (3)			3.85%			4.19%			4.35%

(1) Averages computed at amortized cost.

(2) Includes loans on a nonaccrual status and loans held for sale.

(3) Tax equivalent difference represents the nontaxable interest income on state and municipal securities net of the related non-deductible portion of interest expense.

Noninterest Income and Expenses

Noninterest income was $10.2 million in 2013 compared to $11.9 million in 2012 and $9.3 million in 2011. In 2013, decreases in gains on sold mortgage loans, gains on sold securities and service charges account for the majority of the decrease. In 2012, increases in gains on sold mortgage loans and gains on sold securities account for the majority of the increase.

Securities gains were $1.0 million in 2013, $1.8 million in 2012 and $1.2 million in 2011. These gains are primarily attributed to selling securities which had gains in market value due to declining interest rates and the related inverse relationship of interest rates and market values. Some securities gains were taken in 2013, 2012 and 2011 and used to offset additions to the loan loss reserve and write-downs of other real estate properties owned.

Gains on loans sold were $1.7 million, $2.3 million and $982 thousand in 2013, 2012 and 2011, respectively. Loans held for sale are generally sold after closing to the Federal Home Loan Mortgage Corporation. During 2013, the loan servicing fee income, net of amortization expense for the mortgage servicing right asset, increased $97 thousand, compared to an increase of $172 thousand in 2012. In 2013, the mortgage servicing right asset had a net valuation recovery of prior write-downs of $155 thousand compared to a net recovery of prior write-downs of $36 thousand in the valuation allowance in 2012. Proceeds from the sale of loans were $55 million, $67 million and $33 million in 2013, 2012 and 2011, respectively. The volume of loan originations is inverse to rate changes with historic low rates spurring activity. The volume of loan originations during 2013 was $54 million, $64 million in 2012, and $32 million in 2011.

Other noninterest income, excluding security net gains and gains on the sale of mortgage loans, was $7.6 million in 2013, $7.7 million in 2012 and $7.2 million in 2011. Service charge income, and more particularly overdraft income, is the largest contributor to these numbers. Overdraft income was $2.8 million in 2013, $3.4 million in 2012 and $3.7 million in 2011. The decreases in 2013 and 2012 are primarily attributable to the slower economy, increased consumer awareness and regulatory pressures. Debit card interchange income was the second largest contributor to noninterest income, excluding security gains and gains on the sale of mortgage loans. Debit card interchange income was $1.9 million in 2013, $1.9 million in 2012 and $1.7 million in 2011. Other income was $25 thousand in 2013, $93 thousand in 2012 and $190 thousand in 2011. The decrease in other income during 2013 was attributable to the bank recording a loss of $100 thousand for the sale of a former branch building. Likewise, other income was higher in 2011 due to the bank recording a gain of $55 thousand for the sale of a former branch building.

Noninterest expense increased $1.5 million in 2013 to $27.2 million, and increased $1.1 million in 2012 to $25.7 million from $24.6 million in 2011. The increase in salaries and benefits from $12.6 million in 2012 to $15.4 million in 2013 is attributable to a non-recurring expense of $973 thousand related to additional pension expense for the 2008 termination of the defined benefit pension plan, normal salary and benefit increases, an increase in full-time equivalent employees and increased incentive compensation. The number of full-time equivalent employees increased from 193 at December 31, 2012 to 208 at December 31, 2013. The increase in the number of employees is largely due to the new branch opened in Lexington, KY during the year. Incentive compensation expense increased $527 thousand in 2013 compared to 2012 due to the increased number of employees and the Bank achieving many of the goals as stated in the incentive compensation plan. The increase in salaries and benefits from $12.0 million in 2011 to $12.6 million in 2012 are attributable to normal salary and benefit increases. Incentive compensation was $148 thousand greater in 2012 compared to 2011. Occupancy expense increased $97 thousand in 2013 to $3.1 million and increased $75 thousand in 2012 to $3.0 million.

The largest component of occupancy expense, depreciation, decreased $83 thousand to $1.2 million in 2013, and increased $89 thousand to $1.3 million in 2012. Building repairs and maintenance increased $96 thousand during 2013 to $414 thousand and building and equipment rents increased $101 thousand during 2013 to $158 thousand. The increase in building repairs and maintenance is generally related to additional maintenance work the Company performed during the year. The increase in rent expense is due to the branch expansion into the Lexington, KY market during the year. Other noninterest expenses increased from $9.7 million in 2011 to $10.1 million in 2012 and decreased to $8.7 million in 2013. Repossession expenses, net of rental income, decreased $1.5 million in 2013 compared to 2012 to $267 thousand. The decrease was mostly attributed to net write-downs of other real estate properties owned decreasing from $991 thousand in 2012 to $63 thousand in 2013. Further, other real estate properties owned by the Company decreased from $4.2 million at December 31, 2012 to $3.4 million at December 31, 2013 resulting in a decrease in general expenses incurred with maintaining the properties. FDIC insurance decreased $86 thousand in 2013 compared to 2012 due to changes provided by Dodd-Frank in the calculation the FDIC uses to assess premiums. Legal and professional fees increased $150 thousand from 2012 to 2013, mainly from additional professional services obtained by the Company during the year and early cancellation of a contract by the Bank. Advertising and marketing expenses incurred increased $81 thousand during 2013 compared to 2012 due to the branch expansion in 2013. Taxes other than payroll, property and income increased $32 thousand in 2013 from 2012 to $843 thousand. Data processing was $1.3 million in 2013 compared to $1.2 million in 2012, an increase of $160 thousand. The increase in data processing expense was mostly related to additional services the Company obtained throughout the year. Amortization of core deposits was $215 thousand in 2013, compared to $234 thousand in 2012. See Note 7 in the Company s Consolidated Financial Statements and Notes included in Item 8 for more detail of the goodwill and intangible assets.

The following table is a summary of noninterest income and expense for the three-year period indicated.

	For the Year Ended Year Ended December 31 (in thousands)		
	2013	**2012**	**2011**
NON-INTEREST INCOME			
Service Charges	$ 4,325	$ 4,741	$ 4,604
Loan Service Fee Income (Loss), net	202	105	(66)
Trust Department Income	746	663	637
Investment Securities Gains (Losses),net	967	1,835	1,164
Gains on Sale of Mortgage Loans	1,658	2,325	982
Brokerage Income	351	240	156
Debit Card Interchange Income	1,947	1,868	1,680
Other	26	93	190
Total Non-interest Income	$ 10,222	$ 11,870	$ 9,347
NON-INTEREST EXPENSE			
Salaries and Employee Benefits	$ 15,387	$ 12,584	$ 11,953
Occupancy Expenses	3,129	3,033	2,958
Other	8,687	10,069	9,704
Total Non-interest Expense	$ 27,203	$ 25,686	$ 24,615
Net Non-interest Expense as a Percentage of Average Assets	2.33%	2.02%	2.34%

Income Taxes

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 year ended December 31, 2013, the Company averaged $79.5 million in tax free securities and $20.7 million in tax free loans. For the year ended December 31, 2012, the Company averaged $79.5 million in tax free securities and $21.7 million in tax free loans. As of December 31, 2013, the weighted average remaining maturity for the tax free securities is 130 months, while the weighted average remaining maturity for the tax free loans is 173 months.

The Company had income tax expense of $859 thousand in 2013 and $1.6 million in 2012 and $919 thousand in 2011. This represents an effective income tax rate of 12.9% in 2013, 19.0% in 2012 and 13.9% in 2011. The difference between the effective tax rate and the statutory federal rate of 34% is primarily due to tax exempt income on certain investment securities and loans. In addition, the Company had additional tax credits which also contributed to the lower effective income tax rate for those years. In 2013, the Company had tax credits totaling $358 thousand for investments made in low income housing projects which represented an increase of $180 thousand compared to similar tax credits in 2012.

Balance Sheet Review

Assets increased from $701.0 million at December 31, 2012 to $770.6 million at December 31, 2013. Securities increased $37.6 million and outstanding loan balances increased $38.7 million during 2013. Deposits grew $27.0 million and Federal Home Loan Bank borrowings increased $40.4 million. Assets at year-end 2012 totaled $701 million compared to $660 million in 2011. Loans increased $18.1 million in 2012. Deposits grew $47.5 million and FHLB borrowings decreased $12.9 million during 2012.

Loans

Total loans (including loans held for sale) were $469 million at December 31, 2013 compared to $430 million at December 31, 2012 and $412 million at December 31, 2011. The increases in the loan portfolio during 2013 and 2012 are attributed to improved economic conditions and an increase in demand. As of December 31, 2013 and compared to the prior year-end, commercial loans increased $1.5 million, real estate construction loans decreased $2.9 million, 1-4 family residential property loans increased $23.9 million, multi-family residential property loans increased $4.9, non-farm & non-residential property loans increased $13.4 million, agricultural loans decreased $1.8 million and installment loans decreased $377 thousand. As of the end of 2012 and compared to the prior year-end, commercial loans increased $4.2 million, real estate construction loans increased $841 thousand, 1-4 family residential property loans increased $9.6 million, multi-family residential property loans decreased $1.8 million, non-farm & non-residential property loans increased $13.4 million, agricultural loans decreased $8.0 million and installment loans decreased $130 thousand.

As of December 31, 2013, the real estate mortgage portfolio comprised 72% of total loans which is an increase from 69% in 2012. Of this, 1-4 family residential property represented 58% in 2013 and 2012. Agricultural loans comprised 14% of the loan portfolio in 2013 and 16% in 2012. Approximately 81% of the agricultural loans are secured by real estate in 2013 compared to 78% in 2012. The remainder of the agricultural portfolio is used to purchase livestock, equipment and other capital improvements and for general operation of the farm. Generally, a secured interest is obtained in the capital assets, equipment, livestock or crops. Automobile loans account for 23% in both 2013 and 2012 of the consumer loan portfolio, while the purpose of the remainder of this portfolio is used by customers for purchasing retail goods, home improvement or other personal reasons. The commercial loan portfolio is mainly for capital outlays and business operation. Collateral is requested depending on the creditworthiness of the borrower. Unsecured loans are made to individuals or companies mainly based on the creditworthiness of the customer. Approximately 6% of the loan portfolio is unsecured. Management is not aware of any significant concentrations that may cause future material risks, which may result in significant problems with future income and capital requirements.

The following table represents a summary of the Company s loan portfolio by category for each of the last five years. There is no concentration of loans (greater than 5% of the loan portfolio) in any industry. The Company has no foreign loans or highly leveraged transactions in its loan portfolio.

Loans Outstanding

	December 31 (in thousands)				
	2013	2012	2011	2010	2009
Commercial	$ 34,654	$ 33,137	$ 28,892	$ 22,840	$ 21,933
Real Estate Construction	11,177	14,102	13,261	13,518	16,868
Real Estate Mortgage:					
1-4 Family Residential	194,718	170,825	161,407	158,997	164,445
Multi-Family Residential	16,420	11,512	13,305	13,519	13,687
Non-Farm & Non-Residential	126,791	113,440	100,047	105,580	109,665
Agricultural	68,002	69,806	77,820	78,375	80,619
Installment	17,065	17,442	17,572	18,830	18,277
Other	158	337	324	291	280
Total Loans	468,985	430,601	412,628	411,950	425,771
Less Deferred Loan Fees	107	140	136	120	161
Total Loans, Net of Deferred Loan Fees	468,878	430,461	412,492	411,830	425,610
Less loans held for sale	223	486	625		191
Less Allowance for Loan Losses	5,441	6,047	5,842	4,925	7,601
Net Loans	463,214	423,928	406,025	406,905	417,818

The following table sets forth the maturity distribution and interest sensitivity of selected loan categories at December 31, 2013. Maturities are based upon contractual term. The total loans in this report represent loans net of deferred loan fees, including loans held for sale but excluding the allowance for loan losses. In addition, deferred loan fees on the above table are netted with real estate mortgage loans on the following table.

Loan Maturities and Interest Sensitivity

	December 31, 2013 (in thousands)			
	One Year or Less	**One Through Five Years**	**Over Five Years**	**Total Loans**
Commercial	$ 12,537	$ 18,644	$ 3,473	$ 34,654
Real Estate Construction	4,439	2,339	4,399	11,177
Real Estate Mortgage:				
1-4 Family Residential	6,931	13,972	173,815	194,718
Multi-Family Residential		123	16,297	16,420
Non-Farm & Non-Residential	6,839	18,126	101,826	126,791
Agricultural	16,963	12,060	38,979	68,002
Installment	4,336	9,949	2,780	17,065
Other	158			158
Total Loans, Net of Deferred Loan Fees	52,203	75,213	341,569	468,985
Fixed Rate Loans	20,936	52,990	64,843	138,769
Floating Rate Loans	31,267	22,223	276,726	330,216
Total Loans, Net of Deferred Loan Fees	52,203	75,213	341,569	468,985

Mortgage Banking

The Company has been in mortgage banking since the early 1980 s. The activity in origination and sale of these loans fluctuates, mainly due to changes in interest rates. Mortgage loan originations increased from $32 million in 2011 to $64 million in 2012, and decreased to $54 million in 2013. Proceeds from the sale of loans were $55 million, $67 million and $33 million for the years 2013, 2012 and 2011, respectively. Mortgage loans held for sale were $223 thousand at December 31, 2013 and $486 thousand at December 31, 2012. Fixed rate residential mortgage loans are generally sold when they are made. The volume of loan originations is inverse to rate changes. Historically low interest rates during 2012 resulted in higher loan originations during that year. During 2013, interest rates began to slightly increase resulting in a decrease in mortgage originations. Better pricing and significantly greater demand resulted in an increase in the gain on sale of mortgage loans from 2011 to 2012. The effect of these changes was also reflected on the income statement. As a result, the gain on sale of mortgage loans was $1.7 million in 2013 compared to $2.3 million in 2012 and $1.0 million in 2011.

The Bank has sold various loans to the Federal Home Loan Mortgage Corporation (FHLMC) and the Federal Home Loan Bank (FHLB) while retaining the servicing rights. Gains and losses on loan sales are recorded at the time of the cash sale, which represents the premium or discount paid by the FHLMC and FHLB. The Bank receives a servicing fee from the FHLMC and FHLB on each loan sold. Servicing rights are capitalized based on the relative fair value of the rights and the expected life of the loan and are expensed in proportion to, and over the period of, estimated net servicing revenues. Mortgage servicing rights were $1.3 million at December 31, 2013, $1.2 million at December 31, 2012 and $835 thousand at December 31, 2011. Amortization of mortgage servicing rights was $254 thousand (including $155 thousand in net recoveries of prior write-downs), $310 thousand (including $36 thousand in net recoveries of prior write-downs) and $436 thousand (including $148 thousand in net write-downs) for the years ended December 31, 2013, 2012 and 2011, respectively. See Note 4 in the Company s 2013 Consolidated Financial Statements and Notes included in Item 8 for additional information.

Deposits

For 2013, total deposits increased $27 million to $617 million. Noninterest bearing deposits increased $7 million, time deposits of $100 thousand and over increased $4 million, and other interest bearing deposits increased $15 million. Public fund balances totaled $156 million at December 31, 2013, of which $153 million was interest bearing.

For 2012, total deposits increased $48 million to $590 million. Noninterest bearing deposits increased $14 million, time deposits of $100 thousand and over decreased $1 million, and other interest bearing deposits increased $35 million. Public fund balances totaled $141 million at December 31, 2012, of which $139 million was interest bearing).

The table below provides information on the maturities of time deposits of $100,000 or more at December 31, 2013:

Maturity of Time Deposits of $100,000 or More

		At December 31, 2013 (in thousands)
Maturing 3 Months or Less	$	18,508
Maturing over 3 Months through 6 Months		19,009
Maturing over 6 Months through 12 Months		14,357
Maturing over 12 Months		44,390
Total	$	96,264

Borrowings

The Company utilizes both long and short term borrowings. Long term borrowing at the Bank is mainly from the Federal Home Loan Bank (FHLB). This borrowing is mainly used to fund longer term, fixed rate mortgages, as part of a leverage strategy and to assist in asset/liability management. Advances are either paid monthly or at maturity. As of December 31, 2013, $58 million was borrowed from FHLB, an increase of $40.4 million from December 31, 2012. Throughout 2013, the Bank borrowed $217.5 million in short-term funds from the FHLB. These funds were repaid in full as of December 31, 2013. Also during 2013, the Bank borrowed $47.7 million in longer-term advances and paid down $7.3 million in long term advances from prior years. These advances each have an original maturity of more than 1 year. The increase in long-term advances is attributed to funding the growth in the Banks   loan portfolio and strategically locking in long-term funding with historically low interest rates.

In 2012, $58 million of FHLB advances were paid and new short-term advances totaled $45 million. The following table depicts relevant information concerning our short term borrowings.

Short Term Borrowings

	As of and for the year ended December 31 (in thousands)		
	2013	2012	2011
Federal Funds Purchased:			
Balance at Year end	$	$	$
Average Balance During the Year	1,313	159	1,300
Maximum Month End Balance	12,530	2,691	10,989
Year end rate	0.00%	0.00%	0.00%
Average annual rate	0.49%	0.26%	0.27%
Repurchase Agreements:			
Balance at Year end	$ 12,867	$ 3,815	$ 3,224
Average Balance During the Year	9,646	3,848	3,640
Maximum Month End Balance	13,198	5,034	4,654
Year end rate	0.73%	0.22%	0.30%
Average annual rate	0.68%	0.27%	0.42%
Other Borrowed Funds:			
Balance at Year end	$	$ 500	$ 1,300
Average Balance During the Year	164	995	1,794
Maximum Month End Balance	500	1,300	2,100
Year end rate	0.00%	3.25%	3.25%
Average annual rate	3.25%	3.25%	3.25%

Contractual Obligations

The Bank has required future payments for time deposits and long-term debt. The other required payments under such commitments at December 31, 2013 are as follows:

	Payments due by period (in thousands)				
Contractual Obligations	**Total**	**Less than 1 year**	**1-3 years**	**3-5 years**	**More than 5 years**
Federal Home Loan Bank advances	$ 57,847	$ 12,218	$ 10,824	$ 16,541	$ 18,264
Subordinated debentures	7,217				7,217
Time deposits	190,713	98,438	68,693	23,567	15
Lease payments on premises	1,547	168	335	287	757

Asset Quality

With respect to asset quality, management considers three categories of assets to merit close scrutiny. These categories include: loans that are currently nonperforming, other real estate, and loans that are currently performing but which management believes require special attention.

During periods of economic slowdown, the Company may experience an increase in nonperforming loans.

The Company discontinues the accrual of interest on loans that become 90 days past due as to principal or interest unless reasons for delinquency are documented such as the loan being well collateralized and in the process of collection. A loan remains in a non-accrual status until factors indicating doubtful collection no longer exist. A loan is classified as a restructured loan when the interest rate is materially reduced or the term is extended beyond the original maturity date because of the inability of the borrower to service the interest payments at market rates. Other real estate is recorded at fair value less estimated costs to sell. A summary of the components of nonperforming assets, including several ratios using period-end data, is shown below.

Nonperforming Assets

	At December 31 (in thousands)				
	2013	2012	2011	2010	2009
Non-accrual Loans	$ 2,974	$ 7,024	$ 6,017	$ 12,479	$ 12,038
Accruing Loans which are Contractually past due 90 days or more	554	841	398	706	2,526
Restructured Loans	6,901	7,227	1,104		
Total Nonperforming Loans	10,429	15,092	7,519	13,185	14,564
Other Real Estate	3,379	4,168	8,296	8,424	4,542
Total Nonperforming Assets	$ 13,808	$ 19,260	$ 15,815	$ 21,609	$ 19,106
Total Nonperforming Loans as a Percentage of Loans (including loans held for sale) (1)	2.22%	3.51%	1.83%	3.20%	3.42%
Total Nonperforming Assets as a Percentage of Total Assets	1.79%	2.75%	2.40%	3.28%	2.83%
Allowance to nonperforming assets	0.39%	0.31%	0.37%	0.23%	0.40%

(1) Net of deferred loan fees

Total nonperforming assets at December 31, 2013 were $13.8 million compared to $19.3 million at December 31, 2012 and $15.8 million at December 31, 2011. The decrease from 2012 to 2013 is credited to decreases in non-accrual loans and other real estate. The increase from 2011 to 2012 is mostly attributed to an increase in restructured loans. Total other real estate properties totaled $3.4 million at December 31, 2013, of which $264 thousand is income producing property. Total nonperforming loans were $10.4 million, $15.1 million, and $7.5 million at December 31, 2013, 2012 and 2011, respectively. The decrease in non-accrual loan balances from December 31, 2012 to December 31, 2013 was mostly attributed to one loan which had a non-accrual balance of $3.0 million at December 31, 2012. During 2013, payments of $2.4 million were received on this loan and $578 thousand was charged-off. This loan had a specific allocated loan loss reserve of $503 thousand at December 31, 2012. Total loan charge offs in 2013 were $2.3 million. The non-accrual loan increase from 2011 to 2012 was largely attributable to one loan totaling $3.0 million being placed on non-accrual during the year. The amount of lost interest on our non-accrual loans was $131 thousand for 2013 and $405 thousand for 2012. At December 31, 2013, loans currently performing but which management believes require special attention were $27.7 million, with 37% being 1-4 family residential and 26% being agricultural. The Company continues to follow its long-standing policy of not engaging in international lending and not concentrating lending activity in any one industry.

Impaired loans as of December 31, 2013 were $13.5 million compared to $19.2 million in 2012 and $15.1 million in 2011. These amounts are generally included in the total nonperforming and restructured loans presented in the table above. See Note 4 in the Company s 2012 Consolidated Financial Statements and Notes included in Item 8 herein.

A loan is considered impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. All amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement. Nonaccrual loans are loans for which payments in full of principal or interest is not expected or which principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection. 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 through collateral liquidation.

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. At December 31, 2013, impaired loans totaling $9.1 million had specific impairment allocations of $712 thousand. The remaining $4.4 million in impaired loans did not have a specific impairment allocation. At December 31, 2012, impaired loans totaling $12.3 million had specific impairment allocations of $1.5 million. The remaining $7.7 million in impaired loans did not have a specific impairment allocation.

The allowance for loan losses on impaired loans is determined using one of two methods, either the present value of estimated future cash flows of the loan, discounted at the loan s effective interest rate or the fair value of the underlying collateral. The entire change in present value of expected cash flows is reported as a provision for loan losses in the same manner in which impairment initially was recognized or as a reduction in the amount of provision for loan losses that otherwise would be reported. The total allowance for loan losses related to these loans was $712 thousand, $1.5 million and $1.6 million on December 31, 2013, 2012 and 2011, respectively.

Kentucky Bank has a Problem Loan Committee that meets at least monthly to review problem loans, including past dues and non-performing loans, and other real estate. When analyzing the problem loans and the loan quality as of December 31, 2013, the following factors have been considered:

- Changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off and recovery practices not considered elsewhere in estimating credit losses.
- Change in international, national, regional and local economic and business conditions and developments that affect the collectability of the portfolio, including the condition of various market segments.
- Changes in the nature and volume of the portfolio and in the terms of loans.
- Changes in the experience, ability and depth of lending management and other relevant staff.
- Changes in the volume and severity of past due loans; the volume of non-accrual loans, and the volume and severity of adversely classified or graded loans.
- Changes in the quality of the Bank s loan review system.
- Changes in the value of underlying collateral for collateral-dependent loans.
- The existence and effect of any concentrations of credit, and changes in the level of such concentrations.
- The effect of other external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the Bank s existing portfolio.

Loan Losses

The following table is a summary of the Company s loan loss experience for each of the past five years.

	For the Year Ended December 31 (in thousands)				
	2013	**2012**	**2011**	**2010**	**2009**
Balance at Beginning of Year	$ 6,047	$ 5,842	$ 4,925	$ 7,600	$ 5,465
Amounts Charged-off:					
Commercial	12	21	36	24	340
Real Estate Construction	578	74	143	1,236	39
Real Estate Mortgage:					
1-4 Family Residential	262	1,090	659	2,009	807
Multi-Family Residential	161	88	178	1,336	
Non-Farm & Non-Residential	99	126	333	1,498	
Agricultural	109	15	27	83	22
Consumer	1,083	921	1,170	607	621
Total Charged-off Loans	2,304	2,335	2,546	6,793	1,829
Recoveries on Amounts					
Previously Charged-off:					
Commercial	28	24	74	43	6
Real Estate Construction	23	19			35
Real Estate Mortgage					
1-4 Family Residential	63	38	15	35	71
Multi-Family Residential	113	1	144		
Non-Farm & Non-Residential	18	1	14	706	337
Agricultural	24	9	15	17	
Consumer	379	398	751	67	65
Total Recoveries	648	490	1,013	868	514
Net Charge-offs	1,656	1,845	1,533	5,925	1,315
Provision for Loan Losses	1,050	2,050	2,450	3,250	3,450
Balance at End of Year	5,441	6,047	5,842	4,925	7,600
Total Loans (1)					
Average	444,589	418,049	408,135	418,531	420,710
At December 31	468,878	429,975	411,866	411,830	425,418
As a Percentage of Average Loans (1):					
Net Charge-offs	0.37%	0.44%	0.38%	1.42%	0.31%
Provision for Loan Losses	0.24%	0.49%	0.60%	0.78%	0.82%
Allowance as a Percentage of Year-end Loans (1)	1.16%	1.41%	1.42%	1.20%	1.79%
Beginning Allowance as a Multiple of Net Charge-offs	3.7	3.2	3.2	1.3	4.2
Ending Allowance as a Multiple of Nonperforming Assets	0.39	0.31	0.37	0.23	0.40

(1) Net of deferred loan fees

Loans are typically charged-off when the collection of principal is considered doubtful, and would be well documented and approved by the appropriate responsible party or committee. The provision for loan losses for 2013 was $1.1 million compared to $2.1 million in 2012 and $2.5 million in 2011. Net charge-offs were $1.7 million in 2013, $1.8 million in 2012 and $1.5 million in 2011. Net charge-offs to average loans were 0.37%, 0.44% and 0.38% in 2013, 2012 and 2011, respectively. The loan loss provision decreased $1.0 million from 2012 to 2013 and decreased $400 thousand from 2011 to 2012. The provision for 2013 is lower than 2012 and 2011 due to better loan quality. The allowance for loan losses decreased $607 thousand from December 31, 2012 to December 31, 2013. The decrease in the allowance for loan losses was largely related to one loan which was charged off during 2013 and had a specific reserve of $503 thousand at December 31, 2012. Further, as our loan quality improves and expected charge-off loan balances decrease, the needed allowance for loan losses calculated by management decreased. In evaluating the allowance for loan losses, management considers the composition of the loan portfolio, the historical loan loss experience, the overall quality of the loans and an assessment of current economic conditions. The decline in the economy over the past few years has resulted in more loan losses, higher loan loss provisions and declining loan quality numbers, compared to prior years. At December 31, 2013, the allowance for loan losses was 1.16% of loans outstanding compared to 1.41% at year-end 2012 and 1.42% at year-end 2011. Management believes the allowance for loan losses at the end of 2012 is adequate to cover probable incurred credit losses within the portfolio.

The following tables set forth an allocation for the allowance for loan losses and loans by category. In making the allocation, management evaluates the risk in each category, current economic conditions and charge-off experience. An allocation for the allowance for loan losses is an estimate of the portion of the allowance that will be used to cover future charge-offs in each loan category, but it does not preclude any portion of the allowance allocated to one type of loan being used to absorb losses of another loan type.

Allowance for Loan Losses (in thousands)

	2013	2012	2011	2010	2009
Commercial	$ 280	$ 250	$ 342	$ 264	$ 645
Real Estate Construction	358	918	1,008	758	819
Real Estate Mortgage:					
1-4 Family Residential	2,535	2,421	2,258	1,850	2,149
Multi-family Residential	327	414	336	168	179
Non-farm & Non-residential	664	628	604	917	1,434
Agricultural	678	845	720	296	1,437
Consumer	599	571	574	672	937
Total	5,441	6,047	5,842	4,925	7,600

Loans (in thousands)

	2013		2012		2011		2010		2009	
	Dollars	Percentage	Dollars	Percentage	Dollars	Percentage	Dollars	Percentage	Dollars	Percentage
Commercial	$ 34,654	7.39%	$ 33,137	7.71%	$ 28,892	7.01%	$ 22,840	5.55%	$ 21,933	5.16%
Real Estate Construction	11,177	2.38%	14,102	3.28%	13,261	3.22%	13,518	3.28%	16,865	3.96%
Real Estate Mortgage:										
1-4 Family Residential	194,388	41.50%	170,199	39.58%	160,645	39.01%	158,877	38.58%	164,092	38.57%
Multi-family Residential	16,420	3.50%	11,512	2.68%	13,305	3.23%	13,519	3.28%	13,687	3.22%
Non-farm & Non-residential	126,791	27.05%	113,440	26.38%	100,047	24.29%	105,580	25.64%	109,665	25.78%
Agricultural	68,002	14.51%	69,806	16.23%	77,820	18.89%	78,375	19.03%	80,619	18.95%
Consumer	17,065	3.64%	17,442	4.06%	17,572	4.27%	18,830	4.57%	18,277	4.30%
Other	158	0.03%	337	0.08%	324	0.08%	291	0.07%	280	0.06%
Total, Net (1)	468,655	100.00%	429,975	100.00%	411,866	100.00%	411,830	100.00%	425,418	100.00%

(1) Including loans held for sale, net of deferred loan fees

Off-balance Sheet Arrangements

Some financial instruments, such as loan commitments, credit lines, letters of credit, and overdraft protection, are issued to meet customer financing needs. These are agreements to provide credit or to support the credit of others, as long as conditions established in the contract are met, and usually have expiration dates. Commitments may expire without being used. Off-balance sheet risk to credit loss exists up to the face amount of these instruments, although material losses are not anticipated. The same credit policies are used to make such commitments as are used for loans, including obtaining collateral at exercise of the commitment.

Financial instruments with off-balance sheet risk were as follows at year-end (in thousands):

	2013	2012
Unused lines of credit	$ 85,655	$ 85,231
Commitments to make loans	3,482	12,607
Letters of credit	554	1,538

Unused lines of credit are substantially all at variable rates. Commitments to make loans are generally made for a period of 60 days or less and are primarily fixed at current market rates ranging from 3.25% to 5.00% with maturities ranging from 1 to 30 years and are intended to be sold.

Capital

As displayed by the following table, the Company s Tier I capital (as defined by the Federal Reserve Board under the Board s risk-based guidelines) at December 31, 2013 increased $4.3 million to $66.5 million. Stockholders equity, excluding accumulated other comprehensive loss, was $72.8 million at December 31, 2013. Included in Tier I capital is $7 million of trust preferred securities issued in August 2003. The disallowed amount of stockholders equity is mainly attributable to the goodwill and core deposit intangible, resulting from the Peoples acquisition in 2006 and the Kentucky First acquisition in 2003. The Company s risk-based capital and leverage ratios, as shown in the following table, exceeded the levels required to be considered well capitalized . The leverage ratio compares Tier I capital to total average assets less disallowed amounts of goodwill.

	At December 31 (in thousands)		
	2013	2012	Change
Stockholders Equity (1)	$ 72,799	$ 69,726	3,073
Trust Preferred Securities	7,000	7,000	
Less Disallowed Amount	13,331	14,631	(1,300)
Tier I Capital	66,468	62,095	4,373
Allowance for Loan Losses	5,516	5,845	(329)
Other	9	16	(7)
Tier II Capital	5,525	5,861	(336)
Total Capital	71,993	67,956	4,037
Total Risk Weighted Assets	510,900	467,308	43,592
Ratios:			
Tier I Capital to Risk-weighted Assets	13.0%	13.3%	(0.3)%
Total Capital to Risk-weighted Assets	14.1%	14.5%	(0.4)%

Leverage	8.8%	9.2%	(0.4)%

(1) Excluding accumulated other comprehensive income/loss.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) established five capital categories for insured depository institutions under its Prompt Corrective Action Provisions. The bank regulatory agencies adopted regulations, which became effective in 1992, defining these five capital categories for banks they regulate. The categories vary from well capitalized to critically undercapitalized . A well capitalized bank is defined as one with a total risk-based capital ratio of 10% or more, a Tier I risk-based capital ratio of 6% or more, a leverage ratio of 5% or more, and one not subject to any order, written agreement, capital directive, or prompt corrective action directive to meet or maintain a specific capital level. At December 31, 2013, the bank had ratios that exceeded the minimum requirements established for the well capitalized category.

In July 2013, the FDIC and the other federal bank regulatory agencies issued a final rule that will revise their leverage and risk-based capital requirements and the method of calculating risk-weighted assets to make them consistent with agreements that were reached by the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. Among other things, the rule establishes a new common equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets), increases the minimum Tier 1 capital to risk-based assets requirement (from 4% to 6% of risk-weighted assets) and assigns a higher risk weight (150%) to exposures that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance the acquisition, development or construction of real property. The final rule also requires unrealized gains and losses on certain available-for-sale securities holdings to be included for purposes of calculating regulatory capital requirement unless a one-time opt-in or opt-out is exercised. The rule limits a banking organization s capital distributions and certain discretionary bonus payments if the banking organization does not hold a capital conservation buffer consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements. The final rule becomes effective for the Bank on January 1, 2015. The capital conservation buffer requirement will be phased in beginning January 1, 2016 and ending January 1, 2019, when the full capital conservation buffer requirement will be effective.

In management s opinion, there are no other known trends, events or uncertainties that will have or that are reasonably likely to have a material effect on the Company s liquidity, capital resources or operations.

<u>Securities and Federal Funds Sold</u>

Securities, classified as available for sale, increased from $192.8 million at December 31, 2012 to $230.4 million at December 31, 2013. Federal funds sold totaled $510 thousand at December 31, 2013 and $184 thousand at December 31, 2012.

Per Company policy, fixed rate asset backed securities will not have an average life exceeding seven years, but final maturity may be longer. Adjustable rate securities shall adjust within three years per Company policy. As of December 31, 2013 and 2012, the Company held no adjustable rate mortgage backed securities. Unrealized gains (losses) on investment securities are temporary and change inversely with movements in interest rates. In addition, some prepayment risk exists on mortgage-backed securities and prepayments are likely to increase with decreases in interest rates. The following tables present the investment securities for each of the past three years and the maturity and yield characteristics of securities as of December 31, 2013.

Investment Securities at Fair Value

Investment Securities (at fair value)

	At December 31 (in thousands)		
	2013	2012	2011
Available for Sale			
U.S. government agencies	$ 69,286	$ 48,831	$ 23,354
States and political subdivisions	90,183	82,607	86,607
Mortgage-backed			
Fixed -			
GNMA, FNMA, FHLMC Passthroughs	55,299	47,950	67,601
GNMA, FNMA, FHLMC CMO s	15,339	13,087	2,554
Total mortgage backed	70,638	61,037	70,155
Equity Securities	289	305	303
Total	$ 230,396	$ 192,780	$ 180,419

Maturity Distribution of Securities

	December 31, 2013 (in thousands)					
	One Year or Less	Over One Year Through Five Years	Over Five Years Through Ten Years	Over Ten Years	Asset Backed & Equity Securities	Total
Available for Sale						
U.S. government agencies	$ 1,343	$ 10,175	$ 42,661	$ 15,107	$	$ 69,286
States and political subdivisions	276	5,014	33,943	50,950		90,183
Mortgage-backed					70,638	70,638
Equity Securities					289	289
Total	1,619	15,189	76,604	66,057	70,927	230,396
Percent of Total	0.7%	6.6%	33.2%	28.7%	30.8%	100.0%
Weighted Average Yield (1)	1.72%	1.94%	2.61%	4.53%	2.37%	3.04%

(1) Tax Equivalent yield

Impact of Inflation and Changing Prices

The majority of the Company s assets and liabilities are monetary in nature. Therefore, the Company differs greatly from most commercial and industrial companies that have significant investments in nonmonetary assets and inventories. However, inflation does have an important impact on the growth of assets in the banking industry and the resulting need to increase equity capital at higher than normal rates in order to maintain an appropriate equity to assets ratio. Inflation also affects other expenses, which tend to rise during periods of inflation.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Market risk is the risk of loss arising from adverse changes in market prices and rates. Management considers interest rate risk and liquidity risk to be significant market risks to the Company, but considers interest risk to be the most significant.

Kentucky Bank s Asset/Liability Committee oversees the Company s interest rate risk and liquidity risks. The Bank has developed procedures designed to ensure safety and soundness, maintain liquidity and regulatory capital standards, and achieve acceptable net interest income. The exposure to market risk is reviewed on a regular basis by the Asset/Liability Committee.

Interest Rate Risk. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect on net interest income and to adjust the balance sheet to minimize the inherent risk while at the same time maximize income.

Management realizes certain risks are inherent and that the goal is to identify and minimize the risks. The primary tool used by management is an interest rate shock simulation model. Certain assumptions, such as prepayment risks, are included in the model. However, actual prepayments may differ from those assumptions. In addition, immediate withdrawal of interest checking and other savings accounts may have an effect on the results of the model. The Bank has no market risk sensitive instruments held for trading purposes.

The following table depicts the change in net interest income resulting from 100 and 300 basis point changes in rates. The projections are based on balance sheet growth assumptions and repricing opportunities for new, maturing and adjustable rate amounts. In addition, the projected percentage changes from level rates are outlined below along with the Board of Directors approved limits. As of December 31, 2013 the projected net interest income percentages are within the Board of Directors limits. Please note that at in the current low interest rate environment, many rates cannot decline by 300 or 100 basis points. Therefore, the projected net interest income changes below as of December 31, 2013 for a declining rate environment are not relevant. The projected net interest income report summarizing the Company s interest rate sensitivity as of December 31, 2013 and December 31, 2012 is as follows:

Projected Net Interest Income (December 31, 2013)

Rate Change:	**300**	**100**	**Level Rates**	**+100**	**+300**
Year One (1/14 - 12/14)					
Net interest income	$ 24,290	$ 24,965	$ 25,786	$ 26,067	$ 26,056
Net interest income dollar change	$ (1,494)	$ (820)	$	$ 282	$ 270
Net interest income percentage change	5.8%	3.2%	N/A	1.1%	1.0%
Limitation on % Change	>-18.0%	>-6.0%	N/A	>-4.0%	>-10.0%

Projected Net Interest Income (December 31, 2012)

Rate Change:	**300**	**100**	**Level Rates**	**+100**	**+300**
Year One (1/13 - 12/13)					
Net interest income	$ 22,943	$ 23,797	$ 24,776	$ 25,250	$ 25,521
Net interest income dollar change	$ (1,833)	$ (979)	$	$ 474	$745
Net interest income percentage change	7.4%	4.0%	N/A	1.9%	2.8%
Limitation on % Change	>-18.0%	>-6.0%	N/A	>-4.0%	>-10.0%

The numbers in 2013 are comparable to 2012. In 2013, year one reflected an increase in net interest income of 1.1% compared to 1.9% projected increase from 2012 with a 100 basis point increase. The 300 basis point increase in rates reflected a 1.0% increase in net interest income in 2013 compared to a 2.8% increase in 2012. The 100 point decrease in rates reflected a 3.2% decrease in net interest income in 2013 compared to a 4.0% decrease in 2012.

Management measures the Company s interest rate risk by computing estimated changes in net interest income in the event of a range of assumed changes in market interest rates. The Company s exposure to interest rates is reviewed on a monthly basis by senior management and quarterly with the Board of Directors. Exposure to interest rate risk is measured with the use of interest rate sensitivity analysis to determine the change in net interest income in the event of hypothetical changes in interest rates, while interest rate sensitivity gap analysis is used to determine the repricing characteristics of the Company s assets and liabilities. If estimated changes to net interest income are not within the limits established by the Board, the Board may direct management to adjust the Company s asset and liability mix to bring interest rate risk within Board approved limits.

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

In addition to cash and cash equivalents, the securities portfolio provides an important source of liquidity. Total securities maturing within one year along with cash and cash equivalents totaled $24.8 million at December 31, 2013. Additionally, securities available-for-sale with maturities greater than one year totaled $228.8 million at December 31, 2013. The available for sale securities are available to meet liquidity needs on a continuing basis.

The Company maintains a relatively stable base of customer deposits and its steady growth is expected to be adequate to meet its funding demands. In addition, management believes the majority of its $100,000 or more certificates of deposit are no more volatile than its core deposits. At December 31, 2013 these balances totaled $96.3 million, approximately 16% of total deposits.

The Company also relies on Federal Home Loan Bank advances for both liquidity and asset/liability management purposes. These advances are used primarily to fund long-term fixed rate residential mortgage loans. We have sufficient collateral to borrow an additional $70 million from the Federal Home Loan Bank at December 31, 2013. In addition, as of December 31, 2013, $19 million is available in overnight borrowing through various correspondent banks and the Company has access to $247 million in brokered deposits.

Generally, the Company relies upon net cash inflows from financing activities, supplemented by net cash inflows from operating activities, to provide cash used in its 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. The Company s primary investing activities include purchasing investment securities and loan originations.

Management believes there is sufficient cash flow from operations to meet investing and liquidity needs related to reasonable borrower, depositor and creditor needs in the present economic environment.

The cash flow statements for the periods presented provide an indication of the Company s sources and uses of cash as well as an indication of the ability of the Company to maintain an adequate level of liquidity.

A number of other techniques are used to measure the liquidity position, including the ratios presented below. These ratios are calculated based on annual averages for each year.

Liquidity Ratios

	December 31		
	2013	**2012**	**2011**
Average Loans (including loans held for sale)/Average Deposits	74.3%	74.5%	76.5%
Average Securities sold under agreements to repurchase and other borrowings/Average Assets	2.5%	1.8%	2.1%

This chart shows that the loan to deposit ratio decreased slightly in 2013 and also decreased in 2012. The decrease in the ratio in 2013 compared to 2012 and 2012 compared to 2011 is attributed to average deposit growth exceeding loan growth.

Item 8. Financial Statements

The management of the Company has the responsibility for preparing the accompanying consolidated financial statements and for their integrity and objectivity. The statements were prepared in accordance with generally accepted accounting principles in the United States of America. The consolidated financial statements include amounts that are based on management s best estimates and judgments. Management also prepared other information in the annual report and is responsible for its accuracy and consistency with the financial statements.

The Company s 2013 consolidated financial statements have been audited by Crowe Horwath LLP, an independent registered public accounting firm. Management has made available to Crowe Horwath LLP all financial records and related data, as well as the minutes of Boards of Directors meetings. Management believes that all representations made to Crowe Horwath LLP during the audit were valid and appropriate.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Audit Committee

Kentucky Bancshares, Inc.

Paris, Kentucky

We have audited the accompanying consolidated balance sheets of Kentucky Bancshares, Inc. as of December 31, 2013 and 2012, and the related consolidated statements of income, comprehensive income (loss), changes in stockholders equity, and cash flows for each of the three years in the period ended December 31, 2013. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2013 and 2012, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2013, in conformity with U.S. generally accepted accounting principles.

/s/Crowe Horwath LLP
Crowe Horwath LLP

Louisville, Kentucky
March 27, 2014

KENTUCKY BANCSHARES, INC.

Paris, Kentucky

CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2013, 2012 and 2011

CONSOLIDATED BALANCE SHEETS

December 31

		2013		2012
ASSETS				
Cash and due from banks	$	22,650,487	$	31,579,930
Federal funds sold		510,000		184,000
Cash and cash equivalents		23,160,487		31,763,930
Securities available for sale		230,396,296		192,780,473
Mortgage loans held for sale		223,250		485,845
Loans		468,654,972		429,975,099
Allowance for loan losses		(5,440,720)		(6,047,343)
Net loans		463,214,252		423,927,756
Federal Home Loan Bank stock		6,730,600		6,730,600
Real estate owned, net		3,378,958		4,168,356
Bank premises and equipment, net		16,708,962		16,768,289
Interest receivable		3,617,673		3,946,478
Mortgage servicing rights		1,343,887		1,152,436
Goodwill		13,116,710		13,116,710
Other intangible assets		316,760		531,733
Other assets		8,371,008		5,637,704
Total assets	$	770,578,843	$	701,010,310
LIABILITIES AND STOCKHOLDERS EQUITY				
Deposits				
Non-interest bearing	$	152,052,558	$	144,574,752
Time deposits, $100,000 and over		96,263,691		91,947,596
Other interest bearing		369,084,183		353,902,236
Total deposits		617,400,432		590,424,584
Repurchase agreements and other borrowings		12,867,341		4,315,384
Long-term Federal Home Loan Bank advances		57,846,833		17,448,932
Subordinated debentures		7,217,000		7,217,000
Interest payable		735,859		609,764
Other liabilities		6,838,880		6,985,986
Total liabilities		702,906,345		627,001,650
Commitments and contingent liabilities				
Stockholders equity				
Preferred stock, 300,000 shares authorized and unissued				
Common stock, no par value; 10,000,000 shares authorized; 2,717,434 and 2,719,694 shares issued and outstanding in 2013 and 2012		12,569,979		12,528,988
Retained earnings		60,228,702		57,196,425
Accumulated other comprehensive income (loss)		(5,126,183)		4,283,247
Total stockholders equity		67,672,498		74,008,660
Total liabilities and stockholders equity	$	770,578,843	$	701,010,310

See accompanying notes.

CONSOLIDATED STATEMENTS OF INCOME

Years Ended December 31

	2013	2012	2011
Interest income			
Loans, including fees	$ 22,934,826	$ 23,360,430	$ 24,044,403
Securities			
Taxable	2,179,857	1,561,085	2,433,341
Tax exempt	2,742,349	2,982,158	3,109,483
Other	310,756	329,238	302,102
	28,167,788	28,232,911	29,889,329
Interest expense			
Deposits	2,282,033	2,504,425	3,923,834
Repurchase agreements and other borrowings	79,469	43,526	78,303
Federal Home Loan Bank advances	862,631	922,771	1,326,740
Subordinated debentures	231,638	244,918	236,551
	3,455,771	3,715,640	5,565,428
Net interest income	24,712,017	24,517,271	24,323,901
Provision for loan losses	1,050,000	2,050,000	2,450,000
Net interest income after provision for loan losses	23,662,017	22,467,271	21,873,901
Other income			
Service charges	4,324,986	4,740,500	4,603,909
Loan service fee income (loss), net	202,091	105,490	(66,097)
Trust department income	745,973	662,548	636,588
Securities gains, net	967,454	1,834,839	1,163,798
Gain on sale of mortgage loans	1,658,226	2,325,468	982,214
Brokerage income	350,544	239,980	156,391
Debit card interchange income	1,947,394	1,868,283	1,680,320
Other	24,976	92,864	189,983
	10,221,644	11,869,972	9,347,106
Other expenses			
Salaries and employee benefits	15,387,011	12,583,775	11,953,298
Occupancy expenses	3,129,413	3,033,060	2,957,942
Repossession expenses, net	266,805	1,735,764	2,047,533
FDIC insurance	486,380	572,752	662,578
Legal and professional fees	839,423	689,362	770,723
Data processing	1,346,325	1,186,622	1,038,058
Debit card expenses	955,113	884,445	727,763
Amortization	214,973	233,736	243,736
Advertising and marketing	824,980	744,456	708,370
Taxes other than payroll, property and income	875,029	842,568	774,434
Telephone	268,304	301,111	414,692
Postage	303,260	296,798	302,769
Loan fees	398,464	587,351	239,492
Other	1,907,310	1,994,208	1,773,330
	27,202,790	25,686,008	24,614,718
Income before income taxes	6,680,871	8,651,235	6,606,289
Provision for income taxes	858,997	1,643,673	919,415
Net income	$ 5,821,874	$ 7,007,562	$ 5,686,874

Earnings per share:			
Basic	$ 2.15	$ 2.59	$ 2.09
Diluted	2.15	2.59	2.09

See accompanying notes.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

Years Ended December 31

	2013	2012	2011
Net income	$ 5,821,874	$ 7,007,562	$ 5,686,874
Other comprehensive income (loss)			
Unrealized gains (losses) on securities arising during the period	(13,289,258)	2,612,889	8,772,771
Reclassification of realized amount	(967,454)	(1,834,839)	(1,163,798)
Net change in unrealized gain (loss) on securities	(14,256,712)	778,050	7,608,973
Less: Tax impact	(4,847,282)	264,537	2,587,051
Other comprehensive income (loss)	(9,409,430)	513,513	5,021,922
Comprehensive income (loss)	$ (3,587,556)	$ 7,521,075	$ 10,708,796

See accompanying notes.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

Years Ended December 31, 2013, 2012 and 2011

	Common Stock Shares	Common Stock Amount	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balances, January 1, 2010	2,738,039	$ 12,497,765	$ 49,797,757	$ (1,252,188)	$ 61,043,334
Common stock issued including tax benefit, net (including stock grants of 6,955 shares and employee gifts of 34 shares)	6,640	608			608
Stock compensation expense		76,809			76,809
Common stock purchased and retired	(27,874)	(127,350)	(346,735)		(474,085)
Other Comprehensive Income				5,021,922	5,021,922
Net income			5,686,874		5,686,874
Dividends declared - $0.88 per share			(2,402,361)		(2,402,361)
Balances, December 31, 2011	2,716,805	$ 12,447,832	$ 52,735,535	$ 3,769,734	$ 68,953,101
Common stock issued including tax benefit, net (including stock grants of 5,615 shares and employee gifts of 49 shares)	5,634	1,026			1,026
Stock compensation expense		92,683			92,683
Common stock purchased and retired	(2,745)	(12,553)	(43,996)		(56,549)
Other Comprehensive Income				513,513	513,513
Net income			7,007,562		7,007,562
Dividends declared - $0.92 per share			(2,502,676)		(2,502,676)
Balances, December 31, 2012	2,719,694	$ 12,528,988	$ 57,196,425	$ 4,283,247	$ 74,008,660
Common stock issued including tax benefit, net (including stock grants of 6,965 shares and employee gifts of 18 shares)	6,758	462			462
Stock compensation expense		82,115			82,115
Common stock purchased	(9,018)	(41,586)	(176,619)		(218,205)
Other Comprehensive Income				(9,409,430)	(9,409,430)
Net income			5,821,874		5,821,874
Dividends declared - $0.96 per share			(2,612,978)		(2,612,978)
Balances, December 31, 2013	2,717,434	$ 12,569,979	$ 60,228,702	$ (5,126,183)	$ 67,672,498

See accompanying notes.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended December 31

	2013	2012	2011
Cash flows from operating activities			
Net income	$ 5,821,874	$ 7,007,562	$ 5,686,874
Adjustments to reconcile net income to net cash from operating activities:			
Depreciation and amortization	1,664,975	1,822,714	1,851,344
Provision for loan losses	1,050,000	2,050,000	2,450,000
Securities amortization, net	844,962	1,587,182	486,250
Securities (gains) losses, net	(967,454)	(1,834,839)	(1,163,798)
Originations of loans held for sale	(53,578,104)	(64,419,001)	(32,274,699)
Proceeds from sale of loans	55,498,925	66,884,024	32,631,513
Gain on sale of mortgage loans	(1,658,226)	(2,325,468)	(982,214)
Stock based compensation expense	82,115	92,683	76,809
Losses (gain) on disposition of fixed assets	99,625	(13,742)	(54,744)
Losses (gain) on other real estate	(43,213)	179,873	94,509
Changes in:			
Interest receivable	328,805	105,414	474,250
Write-downs of other real estate, net	63,302	990,570	1,229,644
Other assets	(3,249,889)	(2,035,285)	930,148
Interest payable	126,095	(352,764)	(293,986)
Other liabilities	4,700,176	2,174,250	320,386
Net cash from operating activities	10,783,968	11,913,173	11,462,286
Cash flows from investing activities			
Purchases of securities	(141,135,109)	(135,155,986)	(94,712,642)
Proceeds from sales of securities	38,088,640	59,050,719	44,657,806
Proceeds from principal payments and maturities of securities	51,296,426	64,769,877	54,788,752
Net change in loans	(40,807,996)	(22,219,911)	(7,315,100)
Purchases of bank premises and equipment	(1,494,072)	(1,348,567)	(729,270)
Proceeds from sale of other real estate	1,311,582	5,224,277	4,549,678
Proceeds from sale of bank premises and equipment	258,133	16,800	200,800
Net cash from investing activities	(92,482,396)	(29,662,791)	1,440,024
Cash flows from financing activities			
Net change in deposits	26,975,848	47,500,706	5,523,251
Net change in repurchase agreements and other borrowings	9,051,957	591,858	(1,855,574)
Short-term advances from Federal Home Loan Bank	217,500,000	45,000,000	25,000,000
Short-term payments from Federal Home Loan Bank	(217,500,000)	(45,000,000)	(25,000,000)
Long-term advances from Federal Home Loan Bank	47,660,000		
Payments on long-term Federal Home Loan Bank advances	(7,262,099)	(12,877,297)	(12,862,089)
Payments on note payable	(500,000)	(800,000)	(800,000)
Proceeds from issuance of common stock, including options and grants, including tax benefits	462	1,026	608
Purchase of common stock	(218,205)	(56,549)	(474,085)
Dividends paid	(2,612,978)	(2,502,676)	(2,402,361)
Net cash from financing activities	73,094,985	31,857,068	(12,870,250)

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended December 31

		2013		2012		2011
Net change in cash and cash equivalents	$	(8,603,443)	$	14,107,450	$	32,060
Cash and cash equivalents at beginning of year		31,763,930		17,656,480		17,624,420
Cash and cash equivalents at end of year	$	23,160,487	$	31,763,930	$	17,656,480
Supplemental disclosures of cash flow information Cash paid during the year for:						
Interest expense	$	3,329,676	$	4,068,404	$	5,859,414
Income taxes		1,475,000		1,300,000		900,000
Supplemental schedules of non-cash investing activities						
Real estate acquired through foreclosure	$	471,500	$	2,266,875	$	5,745,840

See accompanying notes.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation: The consolidated financial statements include the accounts of Kentucky Bancshares, Inc. (the Company), 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, Elliot, Fayette, 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, other real estate owned, mortgage servicing rights, goodwill and fair value of financial instruments are particularly subject to change.

Cash Flows: For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold, and certain short-term investments with maturities of less than three months. Generally, federal funds are sold for one-day periods. Net cash flows are reported for loan, deposit and short-term borrowing transactions.

Securities: The Company is required to classify its securities portfolio into one of three categories: trading securities, securities available for sale and securities held to maturity. Fair value adjustments are made to the securities based on their classification with the exception of the held to maturity category. The Company has no investments classified as trading securities, or securities held to maturity. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income.

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level-yield method without anticipating prepayments, except for mortgage backed securities where prepayments are anticipated. Gains and losses on sales are recorded on the settlement date and determined using the specific identification method.

Management evaluates securities for other-than-temporary impairment (OTTI) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) other-than-temporary impairment (OTTI) related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

Loans Held for Sale: Loans held for sale are valued at the lower of cost or fair value as determined by outstanding commitments from investors or current secondary market prices, calculated on the aggregate loan basis. The Company also provides for any losses on uncovered commitments to lend or sell. Loans are generally sold with servicing rights retained.

Loans: Loans are stated at the amount of unpaid principal, reduced by an allowance for loan losses. Interest income on loans is recognized on the accrual basis except for those loans on a nonaccrual status. The accrual of interest on impaired loans is discontinued when management believes, after consideration of economic and business conditions and collection efforts, that the borrowers financial condition is such that collection of interest is doubtful. Interest income on real estate mortgage (1-4 family residential and multi-family residential) and consumer loans is discontinued at the time the loan is 90 days delinquent, and interest income on real estate construction, non-farm and non-residential mortgage, agricultural and commercial loans is discontinued at the time the loan is 120 days delinquent, unless the loan is well-secured and in process of collection. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. 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. Recorded investment is the outstanding loan balance, excluding accrued interest receivable.

When interest accrual is discontinued, interest income received on such loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. Typically, the Company seeks to establish a payment history of at least six consecutive payments made on a timely basis before returning a loan to accrual status. Consumer and credit card loans are typically charged off no later than 120 days past due. Loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful.

Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment of the yield on the related loan.

Loans are charged off when available information confirms that loans, or portions thereof, are uncollectible. While management considers the number of days a loan is past due in its evaluation process, we also consider a variety of other factors. Factors considered by management in evaluating the charge-off decision include collateral value, availability of current financial information for both borrower and guarantor, and the probability of collecting contractual principal and interest payments. These considerations may result in loans being charged off before they are 90 days or more past due. This evaluation framework for determining charge-offs is consistently applied to each segment. Consumer loans are typically charged off no later than 120 days past due. Other types of loans do not have a defined number of days delinquent before they are charged off.

From time to time, the Company will charge-off a portion of impaired and non-performing loans. Loans that meet the criteria under ASU 310 are evaluated individually for impairment. Management considers payment status, collateral value, availability of current financial information for the borrower and guarantor, actual and expected cash flows, and probability of collecting amounts due. If a loan s collection status is deemed to be collateral dependent and foreclosure imminent, the loan is charged down to the fair value of the collateral, less selling costs. In circumstances where the loan is not deemed to be collateral dependent, but we believe, after completing our evaluation process, that probable loss has been incurred, we will provide a specific allocation on that loan.

At December 31, 2013, loans totaling $660 thousand (net of partial charge-offs) had partial charge-offs of $143 thousand thousand. At December 31, 2012, loans totaling $170 thousand (net of partial charge-offs) had partial charge-offs of $45 thousand. These loans are classified as impaired and are generally on non-accrual status.

The impact of recording partial charge-offs is a reduction of gross loans and a reduction of the loan loss reserve. The net loan balance is unchanged in instances where the loan had a specific allocation as a component of the allowance for loan losses. The allowance as a percentage of total loans may be lower as the allowance no longer needs to include a component for the loss, which has now been recorded, and net charge-off amounts are increased as partial charge-offs are recorded.

Concentration of Credit Risk: Most of the Company s business activity is with customers located within Bourbon, Clark, Elliott, Fayette, Harrison, Jessamine, Rowan, Scott, Woodford and surrounding counties located in Kentucky. Therefore, the Company s exposure to credit risk is significantly affected by changes in the economy in these counties.

Allowance for Loan Losses: The allowance for loan losses is a valuation allowance for probable incurred credit losses. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

Adjustments are made to the historical loss experience ratios based on the qualitative factors as outlined in the regulatory Interagency Policy Statement on the Allowance for Loan and Lease Losses. These qualitative factors include the nature and volume of portfolio, economic and business conditions, classification, past due and non-accrual trends. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management s judgment, should be charged off.

The allowance for loan losses is evaluated at the portfolio segment level using the same methodology for each segment. The recent historical actual net losses is the basis for the general reserve for each segment which is then adjusted for qualitative factors as outlined above (i.e., nature and volume of portfolio, economic and business conditions, classification, past due and non-accrual trends) specifically evaluated at individual segment levels.

As of December 31, 2013, the allowance for loan losses related to loans collectively evaluated for impairment is $4,729,000. The amount attributable to the recent historical actual net average is $4,213,000, leaving $516,000 attributable to qualitative factors. As of December 31, 2012, the allowance for loan losses related to loans collectively evaluated for impairment is $4,589,000. The amount attributable to the recent historical actual net loss average is $4,056,000, leaving $533,000 attributable to qualitative factors. The amount related to qualitative factors decreased $17,000 from December 31, 2012 to December 31, 2013.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired. The general component covers non-classified loans and is based on historical loss experience adjusted for current factors for non-classified loans and a migration analysis for classified loans.

A loan is impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loans, for which the terms have been modified, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower s prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

Commercial and real estate construction and real estate mortgage loans (multi-family residential, and non-farm and non-residential mortgage) over $200 thousand are individually evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan s existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and 1-4 family residential real estate loans, are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosures. Troubled debt restructurings are separately identified for impairment disclosures and are measured at the present value of estimated future cash flows using the loan s effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral. For troubled debt restructurings that subsequently default, the Company determines the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

The general component covers non-impaired loans and is based on historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by the Company over the most recent 3 years. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations.

A portfolio segment is defined as the level at which an entity develops and documents a systematic methodology to determine its allowance for loan losses. The Company has identified the following portfolio segments: commercial, real estate construction, real estate mortgage, agricultural, consumer (credit cards and other consumer) and other (overdrafts).

The Company analyzes all relevant risk characteristics for each portfolio segment of loans. Each of the portfolio segments possess similar general risk characteristics that are analyzed by the Company in connection with its loan underwriting procedures.

Due to the overall high level of real estate mortgage loans within the loan portfolio as a whole, as compared to other portfolio segments, for risk assessment and allowance purposes this segment was segregated into more granular pools by collateral property type. Real estate construction loans have the highest qualitative adjustments for economic and other credit risk factors, such as the incomplete status of the collateral and the effect of the recent economic downturn on these types of properties. The non-farm non-residential and the multi-family real estate mortgage loan portfolio segments had the next highest level of qualitative adjustments due to the effects of local markets and economies on the underlying collateral property values, as well as for industry concentrations and risks related to the this type of property. Within the commercial portfolio, risk analysis is performed primarily based on the individual loan type.

Mortgage Servicing Rights: The Bank has sold certain residential mortgage loans to the Federal Home Loan Mortgage Corporation (FHLMC) while retaining the servicing rights.

Servicing rights are recognized separately when they are acquired through sales of loans. When mortgage loans are sold, servicing rights are initially recorded at fair value with the income statement effect recorded in gain on sale of mortgage loans. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses. All classes of servicing assets are subsequently measured using the amortization method which requires servicing rights to be amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying loans.

Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to carrying amount. Impairment is determined by stratifying rights into groupings based on predominant risk characteristics, such as interest rate, loan type and investor type. Impairment is recognized through a valuation allowance for an individual grouping, to the extent that fair value is less than the carrying amount. If the Company later determines that all or a portion of the impairment no longer exists for a particular grouping, a reduction of the allowance may be recorded as an increase to income. The fair values of servicing rights are subject to significant fluctuations as a result of changes in estimated and actual prepayment speeds and default rates and losses.

Servicing fee income, which is reported on the income statement as loan service income, net, is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal or a fixed amount per loan and are recorded as income when earned. The amortization of mortgage servicing rights and valuation allowance are netted against loan servicing fee income. Servicing fees totaled $456,452, $415,727, and $370,088 for the years ended December 31, 2013, 2012 and 2011 and are included in loan service fee income on the income statement. Late fees and ancillary fees related to loan servicing are not material.

Federal Home Loan Bank (FHLB) Stock: The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

Bank Premises and Equipment: Land is carried at cost. Bank premises and equipment are stated at cost less accumulated depreciation. Buildings and related components are depreciated using the straight-line method with useful lives ranging from 5 to 40 years. Furniture, fixtures and equipment are depreciated using the straight-line (or accelerated) method with useful lives ranging from 3 to 10 years.

Real Estate Owned: Real estate acquired through foreclosure is initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at the lower of cost or fair value less estimated costs to sell. The value of the underlying loan is written down to the fair value of the real estate to be acquired by a charge to the allowance for loan losses, if necessary. Any subsequent write-downs are charged to operating expenses. Operating expenses of such properties, net of related income, and gains and losses on their disposition are included in other expenses.

Investments in Limited Partnerships: Investments in limited partnerships represent the Company s investments in affordable housing projects for the primary purpose of available tax benefits. The Company is a limited partner in these investments and as such, the Company is not involved in the management or operation of such investments. These investments are accounted for using the equity method of accounting. Under the equity method of accounting, the Company records its share of the partnership s earnings or losses in its income statement and adjusts the carrying amount of the investments on the balance sheet. These investments are evaluated for impairment when events indicate the carrying amount may not be recoverable. The investment recorded at December 31, 2013 was $4.2 million and $3.8 million at December 31, 2012, respectively, and is included with other assets in the balance sheet.

Repurchase Agreements: Substantially all repurchase agreement liabilities represent amounts advanced by various customers. Securities are pledged to cover these liabilities, which are not covered by federal deposit insurance.

Stock-Based Compensation: Compensation cost is recognized for stock options and restricted stock awards issued to employees, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options, while the market price of the Company s common stock at the date of grant is used for restricted stock awards. Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award.

Income Taxes: Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

A tax position is recognized as a benefit only if it is more likely than not that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the more likely than not test, no tax benefit is recorded.

The Company recognizes interest related to income tax matters as interest expense and penalties related to income tax matters as other expense.

Retirement Plans: Employee 401(k) and profit sharing plan expense is the amount of matching contributions.

Goodwill: Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually. The Company has selected December 31 as the date to perform the annual impairment test. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Goodwill is the only intangible asset with an indefinite life on our balance sheet.

Intangible Assets: Intangible assets consist of core deposit intangible assets arising from whole bank and branch acquisitions. They are initially measured at fair value and then are amortized on either an accelerated or straight-line basis, over ten or fifteen years.

Loan Commitments and Related Financial Instruments: Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

Earnings Per Common 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 include the dilutive effect of additional potential common shares issuable under stock options. Earnings and dividends per share are restated for all stock splits and dividends through the date of issuance of the financial statements.

Comprehensive Income (Loss): Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains and losses on securities available for sale, which are also recognized as a separate component of equity.

Fair Value of Financial Instruments: Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in a separate note. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

Operating Segments: While the Company s chief decision makers monitor the revenue streams of the various Company products and services, operations are managed and financial performance is evaluated on a Company-wide basis. Accordingly, all of the Company s operations are considered by management to be aggregated into one reportable operating segment: banking.

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

Adoption of New Accounting Standards:

In July 2013, the FASB amended existing guidance related to the inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a benchmark interest rate for hedge accounting purposes These amendments permit the Fed Funds Effective Swap Rate to be used as a U.S. benchmark interest rate for hedge accounting purposes, in addition to UST and LIBOR. The amendments also remove the restriction on using different benchmark rates for similar hedges. The amendments apply to all entities that elect to apply hedge accounting of the benchmark interest rate. These amendments are effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013. The effect of adopting this standard did not have a material effect on the Company s operating results or financial condition.

NOTE 2 - RESTRICTIONS ON CASH AND DUE FROM BANKS

Included in cash and due from banks are certain interest bearing deposits that are held at the Federal Reserve or maintained in vault cash in accordance with average balance requirements specified by the Federal Reserve Board of Governors. The reserve requirement at December 31, 2013 was $0 and $1.1 million at December 31, 2012.

NOTE 3 - SECURITIES AVAILABLE FOR SALE

The following table summarizes the amortized cost and fair value of the securities at December 31, 2013 and 2012 and the corresponding amounts of gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
2013				
U. S. government agencies	$ 73,930,275	$ 51,000	$ (4,695,333)	$ 69,285,942
States and municipals	91,043,216	1,613,981	(2,473,566)	90,183,631
Mortgage-backed - residential	72,919,750	43,956	(2,325,919)	70,637,787
Equity securities	270,000	18,936		288,936
Total	$ 238,163,241	$ 1,727,873	$ (9,494,818)	$ 230,396,296
2012				
U. S. government agencies	$ 48,730,031	$ 122,141	$ (21,389)	$ 48,830,783
States and municipals	77,866,571	4,887,483	(147,078)	82,606,976
Mortgage-backed - residential	59,424,104	1,634,869	(21,827)	61,037,146
Equity securities	270,000	35,568		305,568
Total	$ 186,290,706	$ 6,680,061	$ (190,294)	$ 192,780,473

The amortized cost and fair value of securities at December 31, 2013, 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.

	Amortized Cost	Fair Value
Due in one year or less	$ 1,638,090	$ 1,618,724
Due after one year through five years	15,256,463	15,189,305
Due after five years through ten years	79,981,698	76,603,923
Due after ten years	68,097,240	66,057,621
	164,973,491	159,469,573
Mortgage-backed - residential	72,919,750	70,637,787
Equity	270,000	288,936
Total	$ 238,163,241	$ 230,396,296

Proceeds from sales of securities during 2013, 2012 and 2011 were $38,088,640 $59,050,719 and $44,657,806. Gross gains of $967,454, $1,834,839 and $1,163,798 and gross losses of $0, $0 and $0, were realized on those sales, respectively. The tax provision related to these realized gains and losses was $328,934, $623,845 and $395,691, respectively.

Securities with an approximate carrying value of $212,724,000 and $182,929,000 at December 31, 2013 and 2012, were pledged to secure public deposits, trust funds, securities sold under agreements to repurchase and for other purposes as required or permitted by law.

Securities with unrealized losses at year end 2013 and 2012 not recognized in income are as follows:

2013

	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	$ 57,203,132	$ (3,812,603)	$ 8,117,270	$ (882,730)	$ 65,320,402	$ (4,695,333)
States and municipals	32,288,713	(2,105,793)	2,879,347	(367,773)	35,168,060	(2,473,566)
Mortgage-backed - residential	62,125,854	(2,325,919)			62,125,854	(2,325,919)
Total temporarily impaired	$ 151,617,699	$ (8,244,315)	$ 10,996,617	$ (1,250,503)	$ 162,614,316	$ (9,494,818)

2012

	Less than 12 Months		12 Months or More		Total	
Description of Securities	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Government agencies	$ 11,978,611	$ (21,389)	$	$	$ 11,978,611	$ (21,389)
States and municipals	7,518,768	(147,078)			7,518,768	(147,078)
Mortgage-backed - residential	5,773,396	(21,827)			5,773,396	(21,827)
Total temporarily impaired	$ 25,270,775	$ (190,294)	$	$	$ 25,270,775	$ (190,294)

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, the Company may consider whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, and the results of reviews of the issuer s financial condition.

Unrealized losses on securities have not been recognized into income because the issues are of high credit quality, management does not intend to sell and it is more likely than not that management would be required to sell the securities prior to their anticipated recovery, and the decline in fair value is largely due to changes in interest rates. The fair value is expected to recover as the securities approach maturity.

At December 31, 2013, twenty-nine U.S. government agency securities have unrealized losses with aggregate depreciation of 6.7% from their amortized cost, twenty-six mortgage-backed securities have an unrealized loss with depreciation of 3.6% from their amortized cost basis, and seventy five states and municipals have unrealized losses with aggregate depreciation of 6.6% from their amortized cost basis. Management believes the declines in fair value from these and other securities are largely due to changes in interest rates. The Company believes there is no other than temporary impairment and does not have the intent to sell these securities and it is likely that it will not be required to sell the securities before their anticipated recovery.

NOTE 4 - LOANS

Loans at year-end were as follows:

	2013	2012
Commercial	$ 34,653,869	$ 33,137,302
Real estate construction	11,176,919	14,102,265
Real estate mortgage:		
1-4 family residential	194,387,543	170,199,066
Multi-family residential	16,420,429	11,511,410
Non-farm & non-residential	126,791,109	113,440,371
Agricultural	68,002,303	69,805,492
Consumer	17,064,948	17,441,841
Other	157,852	337,352
	$ 468,654,972	$ 429,975,099

The following table presents the activity in the allowance for loan losses by portfolio segment for the years ending December 31, 2013, 2012, and 2011 (in thousands):

December 31, 2013

	Beginning Balance	Charge-offs	Recoveries	Provision	Ending Balance
Commercial	$ 150	$ 12	$ 28	$ 64	$ 230
Real estate Construction	918	578	23	(5)	358
Real estate mortgage:					
1-4 family residential	1,989	262	63	379	2,169
Multi-family residential	414	161	113	61	427
Non-farm & non-residential	628	99	18	17	564
Agricultural	845	109	24	(182)	578
Consumer	517	460	35	456	548
Other	54	623	344	276	51
Unallocated	532			(16)	516
	$ 6,047	$ 2,304	$ 648	$ 1,050	$ 5,441

December 31, 2012

	Beginning Balance	Charge-offs	Recoveries	Provision	Ending Balance
Commercial	$ 192	$ 21	$ 24	$ (45)	$ 150
Real estate Construction	1,008	74	19	(35)	918
Real estate mortgage:					
1-4 family residential	2,257	1,090	38	784	1,989
Multi-family residential	336	88	1	165	414
Non-farm & non-residential	410	126	1	343	628
Agricultural	721	15	9	130	845
Consumer	524	424	64	353	517
Other	50	497	334	167	54
Unallocated	344			188	532
	$ 5,842	$ 2,335	$ 490	$ 2,050	$ 6,047

December 31, 2011

	Beginning Balance	Charge-offs	Recoveries	Provision	Ending Balance
Commercial	$ 235	$ 36	$ 74	$ (81)	$ 192
Real estate Construction	721	143		430	1,008
Real estate mortgage:					
1-4 family residential	1,827	659	15	1,074	2,257
Multi-family residential	148	178	144	222	336
Non-farm & non-residential	889	333	14	(160)	410
Agricultural	265	27	15	468	721
Consumer	582	237	23	156	524
Other	58	933	728	197	50
Unallocated	200			144	344
	$ 4,925	$ 2,546	$ 1,013	$ 2,450	$ 5,842

The following tables present the balance in the allowance for loan losses and the recorded investment (excluding accrued interest receivable amounting to $2,302,435 and $2,808,210) in loans by portfolio segment and based on impairment method as of December 31, 2013 and December 31, 2012 (in thousands):

As of December 31, 2013

	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Total
Allowance for Loan Losses:			
Commercial	$	$ 230	$ 230
Real estate construction		358	358
Real estate mortgage:			
1-4 family residential	228	1,941	2,169
Multi-family residential	76	351	427
Non-farm & non-residential	110	454	564
Agricultural	298	280	578
Consumer		548	548
Other		51	51
Unallocated		516	516
	$ 712	$ 4,729	$ 5,441
Loans:			
Commercial	$	$ 34,654	$ 34,654
Real estate construction		11,177	11,177
Real estate mortgage:			
1-4 family residential	2,873	191,515	194,388
Multi-family residential	274	16,146	16,420
Non-farm & non-residential	2,716	124,075	126,791
Agricultural	7,673	60,329	68,002
Consumer		17,065	17,065
Other		158	158
	$ 13,536	$ 455,119	$ 468,655

As of December 31, 2012

	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Total
Allowance for Loan Losses:			
Commercial	$	$ 150	$ 150
Real estate construction	503	415	918
Real estate mortgage:			
1-4 family residential	109	1,880	1,989
Multi-family residential	147	267	414
Non-farm & non-residential	150	478	628
Agricultural	549	296	845
Consumer		517	517
Other		54	54
Unallocated		532	532
	$ 1,458	$ 4,589	$ 6,047
Loans:			
Commercial	$	$ 33,137	$ 33,137
Real estate construction	3,035	11,067	14,102
Real estate mortgage:			
1-4 family residential	3,610	166,589	170,199
Multi-family residential	311	11,201	11,512
Non-farm & non-residential	4,183	109,257	113,440
Agricultural	8,045	61,761	69,806
Consumer		17,442	17,442
Other		337	337
	$ 19,184	$ 410,791	$ 429,975

The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2013 (in thousands):

	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Average Recorded Investment	Interest Income Recognized	Cash Basis Interest Recognized
With no related allowance recorded:						
Commercial	$	$	$	$	$	$
Real estate construction						
Real estate mortgage:						
1-4 family residential	824	793		1,217	28	28
Multi-family residential						
Non-farm & non-residential	1,650	803		1,471	81	81
Agricultural	2,912	2,826		2,802	123	123
Consumer						
Other						
With an allowance recorded:						
Commercial						
Real estate construction				607		
Real estate mortgage						
1-4 family residential	2,080	2,080	228	1,349	96	96
Multi-family residential	274	274	76	443	3	3
Non-farm & non-residential	1,913	1,913	110	1,938	79	79
Agricultural	4,847	4,847	298	4,864	287	287
Consumer						
Other						
Total	$ 14,501	$ 13,536	$ 712	$ 14,691	$ 697	$ 697

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

The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2012 (in thousands):

	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Average Recorded Investment	Interest Income Recognized	Cash Basis Interest Recognized
With no related allowance recorded:						
Commercial	$	$	$	$	$	$
Real estate construction				640		
Real estate mortgage:						
1-4 family residential	2,272	2,243		1,322	75	75
Multi-family residential				41		
Non-farm & non-residential	2,775	2,008		1,756	158	158
Agricultural	2,657	2,657		1,432	275	275
Consumer						
Other						
With an allowance recorded:						
Commercial						
Real estate construction	3,035	3,035	503	2,020	111	111
Real estate mortgage:						
1-4 family residential	1,367	1,367	109	976	57	57
Multi-family residential	311	311	147	225	12	12
Non-farm & non-residential	2,175	2,175	150	1,189	104	104
Agricultural	5,388	5,388	549	4,024	252	252
Consumer						
Other						
Total	$ 19,980	$ 19,184	$ 1,458	$ 13,625	$ 1,044	$ 1,044

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

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

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

Nonperforming loans include impaired loans and smaller balance homogeneous loans, such as residential mortgage and consumer loans, that are collectively evaluated for impairment.

Nonaccrual loans secured by real estate make up 99.8% of the total nonaccruals.

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 December 31, 2013 and 2012 (in thousands):

As of December 31, 2013

Loans Past Due

	Nonaccrual	Over 90 Days Still Accruing	Troubled Debt Restructurings
Commercial	$	$	$
Real estate construction			
Real estate mortgage:			
1-4 family residential	1,171	314	493
Multi-family residential	275		
Non-farm & non-residential	803		1,878
Agricultural	717	232	4,530
Consumer	8	8	
Other			
Total	$ 2,974	$ 554	$ 6,901

As of December 31, 2012

	Nonaccrual	Loans Past Due Over 90 Days Still Accruing	Troubled Debt Restructurings
Commercial	$ 45	$	$
Real estate construction	3,035		
Real estate mortgage:			
1-4 family residential	1,065	373	505
Multi-family residential	311		
Non-farm & non-residential	1,589		1,924
Agricultural	894	426	4,798
Consumer	85	42	
Other			
Total	$ 7,024	$ 841	$ 7,227

The following tables present the aging of the recorded investment in past due and non-accrual loans as of December 31, 2013 and 2012 by class of loans (in thousands):

2013

	30 59 Days Past Due	60 89 Days Past Due	Greater than 90 Days Past Due	Non-accrual	Total Past Due & Non-accrual	Loans Not Past Due
Commercial	$ 49	$	$	$	$ 49	$ 34,605
Real estate construction	175				175	11,002
Real estate mortgage:						
1-4 family residential	1,981	1,285	314	1,171	4,751	189,637
Multi-family residential				275	275	16,145
Non-farm & non-residential	503			803	1,306	125,485
Agricultural	155		232	717	1,104	66,898
Consumer	102	27	8	8	145	16,920
Other						158
Total	$ 2,965	$ 1,312	$ 554	$ 2,974	$ 7,805	$ 460,850

2012

	30 59 Days Past Due	60 89 Days Past Due	Greater than 90 Days Past Due	Non-accrual	Total Past Due & Non-accrual	Loans Not Past Due
Commercial	$ 16	$	$	$ 45	$ 61	$ 33,076

Real estate construction				3,035	3,035	11,067
Real estate mortgage:						
1-4 family residential	2,282	652	373	1,065	4,372	165,827
Multi-family residential				311	311	11.201
Non-farm & non-residential	90			1,589	1,679	111,761
Agricultural	655		426	894	1,975	67,831
Consumer	171	21	42	85	319	17,123
Other						337
Total	$ 3,214	$ 673	$ 841	$ 7,024	$ 11,752	$ 418,223

Troubled Debt Restructurings:

At December 31, 2013 & 2012, the Company had a recorded investment in trouble debt restructurings of $6.9 million and $7.2 million. The Company has allocated $428 thousand and $663 thousand in reserves to customers whose loan terms have been modified in troubled debt restructurings as of December 31, 2013 and 2012. The Company has not committed to lend additional amounts as of December 31, 2013 and 2012 to customers with outstanding loans that are classified as troubled debt restructurings.

During the year ending December 31, 2013, no loans were modified that met the definition of troubled debt restructurings. Prior to January 1, 2013, the terms of certain loans were modified as troubled debt restructurings. Two loans were modified during 2012 which met the definition of troubled debt restructurings. The modifications of the terms of such loans were to interest only payments for a 1 year term and lower interest rates.

The following table presents loans by class modified as troubled debt restructurings during 2012.

December 31, 2012

(in thousands):

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings:			
Real estate mortgage:			
Agricultural	1	4,847	4,798
Non-farm & non-residential	1	1,926	1,924
Total	2	$ 6,773	$ 6,722

Loans classified as troubled debt restructurings increased the allowance for loan losses by $428 thousand and $663 and resulted in no charge offs during the periods ending December 31, 2013 and 2012.

For the years ending December 31, 2013 and 2012, no loans modified as troubled debt restructurings had defaulted on payment.

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 includes primarily non-homogeneous loans with an outstanding balance greater than $200,000 such as commercial and commercial real estate loans. 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.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans. The following tables present the risk category of loans by class of loans, based on the most recent analysis performed, as of December 31, 2013 and 2012 (in thousands):

2013

	Pass	Special Mention	Substandard	Doubtful
Commercial	$ 32,771	$ 1,587	$ 296	$
Real estate construction	9,660	1,517		
Real estate mortgage:				
1-4 family residential	176,553	10,346	7,489	
Multi-family residential	14,392	1,579	449	
Non-farm & non-residential	120,195	5,327	1,269	
Agricultural	56,713	7,297	3,992	
Total	$ 410,284	$ 27,653	$ 13,495	$

2012

	Pass	Special Mention	Substandard	Doubtful
Commercial	$ 31,419	$ 1,362	$ 350	$ 6
Real estate construction	4,394	6,674	3,035	
Real estate mortgage:				
1-4 family residential	149,104	12,242	8,827	26
Multi-family residential	9,305	1,812	394	
Non-farm & non-residential	105,170	3,593	4,677	
Agricultural	56,516	3,569	9,718	2
Total	$ 355,908	$ 29,252	$ 27,001	$ 34

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 $16,000 at December 31, 2013 and $127,000 at December 31, 2012.

Non-consumer loans with an outstanding balance less than $200,000 are evaluated similarly to consumer loans over $200,000. Both are reviewed at least quarterly and credit quality grades are updated as needed.

Certain directors and executive officers of the Company and companies in which they have beneficial ownership were loan customers of the Bank during 2013 and 2012. An analysis of the activity with respect to all director and executive officer loans is as follows (in thousands):

	2013	2012
Balance, beginning of year	$ 3,858	$ 3,956
New loans	45	7
Effect of changes in composition of related parties	(2,070)	
Repayments	(545)	(105)
Balance, end of year	$ 1,288	$ 3,858

Loan Servicing

Mortgage loans serviced for others are not included in the accompanying consolidated balance sheets. The unpaid principal balances of mortgage loans serviced for others were approximately $186,288,000 and $176,180,000 at December 31, 2013 and 2012. Custodial escrow balances maintained in connection with the foregoing loan servicing, and included in demand deposits, were approximately $578,000 and $575,000 at December 31, 2013 and 2012.

Activity for mortgage servicing rights and the related valuation allowance follows:

	2013	2012	2011
Servicing Rights:			
Beginning balance	$ 1,152,436	$ 834,675	$ 958,193
Additions	445,812	627,999	312,588
Amortization	(409,361)	(346,238)	(288,106)
Change in valuation allowance	155,000	36,000	(148,000)
Ending balance	$ 1,343,887	$ 1,152,436	$ 834,675
Valuation Allowance:			
Beginning balance	$ 214,000	$ 250,000	$ 102,000
Additions expensed	73,000	92,000	189,000
Reductions credited to operations	228,000	128,000	41,000
Ending balance	$ 59,000	$ 214,000	$ 250,000

The fair value of servicing rights was $1.7 million and $1.3 million at year-end 2013 and 2012. Fair value at year-end 2013 was determined using a discount rate of 12.0%, prepayment speeds ranging from 7.0% to 23.5%, depending on the stratification of the specific right, and default rates ranging from 0.1% to 0.9%. Fair value at year-end 2012 was determined using a discount rate of 12.0%, prepayment speeds ranging from 3.0% to 45.0%, depending on the stratification of the specific right, and default rates ranging from 0.1% to 0.9%.

The weighted average amortization period is 4.8 years. Estimated amortization expense for each of the next five years is:

2014	$ 315,000
2015	282,000
2016	225,000
2017	172,000
2018	127,000

NOTE 5 - REAL ESTATE OWNED

Activity in real estate owned was as follows:

	Twelve Months Ended 2013	2012
Beginning of year	$ 4,168,356	$ 8,296,200
Additions	542,273	2,266,875
Sales	(1,475,565)	(6,057,937)
Additions to valuation allowance, net	(63,302)	(990,570)
Recovery from sale in valuation allowance	207,196	653,788
End of period	$ 3,378,958	$ 4,168,356

Activity in the valuation allowance was as follows:

	2013	2012	2011
Beginning of year	$ 1,668,202	$ 1,331,420	$ 799,320
Additions to valuation allowance, net	63,302	990,570	1,229,644
Recovery from sale	(207,196)	(653,788)	(697,544)
End of year	$ 1,524,308	$ 1,668,202	$ 1,331,420

Expenses related to foreclosed assets include:

	2013	2012	2011
Net loss (gain) on sales	$ (43,213)	$ 179,873	$ 94,509
Additions to valuation allowance, net	63,302	990,570	1,229,644
Operating expenses (receipts), net of rental income	203,503	745,194	817,889
Repossession expense, net	266,805	1,735,764	2,047,533
End of year	$ 223,592	$ 1,915,637	$ 2,142,042

NOTE 6 - PREMISES AND EQUIPMENT

Year-end premises and equipment were as follows:

	2013	2012

Land and buildings	$	19,937,331	$	19,961,251
Furniture and equipment		16,056,371		15,515,657
		35,993,702		35,476,908
Less accumulated depreciation		(19,284,740)		(18,708,619)
	$	16,708,962	$	16,768,289

Depreciation expense was $1,195,641, $1,278,740 and $1,189,661 in 2013, 2012, and 2011.

Certain premises, not included in premises and equipment above, are leased under operating leases. Minimum rental payments are as follows:

2014	$	167,738
2015		167,738
2016		167,738
2017		142,538
2018		144,676
Thereafter		756,591
	$	1,547,019

NOTE 7 - GOODWILL AND INTANGIBLE ASSETS

The change in balance for goodwill during the year is as follows:

	2013	2012	2011
Beginning of year	$ 13,116,710	$ 13,116,710	$ 13,116,710
Acquired goodwill			
Impairment			
End of year	$ 13,116,710	$ 13,116,710	$ 13,116,710

Goodwill is not amortized but instead evaluated periodically for impairment.

Acquired intangible assets were as follows at year-end:

	2013		2012	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortized intangible assets:				
Core deposit intangibles	$ 2,530,102	$ 2,213,342	$ 2,530,102	$ 1,998,369

Aggregate amortization expense was $214,973, $233,736 and $243,736 for 2013, 2012 and 2011.

Estimated amortization expense for each of the next five years:

2014	$ 140,000
2015	121,000
2016	56,000
2017	
2018	

Impairment exists when a reporting unit s carrying value of goodwill exceeds its fair value, which is determined through a two-step impairment test. Step 1 includes the determination of the carrying value of our single reporting unit, including the existing goodwill and intangible assets, and estimating the fair value of the reporting unit. We determined the fair value of our reporting unit and compared it to its carrying amount. If the carrying amount of a reporting unit exceeds its fair value, we are required to perform a second step to the impairment test.

Our annual impairment analysis as of December 31, 2013 and 2012, indicated that the Step 2 analysis was not necessary. If needed, Step 2 of the goodwill impairment test is performed to measure the impairment loss. Step 2 requires that the implied fair value of the reporting unit goodwill be compared to the carrying amount of that goodwill. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss shall be recognized in an amount equal to that excess.

NOTE 8 - DEPOSITS

Time deposits of $100,000 or more were $96,264,000 and $91,948,000 at year-end 2013 and 2012, respectively.

At December 31, 2013, the scheduled maturities of time deposits for the next five years are as follows:

2014	$	98,438,566
2015		45,633,606
2016		23,059,235
2017		11,807,076
2018		11,759,515

Certain directors and executive officers of the Company and companies in whom they have beneficial ownership are deposit customers of the Bank. The amount of these deposits was approximately $5,878,000 and $2,645,000 at December 31, 2013 and 2012.

NOTE 9 - REPURCHASE AGREEMENTS AND OTHER BORROWINGS

Securities sold under agreements to repurchase are secured by U.S. Government securities with a carrying amount of $12,867,341 and $3,815,384 at year-end 2013 and 2012.

Repurchase agreements generally mature within one year from the transaction date and range in maturities from 1 day to 65 months. The securities underlying the agreements are maintained in a third-party custodian s account under a written custodial agreement. Information concerning repurchase agreements for 2013, 2012 and 2011 is summarized as follows:

		2013		**2012**		**2011**
Average daily balance during the year	$	9,645,729	$	3,847,580	$	3,640,488
Average interest rate during the year		0.68%		0.27%		0.42%
Maximum month-end balance during the year	$	13,197,530	$	5,033,965	$	4,654,159
Weighted average interest rate at year end		0.73%		0.22%		0.30%

The promissory note payable the Company had outstanding at December 31, 2012 in the principal amount of $500,000 was paid in full during the second quarter of 2013. The $5 million revolving promissory note is scheduled to mature July 27, 2014. The Company had no outstanding balances at December 31, 2013.

NOTE 10 - FEDERAL HOME LOAN BANK ADVANCES

At year-end, advances from the Federal Home Loan Bank were as follows:

	2013	2012
Maturities January 2014 through March 2030, fixed rates from 1.00% to 7.23%, averaging 2.22% in 2013 and 4.09% in 2012	$ 57,846,833	$ 17,448,932

Advances are paid either on a monthly basis or at maturity. All advances require a prepayment penalty, and are secured by the FHLB stock and substantially all first mortgage residential, multi-family and farm real estate loans.

Scheduled principal payments due on advances during the years subsequent to December 31, 2013 are as follows:

2014	$ 12,217,630
2015	6,137,660
2016	4,686,024
2017	4,286,438
2018	12,255,040
Thereafter	18,264,041
	$ 57,846,833

NOTE 11 - SUBORDINATED DEBENTURES

In August 2003, the Company formed Kentucky Bancshares, Statutory Trust I (Trust). The Trust issued $217,000 of common securities to the Company and $7,000,000 of trust preferred securities as part of a pooled offering of such securities. The Company issued $7,217,000 subordinated debentures to the Trust in exchange for the proceeds of the offering, which debentures represent the sole asset of the Trust. The debentures paid interest quarterly at 7.06% for the first 5 years. Starting September 2008, the rate converted to three-month LIBOR plus 3.00% adjusted quarterly, which was 3.25% at year-end 2013. The Company is not considered the primary beneficiary of this Trust (variable interest entity), therefore the trust is not consolidated in the Company s financial statements, but rather the subordinated debentures are shown as a liability.

The Company may redeem the subordinated debentures, in whole or in part, beginning September 2008 at a price of 100% of face value. The subordinated debentures must be redeemed no later than 2033. The Company has the option to defer interest payments on the subordinated debentures from time to time for a period not to exceed five consecutive years.

The subordinated debentures may be included in Tier I capital (with certain limitations applicable) under current regulatory guidelines and interpretations.

NOTE 12 - INCOME TAXES

Income tax expense was as follows:

	2013	2012	2011
Current	$ 900,288	$ 1,962,873	$ 1,060,302
Deferred	(41,291)	(319,200)	(140,887)
	$ 858,997	$ 1,643,673	$ 919,415

Year-end deferred tax assets and liabilities were due to the following. No valuation allowance for the realization of deferred tax assets is considered necessary.

	2013	2012
Deferred tax assets		
Allowance for loan losses	$ 1,875,345	$ 2,081,597
Other real estate owned	518,265	536,587
Nonaccrual loan interest	117,991	153,186
Unrealized loss on securities	2,640,761	
Accrued pension	330,783	
Accrued expenses	214,880	151,980
Other	71,566	73,386
Deferred tax liabilities		
Unrealized gain on securities		(2,206,521)
Bank premises and equipment	(1,061,101)	(1,002,811)
FHLB stock	(1,343,242)	(1,343,242)
Mortgage servicing rights	(456,922)	(391,828)
Core deposit intangibles	(103,360)	(169,943)
Low income housing investments	(148,470)	(118,890)
Other	(218,956)	(214,534)
Net deferred tax asset (liability)	$ 2,437,540	$ (2,451,033)

Effective tax rates differ from federal statutory rates applied to financial statement income due to the following:

	2013	2012	2011
U. S. federal income tax rate	34.0%	34.0%	34.0%
Changes from the statutory rate			
Tax-exempt interest income	(16.8)	(13.8)	(18.4)
Historic and low income tax credits	(5.4)	(2.1)	(2.7)
Non-deductible interest expense related to carrying tax-exempt investments	0.5	0.4	0.8
Other	0.6	0.5	0.2
	12.9%	19.0%	13.9%

Federal income tax laws provided the Federal Savings Bank, acquired by the Company in 2003, with additional bad debt deductions through 1987, totaling $1.3 million. Accounting standards do not require a deferred tax liability to be recorded on this amount, which otherwise would total a $441,000 liability at December 31, 2013. The Company s acquisition of First Federal Savings Bank did not require the recapture of the bad debt reserve. However, if Kentucky Bank was liquidated or otherwise ceased to be a bank, or if tax laws were to change, the $441,000 would be recorded as expense.

Unrecognized Tax Benefits

The Company does not have any beginning and ending unrecognized tax benefits. The Company does not expect the total amount of unrecognized tax benefits to significantly increase or decrease in the next twelve months.

There were no interest and penalties recorded in the income statement or accrued for the years ended December 31, 2013 and December 31, 2012.

The Company and its subsidiary file a consolidated U.S. Corporation income tax return and a corporate income tax return in the state of Kentucky. The Company is no longer subject to examination by taxing authorities for years before 2010.

NOTE 13 - EARNINGS PER SHARE

The factors used in the earnings per share computation follow:

		2013		**2012**		**2011**
Basic Earnings Per Share						
Net income	$	5,821,874	$	7,007,562	$	5,686,874
Weighted average common shares outstanding		2,704,606		2,705,456		2,718,561
Basic earnings per share	$	2.15	$	2.59	$	2.09
Diluted Earnings Per Share						
Net income	$	5,821,874	$	7,007,562	$	5,686,874
Weighted average common shares outstanding		2,704,606		2,705,456		2,718,561
Add effect of dilutive shares		3,980		2,146		1,094
Weighted average common shares outstanding including dilutive shares		2,708,586		2,707,602		2,719,655
Diluted earnings per share	$	2.15	$	2.59	$	2.09

Stock options of 19,100 shares common stock from 2013, 28,460 shares common stock from 2012 and 30,660 shares common stock from 2011 were excluded from diluted earnings per share because their impact was antidilutive. Stock grants of 0 shares common stock from 2013, 585 shares common stock from 2012 and 6,221 shares common stock from 2011 were excluded from diluted earnings per share because their impact was antidilutive.

NOTE 14 - RETIREMENT PLAN

The Company has a qualified profit sharing plan which covers substantially all employees and includes a 401(k) provision. Profit sharing contributions, excluding the 401(k) provision, are at the discretion of the Company s Board of Directors. Expense recognized in connection with the plan was $776,939, $695,831 and $647,846 in 2013, 2012 and 2011.

NOTE 15 - STOCK BASED COMPENSATION

The Company has four share based compensation plans as described below. Total compensation cost that has been charged against income for those plans was $82,115, $92,683, and $76,809 for 2013, 2012 and 2011. The total income tax benefit was $0, $0, and $0.

Two Stock Option Plans

Under its expired 1999 Employee Stock Option Plan, the Company has granted certain officers and key employees stock option awards which vest and become fully exercisable at the end of five years and provided for issuance of up to 100,000 options. Under the expired 1993 Non-Employee Directors Stock Ownership Incentive Plan, the Company had also granted certain directors stock option awards which vest and become fully exercisable immediately and provided for issuance of up to 20,000 options. The exercise price of each option, which has a ten year life, was equal to the market price of the Company s stock on the date of grant.

The fair value of each option award is estimated on the date of grant using a closed form option valuation (Black-Scholes) model that uses various assumptions. Expected volatilities are based on historical volatilities of the Company s common stock. The Company uses historical data to estimate option exercise and post-vesting termination behavior. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant.

No options were granted in 2013, 2012 or 2011.

Summary of activity in the stock option plan for 2013 follows:

	Shares	**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Term**	**Aggregate Intrinsic Value**
Outstanding, beginning of year	28,460	$ 29.86		
Granted				
Forfeited or expired	(9,360)	26.56		
Exercised				
Outstanding, end of year	19,100	$ 31.50	14.8 months	$
Vested and expected to vest	19,100	$ 31.50	14.8 months	$
Exercisable, end of year	19,100	$ 31.50	14.8 months	$

Options outstanding at year-end 2013 were as follows:

	Outstanding			Exercisable	
Range of Exercise Prices	**Options**	**Weighted Average Remaining Contractual Life**	**Weighted Average Exercise Price**	**Options**	**Weighted Average Exercise Price**
From $29.50 to $31.00 per share	13,350	16.2	30.46	13,350	30.46
From $33.90 to $34.00 per share	5,750	0.3	33.91	5,750	33.91
	19,100			19,100	

As of December 31, 2013, there was $0 of total unrecognized compensation cost related to nonvested stock options granted under the Plan. Since both stock option plans have expired, as of December 31, 2013 neither plan allows for additional options to be issued.

2005 Restricted Stock Grant Plan

On May 10, 2005, the Company s stockholders approved a restricted stock grant plan. Total shares issuable under the plan are 50,000. There were 6,065 shares issued during 2013 and 5,615 shares issued during 2012. There were 225 shares forfeited during 2013 and 30 shares forfeited during 2012.

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, 2013	14,739	$ 267,658	$ 18.16
Granted	6,065	112,203	18.50
Vested	(5,014)	(88,177)	17.59
Forfeited	(225)	(4,163)	18.50
Nonvested at December 31, 2013	15,565	$ 280,016	$ 17.99

As of December 31, 2013, there was $198,577 of total unrecognized compensation cost related to nonvested shares granted under the Plan. The cost is expected to be recognized over a weighted-average period of 5 years. The total fair value of shares vested during the years ended December 31, 2013, 2012 and 2011 was $88,177, $54,535 and $56,581. As of December 31, 2013, the restricted stock grant plan allows for additional restricted stock share awards of up to 12,470 shares.

2009 Stock Award Plan

On May 13, 2009, the Company s stockholders approved a stock award plan that provides for the granting of both incentive and nonqualified stock options and other share based awards. Total shares issuable under the plan are 150,000. There were 900 shares issued during 2013 and no shares were issued during 2012. There were no shares forfeited during 2013 or 2012.

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, 2013		$	$
Granted	900	20,880	23.20
Vested			
Forfeited			
Nonvested at December 31, 2013	900	$ 20,880	$ 23.20

As of December 31, 2013, there was $17,400 of total unrecognized compensation cost related to nonvested shares granted under the Plan. The cost is expected to be recognized over a weighted-average period of 5 years. The total fair value of shares vested during the years ended December 31, 2013, 2012 and 2011 was $0, $0 and $0. As of December 31, 2013, the restricted stock grant plan allows for additional restricted stock share awards of up to 149,100 shares.

NOTE 16 - LIMITATION ON BANK DIVIDENDS

The Company s principal source of funds is dividends received from the Bank. Banking regulations limit the amount of dividends that may be paid by the Bank without prior approval of regulatory agencies. Under these regulations, the amount of dividends that may be paid in any calendar year is limited to the current year s net profits, as defined, combined with the retained net profits of the preceding two years. During 2014 the Bank could, without prior approval, declare dividends on any 2014 net profits retained to the date of the dividend declaration plus $5,086,000.

NOTE 17 - FAIR VALUE

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

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

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

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

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

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

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

Other Real Estate Owned: Assets acquired through, or instead of, loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals which are updated no less frequently than annually. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. Real estate owned properties are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

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

Assets and Liabilities Measured on a Recurring Basis

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

		Fair Value Measurements at December 31, 2013 Using :		
(In thousands)	**Carrying Value**	**Quoted Prices In Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Description				
U. S. government agencies	$ 69,286	$	$ 69,286	$
States and municipals	90,183		90,183	
Mortgage-backed - residential	70,638		70,638	
Equity securities	289	289		
Total	$ 230,396	$ 289	$ 230,107	$

(In thousands)	Carrying Value	Fair Value Measurements at December 31, 2012 Using : Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Description				
U. S. government agencies	$ 48,831	$	$ 48,831	$
States and municipals	82,607		82,607	
Mortgage-backed - residential	61,037		61,037	
Equity securities	305	305		
Total	$ 192,780	$ 305	$ 192,475	$

There were no transfers between level 1 and level 2 during 2013 or 2012.

<u>Assets measured at fair value on a non-recurring basis are summarized below</u>:

(In thousands)	Carrying Value	Fair Value Measurements at December 31, 2013 Using : Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Description				
Impaired loans:				
Real estate construction	$			$
Real Estate Mortgage:				
1-4 family residential	1,420			1,420
Multi-family residential	199			199
Non-farm & non-residential	36			36
Agricultural	275			275
Other real estate owned, net:				
Residential	1,361			1,361
Loan servicing rights	201			201

(In thousands)	Carrying Value	Fair Value Measurements at December 31, 2012 Using: Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Description				
Impaired loans:				
Real estate construction	$ 2,535			$ 2,535
Real Estate Mortgage:				
1-4 family residential	1,255			1,255
Multi-family residential	164			164
Non-farm & non-residential	2,025			2,025
Agricultural	4,839			4,839
Other real estate owned, net:				
Residential	2,539			2,539
Loan servicing rights	529			529

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a net carrying amount of $1.9 million, with a valuation allowance of $284 thousand at December 31, 2013. During 2013, five new loans became impaired resulting in an additional provision for loan losses of $253 thousand. The total allowance for specific impaired loans decreased $746 thousand for the year ending December 31, 2013. At December 31, 2012, impaired loans had a net carrying amount of $10.8 million, with a valuation allowance of $1.5 million, resulting in an additional provision for loan losses of $168 thousand for the year ending December 31, 2012.

Other real estate owned which is measured at fair value less costs to sell, had a net carrying amount of $1.4 million, which is made up of the outstanding balance of $2.9 million, net of a valuation allowance of $1.5 million at December 31, 2013. Write-downs of other real estate netted to a recovery of $63 thousand for the year ending December 31, 2013. At December 31, 2012, other real estate owned had a net carrying amount of $2.5 million, which is made up of the outstanding balance of $4.2 million, net of a valuation allowance of $1.7 million at December 31, 2012, resulting in a net write-down of $990 thousand for the year ending December 31, 2012.

Loan servicing rights, which are carried at lower of cost or fair value, were carried at their fair value of $201 thousand, which is made up of the outstanding balance of $260 thousand, net of a valuation allowance of $51 thousand at December 31, 2013. Net Recoveries for prior write-downs were recorded in the amount of $155 thousand for the year ending December 31, 2013. At December 31, 2012, loan servicing rights were carried at their fair value of $529 thousand, which is made up of the outstanding balance of $743 thousand, net of a valuation allowance of $214 thousand at December 31, 2012, resulting in a net recovery of prior write-downs of $36 thousand for the year ending December 31, 2012.

The following table presents quantitative information about level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at December 31, 2013 and 2012:

December 31, 2013

(In thousands)	**Fair Value**	**Valuation Technique(s)**	**Unobservable Input(s)**	**Range (Weighted Average)**
Impaired loans				
Real estate mortgage:				
1-4 family residential	1,420	sales comparison	adjustment for differences between the comparable sales	0%-99% (14)%
Multi-family residential	199	sales comparison	adjustment for differences between the comparable sales	12%-32% (22)%
Non-farm & non-residential	36	sales comparison	adjustment for differences between the comparable sales	0%-61% (31)%
Agricultural	275	sales comparison	adjustment for differences between the comparable sales	5%-44% (20)%
Other real estate owned:				
Residential	1,361	sales comparison	adjustment for differences between the comparable sales	0%-33% (4)%
		income approach	capitalization rate	8%-8% (8)%
Loan Servicing Rights	201	discounted cash flow	constant prepayment rates	7%-23% (10)%

December 31, 2012

(In thousands)	**Fair Value**	**Valuation Technique(s)**	**Unobservable Input(s)**	**Range (Weighted Average)**
Impaired loans				
Real estate construction	$ 2,535	income approach	capitalization rate	18% (18)%
Real estate mortgage:				
1-4 family residential	1,255	sales comparison	adjustment for differences between the comparable sales	0%-44% (6)%
Multi-family residential	164	sales comparison	adjustment for differences between the comparable sales	0%-54% (18)%
Non-farm & non-residential	2,025	sales comparison	adjustment for differences between the comparable sales	7%-11% (9)%
Agricultural	4,839	sales comparison	adjustment for differences between the comparable sales	3%-37% (17)%
Other real estate owned:				
Residential	2,539	sales comparison	adjustment for differences between the comparable sales	0%-70% (8)%
		income approach	capitalization rate	8%-12% (11)%

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Fair Value of Financial Instruments

The carrying amounts and estimated fair values of financial instruments, at December 31, 2013 and December 31, 2012 are as follows:

December 31, 2013

(in thousands)	Carrying Value	Level 1	Level 2	Level 3	Total
Financial assets					
Cash and cash equivalents	$ 23,160	$ 23,160	$	$	$ 23,160
Securities	230,396	289	230,107		230,396
Mortgage loans held for sale	223		229		229
Loans, net	463,214			459,796	459,796
FHLB Stock	6,731				N/A
Interest receivable	3,618		1,315	2,303	3,618
Financial liabilities					
Deposits	$ 617,400	$ 428,239	$ 191,523	$	$ 619,762
Securities sold under agreements to repurchase and other borrowings	12,867		13,013		13,013
FHLB advances	57,847		52,220		52,220
Subordinated Debentures	7,217			7,217	7,217
Interest payable	736		727	9	736

December 31, 2012:

(in thousands)	Carrying Value	Level 1	Level 2	Level 3	Total
Financial assets					
Cash and cash equivalents	$ 31,764	$ 31,764	$	$	$ 31,764
Securities	192,780	305	192,475		192,780
Mortgage loans held for sale	486		500		500
Loans, net	423,928			422,920	422,920
FHLB Stock	6,731				N/A
Interest receivable	3,946		1,138	2,808	3,946
Financial liabilities					
Deposits	$ 590,425	$ 401,164	$ 191,732	$	$ 592,896
Securities sold under agreements to repurchase and other borrowings	4,315		4,314		4,314
FHLB advances	17,449		18,806		18,806
Subordinated Debentures	7,217			7,261	7,261
Interest payable	610		601	9	610

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.

NOTE 18 - OFF-BALANCE SHEET ACTIVITIES AND COMMITMENTS

Some financial instruments, such as loan commitments, credit lines, letters of credit, and overdraft protection, are issued to meet customer financing needs. These are agreements to provide credit or to support the credit of others, as long as conditions established in the contract are met, and usually have expiration dates. Commitments may expire without being used. Off-balance sheet risk to credit loss exists up to the face amount of these instruments, although material losses are not anticipated. The same credit policies are used to make such commitments as are used for loans, including obtaining collateral at exercise of the commitment.

Financial instruments with off-balance sheet risk were as follows at year-end:

		2013		2012
Unused lines of credit	$	85,654,871	$	85,230,958
Commitments to make loans		3,481,833		12,607,179
Letters of credit		554,000		1,538,400

Unused lines of credit are substantially all at variable rates. Commitments to make loans are generally made for a period of 60 days or less and are primarily fixed at current market rates ranging from 3.25% to 5.00% with maturities ranging from 1 to 30 years.

NOTE 19 - PENSION MATTER

The Bank is a defendant in legal actions arising from normal business activities. Management believes these actions are without merit or that the ultimate liability, if any, resulting from them will not materially affect the Company s consolidated financial position or results of operations.

Kentucky Bancshares, Inc. (the Company) terminated the Kentucky Bancshares, Inc. Retirement Plan and Trust (the Plan) in a standard termination, with a termination date of December 31, 2008. Prior to such termination, the Pension Protection Act of 2006 (PPA) had amended Internal Revenue Code (IRC) Section 417(e)(3) in part by changing the definition of applicable interest rate in a manner that in most cases (when combined with other changes to IRC Section 417(e)(3)) would result in a decrease in the value of a participant s or beneficiary s plan benefits under pension plans such as the Company s Plan with the new definition applicable (for most plans, including the Plan) to lump sums with annuity starting dates in or after the 2008 plan year. The Plan had determined in mid-2008 to comply with IRC Section 417(e)(3), as amended by PPA, by using the assumptions governing minimum lump sums, rather than by using the pre-PPA minimum lump sum assumptions, and operated the Plan in compliance with that decision. As permitted by the IRC, the Plan was amended on February 24, 2009 (after the termination of the Plan on December 31, 2008) to formalize that decision in accordance with Section 1107 of PPA.

The Internal Revenue Service issued a favorable determination as to the Plan termination in July 2010. Subsequent to Plan termination and distributions to Plan participants, the Plan was selected for audit by the PBGC. The PBGC asserted that the February, 2009 amendment to the Plan violated PBGC Regulation Section 4041.8(a) because the amendment served to lower benefits to Plan beneficiaries. The PBGC filed a Complaint in May 2013 in United States District Court (Eastern District of Kentucky) to require the Company to make additional distributions to Plan beneficiaries. On March 17, 2014, the United States District Court (Eastern District of Kentucky) issued an Opinion and Order entering judgment in favor of the PBGC and ruling that the Company must comply with the PBGC s determination respecting the Plan. The Company is appraising its options with respect to this judgment, including an appeal of the decision. However, in light of the court s opinion, the Company has now accrued approximately $1.6 million as of December 31, 2013 for this matter. After taking into account income tax adjustments and indemnification undertakings from professionals who assisted the Company in the termination of the Plan, the impact is an approximate $470,000 decrease to the net income disclosed on Form 8-K filed by the Company on January 31, 2014. Moreover, in the event the subject court decision is not overturned, the Company believes it has claims for further contribution towards payment of this liability from professionals who assisted the Company in the termination of the Plan.

NOTE 20 - 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 December 31, 2013 and 2012, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

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

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

[redacted]

2013						
Consolidated						
Total Capital (to Risk-Weighted Assets)	$ 71,993	14.1%	$ 40,872	8%	N/A	N/A
Tier I Capital (to Risk-Weighted Assets)	66,468	13.0	20,436	4	N/A	N/A
Tier I Capital (to Average Assets)	66,468	8.8	30,079	4	N/A	N/A
Bank Only						
Total Capital (to Risk-Weighted Assets)	$ 70,827	13.9%	$ 40,859	8%	$ 51,073	10%
Tier I Capital (to Risk-Weighted Assets)	65,302	12.8	20,429	4	30,644	6
Tier I Capital (to Average Assets)	65,302	8.7	30,070	4	37,588	5
2012						
Consolidated						
Total Capital (to Risk-Weighted Assets)	$ 67,956	14.5%	$ 37,385	8%	N/A	N/A
Tier I Capital (to Risk-Weighted Assets)	62,095	13.3	18,692	4	N/A	N/A
Tier I Capital (to Average Assets)	62,095	9.2	27,050	4	N/A	N/A
Bank Only						
Total Capital (to Risk-Weighted Assets)	$ 67,522	14.2%	$ 37,383	8%	$ 46,729	10%
Tier I Capital (to Risk-Weighted Assets)	61,661	13.2	18,692	4	28,037	6
Tier I Capital (to Average Assets)	61,661	9.1	27,040	4	33,800	5

NOTE 21 - PARENT COMPANY FINANCIAL STATEMENTS

Condensed Balance Sheets

December 31

	2013	2012
	(In Thousands)	
ASSETS		
Cash on deposit with subsidiary	$ 1,008	$ 765
Investment in subsidiary	73,507	80,574
Securities available for sale	20	20
Other assets	364	375
Total assets	$ 74,899	$ 81,734
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities		
Subordinated debentures	$ 7,217	$ 7,217
Notes payable		500
Other Liabilities	9	9
Stockholders equity		
Preferred stock		
Common stock	12,570	12,529
Retained earnings	60,299	57,196
Accumulated other comprehensive income (loss)	(5,126)	4,283
Total liabilities and stockholders equity	$ 74,899	$ 81,734

Condensed Statements of Income and Comprehensive Income (Loss)

Years Ended December 31

	2013	2012 (In Thousands)	2011
Income			
Dividends from subsidiary	$ 3,800	$ 4,200	$ 3,800
Interest income			
Total income	3,800	4,200	3,800
Expenses			
Interest expense	238	277	296
Other expenses	123	112	86
Total expenses	361	389	382
Income before income taxes and equity in undistributed income of subsidiary	3,439	3,811	3,418
Applicable income tax benefits	123	132	150
Income before equity in undistributed income of subsidiary	3,562	3,943	3,568
Equity in undistributed income of subsidiary	2,260	3,065	2,119
Net income	5,822	7,008	5,687
Other comprehensive income (loss), net of tax:			
Unrealized gains (losses) on securities arising during the period	(8,770)	1,723	5,790
Reclassification of realized amount	(639)	(1,210)	(768)
Net change in unrealized gain (loss) on securities	(9,409)	513	5,022
Comprehensive income (loss)	$ (3,587)	$ 7,521	$ 10,709

Condensed Statements of Cash Flows

Years Ended December 31

	2013	2012 (In Thousands)	2011
Cash flows from operating activities			
Net income	$ 5,822	$ 7,008	$ 5,687
Adjustments to reconcile net income to net cash from operating activities:			
Equity in undistributed earnings of subsidiary	(2,260)	(3,065)	(2,119)
Change in other assets	11	(1)	14
Change in other liabilities		(1)	1
Net cash from operating activities	3,573	3,941	3,583
Cash flows from financing activities			
Proceeds from note payable			
Payments on note payable	(500)	(800)	(800)
Dividends paid	(2,613)	(2,503)	(2,402)
Proceeds from issuance of common stock		1	
Purchase of common stock	(217)	(56)	(474)
Net cash from financing activities	(3,330)	(3,358)	(3,676)
Net change in cash	243	583	(93)
Cash at beginning of year	765	182	275
Cash at end of year	$ 1,008	$ 765	$ 182

NOTE 22 - QUARTERLY FINANCIAL DATA (UNAUDITED)

(in thousands, except per share data)

	Interest Income	Net Interest Income	Net Income	Earnings Per Share Basic	Earnings Per Share Fully Diluted
2013					
First quarter	$ 6,956	$ 6,134	$ 1,709	$ 0.63	$ 0.63
Second quarter	6,837	6,021	1,785	0.66	0.66
Third quarter	7,105	6,245	1,367	0.51	0.51
Fourth quarter	7,270	6,312	961	0.35	0.35
2012					
First quarter	$ 7,162	$ 6,110	$ 1,618	$ 0.60	$ 0.60
Second quarter	7,321	6,359	1,778	0.65	0.65
Third quarter	6,937	6,078	1,698	0.63	0.63
Fourth quarter	6,812	5,971	1,914	0.71	0.71

The Company recorded a gain of approximately $289 thousand and $485 thousand during the first and second quarters of 2013 for the gain on the sale of securities. The Company also recorded a gain of $626 thousand and $514 thousand during the first and second quarters of 2013 for the gain on the sale of mortgage loans. The Company recorded additional expenses related to the new branch expansion during the third and fourth quarters of 2013. Further, the Company recorded an additional $973 thousand non-recurring expense during the fourth quarter of 2013 for pension expense related to the 2008 termination of the defined benefit plan.

NOTE 23 - ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following is changes in Accumulated Other Comprehensive Income (Loss) by component, net of tax, for the years ending December 31, 2013 and 2012:

	Unrealized Gains and Losses on Available for Sale Securities 2013	2012
Beginning Balance	$ 4,283,247	$ 3,769,734
Unrealized holding gains (losses) for the period, net of tax	(8,770,910)	1,724,507
Reclassification adjustment for:		
Securities gains realized in income	(967,454)	(1,834,839)
Income taxes	(328,934)	(623,845)
	(638,520)	(1,210,994)
Net current period other comprehensive income	(9,409,430)	513,513

Ending balance	$	(5,126,183)	$	4,283,247

The following is significant amounts reclassified out of each component of accumulated other comprehensive Income (Loss) for the years ending December 31, 2013 and 2012:

December 31, 2013

Details about Accumulated Other Comprehensive Income Components		**Amount Reclassified From Accumulated Other Comprehensive Income**	**Affected Line Item in the Statement Where Net Income is Presented**
Unrealized gains and losses on available-for-sale securities	$	(967,454)	Securities gains, net
		328,934	Provision for income taxes
		(638,520)	Net of tax

December 31, 2012

Details about Accumulated Other Comprehensive Income Components		**Amount Reclassified From Accumulated Other Comprehensive Income**	**Affected Line Item in the Statement Where Net Income is Presented**
Unrealized gains and losses on available-for-sale securities	$	(1,834,839)	Securities gains, net
		623,845	Provision for income taxes
		(1,210,994)	Net of tax

Item 9. Changes In and Disagreements with Accountants on Accounting and Financial Disclosure

None

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls. Our Chief Executive Officer and Chief Financial Officer, with the participation of management, have evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this annual report on Form 10-K. Based on their evaluation, they have concluded that our disclosure controls and procedures are effective as of the end of the period covered by this report to ensure that the Company is able to collect, process and disclose the information it is required to disclose in the reports it files with the SEC within the required time periods.

Management s Report on Internal Control Over Financial Reporting.

General Overview of Internal Controls over Financial Reporting. Management of the Company is responsible for establishing and maintaining effective internal control over financial reporting as defined in Rules 13a-15(f) under the Securities Exchange Act of 1934. The Company s internal control over financial reporting is designed to provide reasonable assurance to the Company s management and Board of Directors regarding the reliability of financial reporting and the preparation and fair presentation of published financial statements. All internal controls, however, have inherent limitations regardless of how well they have been designed.

General Description of Internal Control over Financial Reporting. Internal control over financial reporting refers to a process designed by, or under the supervision of, the Company s Chief Executive Officer and Chief Financial Officer and effected by the Company s Board of Directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles and includes those policies and procedures that:

(1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of Company assets;

(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that Company s receipts and expenditures are being made only in accordance with the authorization of Company s management and members of the Company s Board of Directors; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisitions, uses or dispositions of Company assets that could have a material effect on the Company s financial statements.

Inherent Limitations in Internal Control over Financial Reporting. Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented or overridden by collusion or other improper activities. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process, and it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

Management s Assessment of the Company s Internal Control over Financial Reporting. Management, with participation of the Company s Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company s disclosure controls and procedures as of December 31, 2013. Based on the evaluation, the Company s Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures were effective to ensure that information required to be disclosed by the Company in reports that the Company files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in the 1992 Internal Control Integrated Framework.

No Changes in Internal Controls over Financial Reporting During Most Recent Quarter. The Company s Chief Executive Officer and Chief Financial Officer have also concluded that there were no changes in the Company s internal control over financial reporting or in other factors that occurred during the Company s most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting or any corrective actions with regard to significant deficiencies and material weaknesses in internal control over financial reporting.

Attestation Report of Registered Public Accounting Firm. This annual report does not include an attestation report of the Company s registered public accounting firm regarding internal control over financial reporting. Management s report was not subject to attestation by the Company s registered public accounting firm pursuant to rules of the Securities and Exchange Commission that permit the Company to provide only management s report in this annual report.

Item 9B. Other Information

None

PART III

Item 10. Directors and Executive Officers and Corporate Governance

Set forth below is information about our executive officers who do not serve as Directors, including their business experience for at least the past five years and their ages as of March 28, 2013.

Name	Age	Position with the Company
James B. Braden	35	Senior Vice President, Chief Administrative Officer since 2013. Director of Risk Management from 2010 to 2012. Previously a Senior Manager at a national public accounting firm serving financial institutions.
Brenda S. Bragonier	57	Senior Vice President, Director of Marketing since 1999.
Carol Caskey	56	Senior Vice President, Director of Human Resources since 2011. Previously an Associate Relations Consultant at a national health insurance carrier.
Gregory J. Dawson	53	Senior Vice President, Chief Financial Officer since 1989.
James L. Elliott	67	Senior Vice President, Director of Wealth Management and Market President since 2013. Previously a Senior Vice President and Group Director of private financial services for a financial institution.
Norman J. Fryman	64	Executive Vice President, Chief Credit Officer since 2010. Director of Sales and Service from 2004 to 2009.
Christopher Gorley	43	Senior Vice President, Director of Operations since 2013. Previously a Vice President and Chief Operations Officer with a community bank.
William Hough	59	Senior Vice President, Director of Sales and Service since 2011. Previously a Market President from 2006 to 2010.

The remaining information required by Item 10 is hereby incorporated by reference under the headings Corporate Governance , Section 16(a) Beneficial Ownership Reporting Compliance and Proposal No. 2 Election of Directors from the Company s definitive proxy statement in connection with its annual meeting of stockholders scheduled for May 15, 2014, which will be filed with the Commission on or about April 15, 2014, pursuant to Regulation 14A (2013 Proxy Statement).

Item 11. Executive Compensation

The information required by Item 11 is hereby incorporated by reference under the headings Executive Compensation, Report of Compensation Committee and Compensation of Named Executive Officers in the 2014 Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by Item 12 is hereby incorporated by reference under the heading Stock Ownership of Directors and Executive Officers in the 2014 Proxy Statement. See Part II, Item 5, for information about securities authorized for issuance under the Company s equity compensation plans.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required by Item 13 is hereby incorporated by reference under the headings Corporate Governance and Transactions with Related Persons in the 2014 Proxy Statement.

Item 14. Principal Accountant Fees and Services

The information required by Item 14 is hereby incorporated by reference under the heading Fees of Independent Registered Public Accounting Firm in the 2014 Proxy Statement.

Part IV

Item 15. Exhibits, Financial Statement Schedules and Reports on Form 8-K

(a)(1) Financial Statements

The following financial statements are included in Item 8 of this Form 10-K.

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets

Consolidated Statements of Income

Consolidated Statements of Comprehensive Income (Loss)

Consolidated Statements of Changes in Stockholders Equity

Consolidated Statements of Cash Flow

Notes to Consolidated Financial Statements

(a)(2) Financial Statement Schedules.

All financial statement schedules have been omitted as the required information is inapplicable or the required information has been included in the Consolidated Financial statements or notes thereto.

(a)(3) Exhibits

Reference is made to the Exhibit Index beginning on Page E-1 hereof.

SIGNATURES

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

Kentucky Bancshares, Inc.
By: /s/Louis Prichard
Louis Prichard, President and Chief Executive Officer, Director
March 28, 2014

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

/s/Louis Prichard Louis Prichard, President and Chief Executive Officer, Director	March 28, 2014
/s/Gregory J. Dawson Gregory J. Dawson, Chief Financial and Accounting Officer	March 28, 2014
/s/Buckner Woodford Buckner Woodford, Chairman of the Board, Director	March 28, 2014
/s/B. Proctor Caudill B. Proctor Caudill, Director	March 28, 2014
/s/Henry Hinkle Henry Hinkle, Director	March 28, 2014
/s/Theodore Kuster Theodore Kuster, Director	March 28, 2014
/s/Betty J. Long Betty J. Long, Director	March 28, 2014
/s/Ted McClain Ted McClain, Director	March 28, 2014
/s/Edwin S. Saunier Edwin S. Saunier, Director	March 28, 2014
/s/Robert G. Thompson Robert G. Thompson, Director	March 28, 2014
/s/Woodford Van Meter Woodford Van Meter, Director	March 28, 2014

Kentucky Bancshares, Inc.

Exhibit Index

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

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

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

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

10.1 Kentucky Bancshares, Inc. 1993 Non-Employee Directors Stock Ownership Incentive Plan is incorporated by reference to Exhibit 10.3 of the Registrant s Registration Statement on Form S-4 (File No. 33-96358).

10.2 Kentucky Bancshares, Inc. 1999 Employee Stock Option Plan is incorporated by reference to Exhibit 99.1 of the Registrant s Form 10-K for the fiscal year ended December 31, 1998.

10.3 Employment Agreement for Louis Prichard as incorporated by reference to the Registrant s Current Report on Exhibit 10.1 of the Registrant s Current Report on Form 8-K dated April 3, 2008.

10.4 2005 Restricted Stock Grant Plan, including form of Award Agreement, as incorporated by reference to Exhibit 10.1 of the Registrant s Current Report on Form 8-K dated February 22, 2005.

10.5 2009 Stock Award Plan, as incorporated by reference to Exhibit 10.1 of the Registrant s Quarterly Report on Form 10-Q for the quarterly period ending June 30, 2009.

11 Computation of earnings per share - See Note 13 in the notes to consolidated financial statements included in Item 8.

21 Subsidiaries of Registrant

23 Consent of Crowe Horwath LLP

31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended.

31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended.

32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of 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. Annual Report on Form 10-K for the period ended December 31, 2013, filed with the SEC on March 28, 2014, formatted in Extensible Business Reporting Language (XBRL): (i) Consolidated Balance Sheets at December 31, 2013 and 2012, (ii) Consolidated Statements of Income and Comprehensive Income (Loss) for the years ended December 31, 2013, 2012 and 2011, (iii) Consolidated Statement of Changes in Stockholders Equity for the years ended December 31, 2013, 2012 and 2011, (iv) Consolidated Statements of Cash Flows for the years ended December 31, 2013, 2012 and 2011 and (v) Notes to Consolidated Financial Statements.

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*Pursuant to Rule 406T of Regulation S-T, the XBRL related information in Exhibit 101 to this Annual Report on Form 10-K 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