LAKELAND FINANCIAL CORP
Form 10-Q
November 09, 2011

## UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
[X] QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2011

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

For the transition period from $\qquad$ to $\qquad$

LAKELAND FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

| Indiana | $0-11487$ | $35-1559596$ |
| :---: | :---: | :---: |
| (State or Other Jurisdiction | (Commission File Number) | (IRS Employer |
| of Incorporation or |  | Identification No.) |
| Organization) |  |  |

202 East Center Street, P.O. Box 1387, Warsaw, Indiana 46581-1387
(Address of Principal Executive Offices)(Zip Code)
(574) 267-6144

Registrant's Telephone Number, Including Area Code

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

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

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

Large accelerated filer _ Accelerated filer X Non-accelerated filer _ (do not check if a smaller reporting company) Smaller reporting company

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

Number of shares of common stock outstanding at October 31, 2011: 16,214,019

LAKELAND FINANCIAL CORPORATION<br>Form 10-Q Quarterly Report<br>Table of Contents<br>\section*{PART I.}

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# PART 1 <br> LAKELAND FINANCIAL CORPORATION <br> ITEM 1 - FINANCIAL STATEMENTS 

## LAKELAND FINANCIAL CORPORATION

## CONSOLIDATED BALANCE SHEETS

As of September 30, 2011 and December 31, 2010 (in thousands except for share data)
(Page 1 of 2)

|  | $\begin{gathered} \text { September 30, } \\ 2011 \\ \text { (Unaudited) } \end{gathered}$ |  | $\begin{gathered} \text { December 31, } \\ 2010 \end{gathered}$ |  |
| :---: | :---: | :---: | :---: | :---: |
| ASSETS |  |  |  |  |
| Cash and due from banks | \$ | 54,832 | \$ | 42,513 |
| Short-term investments |  | 46,446 |  | 17,628 |
| Total cash and cash equivalents |  | 101,278 |  | 60,141 |
|  |  |  |  |  |
| Securities available for sale (carried at fair value) |  | 464,072 |  | 442,620 |
| Real estate mortgage loans held for sale |  | 5,444 |  | 5,606 |
|  |  |  |  |  |
| Loans, net of allowance for loan losses of \$52,073 and \$45,007 |  | 2,128,935 |  | 2,044,952 |
|  |  |  |  |  |
| Land, premises and equipment, net |  | 31,660 |  | 30,405 |
| Bank owned life insurance |  | 39,714 |  | 38,826 |
| Accrued income receivable |  | 8,895 |  | 9,074 |
| Goodwill |  | 4,970 |  | 4,970 |
| Other intangible assets |  | 112 |  | 153 |
| Other assets |  | 42,358 |  | 45,179 |
| Total assets | \$ | 2,827,438 | \$ | 2,681,926 |

(continued)

## LAKELAND FINANCIAL CORPORATION CONSOLIDATED BALANCE SHEETS

As of September 30, 2011 and December 31, 2010 (in thousands except for share data)
(Page 2 of 2)

|  | $\begin{gathered} \text { September 30, } \\ 2011 \\ \text { (Unaudited) } \end{gathered}$ |  | $\begin{gathered} \text { December 31, } \\ 2010 \end{gathered}$ |  |
| :---: | :---: | :---: | :---: | :---: |
| LIABILITIES AND EQUITY |  |  |  |  |
| LIABILITIES |  |  |  |  |
| Noninterest bearing deposits |  |  | \$ | 323,666 | \$ | 305,107 |
| Interest bearing deposits |  | 2,032,693 |  | 1,895,918 |
| Total deposits |  | 2,356,359 |  | 2,201,025 |
| Short-term borrowings |  |  |  |  |
| Securities sold under agreements to repurchase |  | 139,016 |  | 142,015 |
| U.S. Treasury demand notes |  | 2,560 |  | 2,037 |
| Other short-term borrowings |  | 0 |  | 30,000 |
| Total short-term borrowings |  | 141,576 |  | 174,052 |
|  |  |  |  |  |
| Accrued expenses payable |  | 12,795 |  | 11,476 |
| Other liabilities |  | 1,893 |  | 2,318 |
| Long-term borrowings |  | 15,040 |  | 15,041 |
| Subordinated debentures |  | 30,928 |  | 30,928 |
| Total liabilities |  | 2,558,591 |  | 2,434,840 |
|  |  |  |  |  |
| EQUITY |  |  |  |  |
| Common stock: 90,000,000 shares authorized, no par value |  |  |  |  |
| $16,211,319$ shares issued and $16,140,533$ outstanding as of September 30, 2011 |  |  |  |  |
| $16,169,119$ shares issued and $16,078,420$ outstanding as of December 31, |  |  |  |  |
|  |  | 87,015 |  | 85,766 |
| Retained earnings |  | 176,154 |  | 161,299 |
| Accumulated other comprehensive gain |  | 6,800 |  | 1,350 |
| Treasury stock, at cost (2011-70,786 shares, 2010-90,699 shares) |  | $(1,211)$ |  | $(1,418)$ |
| Total stockholders' equity |  | 268,758 |  | 246,997 |
|  |  |  |  |  |
| Noncontrolling interest |  | 89 |  | 89 |
| Total equity |  | 268,847 |  | 247,086 |
| Total liabilities and equity | \$ | 2,827,438 | \$ | 2,681,926 |

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

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## LAKELAND FINANCIAL CORPORATION CONSOLIDATED STATEMENTS OF INCOME

 For the Three Months and Nine Months Ended September 30, 2011 and 2010 (in thousands except for share and per share data)(Unaudited)
(Page 1 of 2)

Three Months Ended
September 30,
20112010

Nine Months Ended September 30, 20112010

## NET INTEREST INCOME

Interest and fees on loans

NET INTEREST INCOME AFTER
PROVISION FOR
LOAN LOSSES
LOA

## NONINTEREST INCOME

| Wealth advisory fees | 866 | 784 | 2,613 | 2,409 |
| :--- | ---: | ---: | ---: | ---: |
| Investment brokerage fees | 741 | 676 | 2,093 | 1,692 |
| Service charges on deposit accounts | 2,036 | 2,205 | 5,938 | 6,265 |
| Loan, insurance and service fees | 1,259 | 1,100 | 3,595 | 3,094 |
| Merchant card fee income | 253 | 263 | 775 | 846 |
| Other income | 362 | 491 | 1,380 | 1,506 |
| Mortgage banking income | 440 | 774 | 594 | 939 |
| Net securities gains (losses) | $(1)$ | 4 | $(167)$ | 4 |

Other than temporary impairment loss on available-for-sale securities:
(33) (85) (154) (337)

Total impairment losses recognized on securities

| Loss recognized in other comprehensive |  |  |  |  |
| :--- | ---: | ---: | ---: | ---: |
| income | 0 | 0 | 0 | 0 |
| $\quad$ Net impairment loss recognized in | $(33)$ | $(85)$ | $(154)$ | $(337)$ |
| earnings | 5,923 | 6,212 | 16,667 | 16,418 |
| $\quad$ Total noninterest income |  |  |  |  |

(continued)

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LAKELAND FINANCIAL CORPORATION CONSOLIDATED STATEMENTS OF INCOME For the Three Months and Nine Months Ended September 30, 2011 and 2010 (in thousands except for share and per share data)
(Unaudited)
(Page 2 of 2)

| Three Months Ended | Nine Months Ended |  |
| :---: | :---: | :---: |
| September 30, | September 30, |  |
| 2011 | 2010 |  |


| NONINTEREST EXPENSE |  |  |  | 22,729 |
| :--- | ---: | ---: | ---: | ---: |
| Salaries and employee benefits | 8,611 | 7,659 | 24,802 | 2,199 |
| Occupancy expense | 746 | 711 | 2,373 | 1,568 |
| Equipment costs | 536 | 517 | 1,600 | 2,930 |
| Data processing fees and supplies | 729 | 1,004 | 2,820 | 144 |
| Credit card interchange | 0 | 31 | 2 | 10,532 |
| Other expense | 2,857 | 3,707 | 10,023 | 40,102 |
| Total noninterest expense | 13,479 | 13,629 | 41,620 |  |


| INCOME BEFORE INCOME TAX |  |  |  |  |  |
| :--- | :---: | :---: | :---: | :---: | ---: |
| EXPENSE | 12,865 | 9,650 | 33,447 | 28,220 |  |
| Income tax expense | 4,418 |  | 3,129 | 11,046 | 9,459 |
|  |  |  |  |  |  |
| NET INCOME | $\$$ | 8,447 | $\$$ | 6,521 | $\$$ |


| Dividends and accretion of discount on |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- |
| preferred stock | 0 | 0 | 0 | 3,187 |

NET INCOME AVAILABLE TO COMMON
NHAREHOLDERS
SHA

| BASIC WEIGHTED AVERAGE COMMON |  |  |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| SHARES | $16,208,889$ | $16,138,809$ | $16,201,900$ | $16,112,108$ |  |  |
| BASIC EARNINGS PER COMMON |  |  |  |  |  |  |
| SHARE | $\$$ | 0.52 | $\$$ | 0.40 | $\$$ | 1.38 |

DILUTED WEIGHTED AVERAGE

| COMMON SHARES | $16,324,058$ | $16,232,254$ | $16,309,814$ | $16,205,133$ |
| :--- | :--- | :--- | :--- | :--- |

DILUTED EARNINGS PER COMMON

| SHARE | $\$$ | 0.52 | $\$$ | 0.40 | $\$$ | 1.37 | $\$$ | 0.96 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

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

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## LAKELAND FINANCIAL CORPORATION CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

For the Nine Months Ended September 30, 2011 and 2010 (in thousands except for share and per share data)
(Unaudited)

|  |  | Accumulated |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  |  | Other |  | Total |  |
| Preferred | Common | Retained | Comprehensive | Treasury | Stockholders' |
| Stock | Stock | Earnings | Income (Loss) | Stock | Equity |


| Balance at <br> January 1, 2010 | \$ | 54,095 | \$ | 83,487 | \$ | 149,945 | \$ | $(5,993)$ | \$ | $(1,540)$ | \$ | 279,994 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Comprehensive income: |  |  |  |  |  |  |  |  |  |  |  |  |
| Net income |  |  |  |  |  | 18,761 |  |  |  |  |  | 18,761 |
| Other comprehensive income (loss), net of tax |  |  |  |  |  |  |  | 9,675 |  |  |  | 9,675 |
| Comprehensive income |  |  |  |  |  |  |  |  |  |  |  | 28,436 |
| Common stock cash dividends declared, \$. 465 per share |  |  |  |  |  | $(7,489)$ |  |  |  |  |  | $(7,489)$ |
| Treasury shares purchased under deferred directors' plan |  |  |  |  |  |  |  |  |  |  |  |  |
| ( 10,254 shares) |  |  |  | 195 |  |  |  |  |  | (195) |  | 0 |
| Treasury shares sold under deferred directors' plan |  |  |  |  |  |  |  |  |  |  |  |  |
| (4,477 shares) |  |  |  | (90) |  |  |  |  |  | 90 |  | 0 |
| Stock activity under stock compensation plans (54,108 shares) |  |  |  | 580 |  |  |  |  |  |  |  | 580 |
| Stock compensation expense |  |  |  | 1,212 |  |  |  |  |  |  |  | 1,212 |
| Redemption of 56,044 shares preferred stock |  | $(56,044)$ |  |  |  |  |  |  |  |  |  | $(56,044)$ |
|  |  | 1,949 |  |  |  | $(1,949)$ |  |  |  |  |  |  |


| Accretion of <br> preferred stock <br> discount |
| :--- |
| Preferred stock <br> dividend paid <br> and/or accrued |
| Balance at <br> September 30, <br> 2010 |

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

## LAKELAND FINANCIAL CORPORATION CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Nine Months Ended September 30, 2011 and 2010 (in thousands)
(Unaudited)
(Page 1 of 2)

|  | 2011 |  | 2010 |  |
| :---: | :---: | :---: | :---: | :---: |
| Cash flows from operating activities: |  |  |  |  |
| Net income | \$ | 22,401 | \$ | 18,761 |
| Adjustments to reconcile net income to net cash from operating |  |  |  |  |
| activities: |  |  |  |  |
| Depreciation |  | 1,660 |  | 1,656 |
| Provision for loan losses |  | 10,900 |  | 17,426 |
| Loss on sale and write down of other real estate owned |  | 358 |  | 118 |
| Amortization of intangible assets |  | 41 |  | 41 |
| Amortization of loan servicing rights |  | 427 |  | 463 |
| Net change in loan servicing rights valuation allowance |  | 162 |  | 180 |
| Loans originated for sale |  | $(48,294)$ |  | $(56,044)$ |
| Net gain on sales of loans |  | $(1,004)$ |  | $(1,255)$ |
| Proceeds from sale of loans |  | 49,086 |  | 53,496 |
| Net loss on sales of premises and equipment |  | 17 |  | 4 |
| Net loss (gain) on sales of securities available for sale |  | 167 |  | (4) |
| Impairment on available for sale securities |  | 154 |  | 337 |
| Net securities amortization |  | 2,255 |  | 1,235 |
| Stock compensation expense |  | 1,061 |  | 1,212 |
| Earnings on life insurance |  | (726) |  | (763) |
| Tax benefit of stock option exercises |  | (96) |  | (178) |
| Net change: |  |  |  |  |
| Accrued income receivable |  | 179 |  | (579) |
| Accrued expenses payable |  | 1,259 |  | $(1,082)$ |
| Other assets |  | $(1,565)$ |  | $(3,028)$ |
| Other liabilities |  | (192) |  | 408 |
| Total adjustments |  | 15,849 |  | 13,643 |
| Net cash from operating activities |  | 38,250 |  | 32,404 |
|  |  |  |  |  |
| Cash flows from investing activities: |  |  |  |  |
| Proceeds from sale of securities available for sale |  | 73,318 |  | 0 |
| Proceeds from maturities, calls and principal paydowns of |  |  |  |  |
| securities available for sale |  | 58,668 |  | 69,718 |
| Purchases of securities available for sale |  | $(147,042)$ |  | $(87,929)$ |
| Purchase of life insurance |  | (162) |  | (21) |
| Net increase in total loans |  | $(95,690)$ |  | $(53,098)$ |
| Proceeds from sales of land, premises and equipment |  | 33 |  | 0 |
| Purchases of land, premises and equipment |  | $(2,965)$ |  | $(1,288)$ |
| Proceeds from sales of other real estate |  | 1,254 |  | 1,403 |
| Net cash from investing activities |  | $(112,586)$ |  | $(71,215)$ |

(Continued)

## LAKELAND FINANCIAL CORPORATION CONSOLIDATED STATEMENTS OF CASH FLOWS For the Nine Months Ended September 30, 2011 and 2010 (in thousands) <br> (Unaudited) <br> (Page 2 of 2)

|  | 2011 | 2010 |  |
| :--- | ---: | ---: | ---: |
| Cash flows from financing activities: |  |  |  |
| Net increase (decrease) in total deposits | 155,334 | 419,162 |  |
| Net increase (decrease) in short-term borrowings | $(32,476)$ | $(244,737)$ |  |
| Payments on long-term borrowings | $(1)$ | $(1)$ |  |
| Common dividends paid | $(7,533)$ | $(7,502)$ |  |
| Preferred dividends paid | $(13)$ | $(1,588)$ |  |
| Redemption of preferred stock | 0 | $(56,044)$ |  |
| Proceeds from stock option exercise | 395 | 580 |  |
| Purchase of treasury stock | $(233)$ | $(195)$ |  |
| $\quad$ Net cash from financing activities | 115,473 | 109,675 |  |
| Net change in cash and cash equivalents | 41,137 | 70,864 |  |
| Cash and cash equivalents at beginning of the period | 60,141 | 55,983 |  |
| Cash and cash equivalents at end of the period | 101,278 | $\$$ | 126,847 |
| Cash paid during the period for: | $\$$ | 22,095 | $\$$ |
| $\quad$ Interest | $\$$ | 23,877 |  |
| Income taxes |  | 14,629 | 13,583 |
| Supplemental non-cash disclosures: |  | 807 | 4,094 |

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

## LAKELAND FINANCIAL CORPORATION NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2011
(Table amounts in thousands except for share and per share data)
(Unaudited)

## NOTE 1. BASIS OF PRESENTATION

This report is filed for Lakeland Financial Corporation (the "Company") and its wholly owned subsidiary, Lake City Bank (the "Bank"). All significant inter-company balances and transactions have been eliminated in consolidation. Also included is the Bank's wholly owned subsidiary, LCB Investments II, Inc. ("LCB Investments"). LCB Investments also owns LCB Funding, Inc. ("LCB Funding"), a real estate investment trust.

The unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with instructions for Form 10-Q. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (all of which are normal and recurring in nature) considered necessary for a fair presentation have been included. Operating results for the three-month and nine-month periods ending September 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. The 2010 Lakeland Financial Corporation Annual Report on Form 10-K should be read in conjunction with these statements.

## NOTE 2. EARNINGS PER SHARE

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

|  | Three Months Ended September 30, 20112010 |  |  |  | Nine Months Ended September 30, 20112010 |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Net income | \$ | 8,447 | \$ | 6,521 | \$ | 22,401 | \$ | 18,761 |
| Dividends and accretion of discount on preferred stock |  | 0 |  | 0 |  | 0 |  | 3,187 |
| Net income available to common shareholders | \$ | 8,447 | \$ | 6,521 | \$ | 22,401 | \$ | 15,574 |

Weighted average shares
outstanding for basic earnings per

| common share | $16,208,889$ | $16,138,809$ | $16,201,900$ | $16,112,108$ |
| :--- | ---: | ---: | ---: | ---: |
| Dilutive effect of stock options, | 115,169 | 93,445 | 107,914 | 93,025 |
| awards and warrants | $16,324,058$ | $16,232,254$ | $16,309,814$ | $16,205,133$ |

Weighted average shares
outstanding for diluted earnings per
common share

| Basic earnings per common share | $\$$ | 0.52 | $\$$ | 0.40 | $\$$ | 1.38 | $\$$ | 0.97 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Diluted earnings per common share | $\$$ | 0.52 | $\$$ | 0.40 | $\$$ | 1.37 | $\$$ | 0.96 |

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Stock options for 70,000 and 95,000 shares for the three-month periods ended September 30, 2011 and September 30, 2010, respectively, were not considered in computing diluted earnings per common share because they were antidilutive. Stock options for 70,000 and 109,000 shares for the nine-month periods ended September 30, 2011 and September 30, 2010, respectively, were not considered in computing diluted earnings per common share because they were antidilutive. In addition, warrants for 198,269 shares for the three-month and nine-month periods ended September 30, 2010, were not considered in computing diluted earnings per share because they were antidilutive.

NOTE 3. LOANS

|  | September 30,2011 |  |  | $\begin{gathered} \text { December 31, } \\ 2010 \end{gathered}$ |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Commercial and industrial loans: |  |  |  |  |  |  |
| Working capital lines of credit loans | \$ 382,202 | 17.5 | \% | \$ 281,546 | 13.5 | \% |
| Non-working capital loans | 380,125 | 17.4 |  | 384,138 | 18.4 |  |
| Total commercial and industrial loans | 762,327 | 34.9 |  | 665,684 | 31.8 |  |
| Commercial real estate and multi-family residential loans: |  |  |  |  |  |  |
| Construction and land development loans | 110,493 | 5.1 |  | 106,980 | 5.1 |  |
| Owner occupied loans | 335,514 | 15.4 |  | 329,760 | 15.8 |  |
| Nonowner occupied loans | 363,777 | 16.7 |  | 355,393 | 17.0 |  |
| Multifamily loans | 19,578 | 0.9 |  | 24,158 | 1.2 |  |
| Total commercial real estate and multi-family residential |  |  |  |  |  |  |
| loans | 829,362 | 38.0 |  | 816,291 | 39.0 |  |
| Agri-business and agricultural loans: |  |  |  |  |  |  |
| Loans secured by farmland | 101,978 | 4.7 |  | 111,961 | 5.4 |  |
| Loans for agricultural production | 92,414 | 4.2 |  | 117,518 | 5.6 |  |
| Total agri-business and agricultural loans | 194,392 | 8.9 |  | 229,479 | 11.0 |  |
| Other commercial loans | 58,208 | 2.7 |  | 38,778 | 1.9 |  |
| Total commercial loans | 1,844,289 | 84.6 |  | 1,750,232 | 83.7 |  |
| Consumer 1-4 family mortgage loans: |  |  |  |  |  |  |
| Closed end first mortgage loans | 107,026 | 4.9 |  | 103,118 | 4.9 |  |
| Open end and junior lien loans | 177,940 | 8.2 |  | 182,325 | 8.7 |  |
| Residential construction and land development loans | 4,380 | 0.2 |  | 4,140 | 0.2 |  |
| Total consumer 1-4 family mortgage loans | 289,346 | 13.3 |  | 289,583 | 13.8 |  |
| Other consumer loans | 47,623 | 2.2 |  | 51,123 | 2.4 |  |
| Total consumer loans | 336,969 | 15.4 |  | 340,706 | 16.3 |  |
| Subtotal | 2,181,258 | 100.0 | \% | 2,090,938 | 100.0 | \% |
| Less: Allowance for loan losses | $(52,073)$ |  |  | $(45,007)$ |  |  |
| Net deferred loan fees | (250) |  |  | (979) |  |  |
| Loans, net | \$2,128,935 |  |  | \$2,044,952 |  |  |

## NOTE 4. ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of September 30, 2011:

|  | Commercial and Industrial | Commercial <br> Real Estate and Multifamily Residential |  | Agri-business and Agricultural |  | Other Commercial |  | Consumer <br> 1-4 Family <br> Mortgage |  | Other Consumer |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Three Months Ended September 30, 2011 |  |  |  |  |  |  |  |  |  |  |  |
| Balance July $1,$ | \$ 22,999 | \$ | 20,032 | \$ | 948 | \$ | 560 | \$ | 2,658 | \$ | 6 |
| Provision for loan losses | 1,171 |  | 2,134 |  | (194) |  | (536) |  | (272) |  | 2 |
| Loans charged-off | (883) |  | (557) |  | (103) |  | 0 |  | (292) |  | (26 |
| Recoveries | 465 |  | 10 |  | 0 |  | 0 |  | 5 |  |  |
| Net loans charged-off | (418) |  | (547) |  | (103) |  | 0 |  | (287) |  | (23 |
| Balance <br> September 30, \$ | \$ 23,752 | \$ | 21,619 | \$ | 651 | \$ | 24 | \$ | 2,099 | \$ | 6 |
| Nine Months <br> Ended <br> September 30, 2011 |  |  |  |  |  |  |  |  |  |  |  |
| Balance <br> January 1, | \$ 21,479 | \$ | 15,893 | \$ | 1,318 | \$ | 270 | \$ | 1,694 | \$ | 6 |
| Provision for loan losses | 3,048 |  | 7,362 |  | (564) |  | (246) |  | 1,390 |  | 3 |
| Loans charged-off | $(1,470)$ |  | $(1,973)$ |  | (103) |  | 0 |  | $(1,009)$ |  | (49 |
| Recoveries | 695 |  | 337 |  | 0 |  | 0 |  | 24 |  | 1 |
| Net loans charged-off | (775) |  | $(1,636)$ |  | (103) |  | 0 |  | (985) |  | (33 |
| Balance <br> September 30, \$ | \$ 23,752 | \$ | 21,619 | \$ | 651 | \$ | 24 | \$ | 2,099 | \$ | 6 |

Allowance for
loan losses:
Ending
allowance
balance
attributable to
loans:

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| Individually evaluated for impairment | \$ | 9,809 | \$ | 6,508 | \$ | 236 | \$ | 0 | \$ | 158 | \$ |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Collectively evaluated for impairment |  | 13,943 |  | 15,111 |  | 415 |  | 24 |  | 1,941 |  | 6 |
| Total ending allowance balance | \$ | 23,752 | \$ | 21,619 | \$ | 651 | \$ | 24 | \$ | 2,099 | \$ | 6 |

## Loans:

Loans
individually
evaluated for

| impairment <br> Loans <br> collectively <br> evaluated for <br> impairment | 25,060 | $\$$ | 29,693 | $\$$ | 870 | $\$$ | 0 | $\$$ | 2,041 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

The recorded investment in loans does not include accrued interest.

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The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2010:


Allowance for loan losses:
Ending
allowance
balance
attributable to
loans:
Individually
evaluated for
$\begin{array}{llllllllllll}\text { impairment } & \$ & 6,911 & \$ & 4,663 & \$ & 301 & & & & & \end{array}$
Collectively
evaluated for

| impairment | 14,568 | 11,230 | 1,017 | 80 | 1,618 |
| :--- | :--- | :--- | :--- | :--- | :--- |

Total ending allowance


Loans:

## Loans

individually
evaluated for

| impairment | $\$$ | 20,988 | $\$$ | 23,358 | $\$$ | 1,259 | $\$$ | 197 | 2,204 | $\$$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

Loans
collectively
evaluated for

| impairment | 644,551 | 791,715 | 228,305 | 38,542 | 287,729 | 51,1 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |

Total ending

The recorded investment in loans does not include accrued interest.

The following is an analysis of the allowance for loan losses for the three months and nine months ended September 30, 2010:
$\left.\begin{array}{lcrrr} & \begin{array}{c}\text { Three Months } \\ \text { ended } \\ \text { September 30, } \\ 2010\end{array} & \begin{array}{c}\text { Nine Months } \\ \text { ended }\end{array} \\ \text { September 30, } \\ 2010\end{array}\right]$

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The following table presents loans individually evaluated for impairment as of and for the three-month and nine-month periods ended September 30, 2011:

Three Months Ended September 30, 2011

Nine Months Ended Septem
2011
Cash Basis

| Unpaid |  | Allowance for | Average | Interest | Interest | Average | Interest | In |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Principal | Recorded | Loan Losses | Recorded | Income | Income | Recorded | Income | In | Balance Investment Allocated Investment Recognized Recognized Investment Recognized Rec

With no related allowance
recorded:
Commercial
real estate and multi-family residential
loans:

| Nonowner <br> occupied loans | 0 | $\$$ | 0 | $\$$ | 0 | $\$$ | 0 | 0 | $\$$ | 0 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |

With an
allowance
recorded:
Commercial
and industrial
loans:
Working
capital lines of

| credit loans | 6,098 | 6,097 | 3,366 | 5,466 | 4 | 3 | 5,464 | 10 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| Non-working <br> capital loans | 18,958 | 18,963 | 6,443 | 18,842 | 152 | 165 | 16,857 | 442 |

Commercial
real estate and
multi-family
residential
loans:
Construction
and land
development

| loans | 986 | 987 | 225 | 1,935 | 0 | 0 | 1,554 | 0 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| Owner <br> occupied loans | 2,904 | 2,903 | 1,074 | 2,634 | 7 | 6 | 2,942 | 19 |
| $\quad$Nonowner |  |  |  |  |  |  |  |  |
| occupied loans | 25,801 | 25,803 | 5,209 | 26,001 | 100 | 88 | 22,270 | 135 |
|  | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |

Multifamily
loans

Agri-business
and agricultural
loans:
Loans secured by
farmland $642 \quad 6$ 641 218 716

0
0
603
0
Loans for agricultural
production
229
$229 \quad 18$
$18 \quad 231 \quad 0$
$0 \quad 0$
471
0

Other
commercial

| loans | 0 | 0 | 0 | 126 | 0 | 0 | 171 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

Consumer 1-4
family
mortgage
loans:
Closed end
first mortgage

| loans | 2,041 | 2,041 | 158 | 1,888 | 19 | 24 | 1,848 | 50 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

Open end
and junior lien

| loans | 0 | 0 | 0 | 0 | 0 | 0 | 19 | 0 |
| :--- | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Residential <br> construction <br> loans | 0 | 0 |  |  |  |  |  |  |
| Other <br> consumer loans | 0 |  | 0 | 0 | 0 | 0 | 0 |  |
| Total | $\$ 57,659$ | $\$$ | 57,664 | $\$$ | 16,711 | $\$$ | 57,839 | $\$$ |

The recorded investment in loans does not include accrued interest.

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The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2010:

|  | Unpaid Principal Balance |  | Recorded <br> Investment |  | Allowance for Loan Losses Allocated |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| With no related allowance recorded: Commercial real estate and multi-family residential loans: |  |  |  |  |  |  |
| Nonowner occupied loans | \$ | 870 | \$ | 869 | \$ | 0 |
| With an allowance recorded: |  |  |  |  |  |  |
| Commercial and industrial loans: |  |  |  |  |  |  |
| Working capital lines of credit loans |  | 5,651 |  | 5,652 |  | 2,944 |
| Non-working capital loans |  | 15,335 |  | 15,336 |  | 3,967 |
| Commercial real estate and multi-family residential loans: |  |  |  |  |  |  |
| Construction and land development loans |  | 1,402 |  | 1,401 |  | 195 |
| Owner occupied loans |  | 2,908 |  | 2,909 |  | 948 |
| Nonowner occupied loans |  | 18,186 |  | 18,179 |  | 3,520 |
| Multifamily loans |  | 0 |  | 0 |  | 0 |
|  |  |  |  |  |  |  |
| Agri-business and agricultural loans: |  |  |  |  |  |  |
| Loans secured by farmland |  | 405 |  | 406 |  | 83 |
| Loans for agricultural production |  | 853 |  | 853 |  | 218 |
|  |  |  |  |  |  |  |
| Other commercial loans |  | 197 |  | 197 |  | 190 |
|  |  |  |  |  |  |  |
| Consumer 1-4 family mortgage loans: |  |  |  |  |  |  |
| Closed end first mortgage loans |  | 2,067 |  | 2,063 |  | 75 |
| Open end and junior lien loans |  | 141 |  | 141 |  | 1 |
| Residential construction loans |  | 0 |  | 0 |  | 0 |
|  |  |  |  |  |  |  |
| Other consumer loans |  | 0 |  | 0 |  | 0 |
|  |  |  |  |  |  |  |
| Total | \$ | 48,015 | \$ | 48,006 | \$ | 12,141 |

The recorded investment in loans does not include accrued interest.
The following table presents information on impaired loans for the three and nine months ended September 30, 2010.

|  | Three Months <br> ended <br> September 30, <br> 2010 | Nine Months <br> ended <br> September 30, <br> 2010 |
| :--- | :---: | :---: | :---: |
| Average of impaired loans during the period | $\$ 39,498$ | $\$ 38,128$ |

Interest income recognized during impairment ..... 113 ..... 338
Cash-basis interest income recognized 116 ..... 349

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


The recorded investment in loans does not include accrued interest.

The following table presents the aging of the recorded investment in past due loans as of September 30, 2011 by class of loans:

|  |  |  | Nonaccrual |  | Total Past Due |  | Loans Not Past Due |  | Total |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Commercial and industrial loans: |  |  |  |  |  |  |  |  |  |  |
| Non-impaired watch |  |  |  |  |  |  |  |  |  |  |
| list loans | \$ | 0 | \$ | 137 | \$ | 137 | \$ | 41,811 | \$ | 41,948 |
| Working capital lines of credit loans |  | 161 |  | 4,911 |  | 5,072 |  | 362,976 |  | 368,048 |
| Non-working capital |  |  |  |  |  |  |  |  |  |  |
| loans |  | 121 |  | 5,833 |  | 5,954 |  | 346,290 |  | 352,244 |

Commercial real estate
and multi-family
residential loans:

| Non-impaired watch list loans | 0 | 29 | 29 | 64,037 | 64,066 |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Construction and land development loans | 0 | 988 | 988 | 91,656 | 92,644 |
| Owner occupied loans | 186 | 2,482 | 2,668 | 310,254 | 312,922 |
| Nonowner occupied loans | 313 | 16,984 | 17,297 | 324,024 | 341,321 |
| Multifamily loans | 0 | 0 | 0 | 18,314 | 18,314 |

Agri-business and
agricultural loans:

| Non-impaired watch <br> list loans <br> Loans secured by <br> farmland <br> Loans for agricultural <br> production | 0 | 0 | 0 | 1,073 | 1,073 |
| :--- | :---: | :---: | :---: | :---: | :---: |


| Other commercial loans | 0 | 0 | 0 | 58,201 | 58,201 |
| :--- | :--- | :--- | :--- | :--- | :--- |


| Consumer 1-4 family <br> mortgage loans: <br> Closed end first <br> mortgage loans <br> Open end and junior <br> lien loans <br> Residential <br> construction loans | 2,066 | 842 | 2,908 | 104,106 | 107,014 |
| :--- | :---: | :---: | :---: | :---: | :---: |
| Other consumer loans 246 169 415 177,504 177,919 |  |  |  |  |  |


| Total | $\$$ | 3,364 | $\$$ | 33,257 | $\$$ | 36,621 | $\$$ | $2,144,387$ | $\$$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | 2,181,008

The recorded investment in loans does not include accrued interest.

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The following table presents the aging of the recorded investment in past due loans as of December 31, 2010 by class of loans:

| $30-89$ | Greater than |  |  |  |
| :---: | :---: | :---: | :---: | :---: |
| Days | 90 Days | Total | Loans Not |  |
| Past Due | Past Due | Past Due | Past Due | Total |

Commercial and industrial loans:

| Non-impaired watch | $\$$ | 0 | $\$$ | 372 | $\$$ | 372 | $\$$ |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| list loans | 54,977 | $\$$ | 55,349 |  |  |  |  |
| Working capital lines <br> of credit loans | 0 | 5,405 | 5,405 | 261,556 | 266,961 |  |  |
| Non-working capital <br> loans | 462 | 4,786 | 5,248 | 337,981 | 343,229 |  |  |


| Commercial real estate <br> and multi-family <br> residential loans: |  |  |  |  |  |
| :--- | ---: | ---: | ---: | ---: | ---: |
| Non-impaired watch <br> list loans | 0 | 26 | 26 | 60,473 | 60,499 |
| Construction and land <br> development loans | 0 | 1,400 | 1,400 | 88,089 | 89,489 |
| Owner occupied loans | 27 | 2,935 | 2,962 | 304,702 | 307,664 |
| Nonowner occupied <br> lans | 0 | 19,049 | 19,049 | 314,245 | 333,294 |
| $\quad$ Multifamily loans | 0 | 0 | 0 | 24,127 | 24,127 |

Agri-business and
agricultural loans:

| Non-impaired watch | 0 | 0 | 0 | 4,131 | 4,131 |
| :--- | :---: | :---: | :---: | :---: | ---: |
| list loans <br> Loans secured by <br> farmland | 0 | 406 | 406 | 109,465 | 109,871 |
| Loans for agricultural <br> production | 0 | 878 | 878 | 114,684 | 115,562 |
| Other commercial loans | 0 | 197 | 197 | 38,542 | 38,739 |


| Consumer 1-4 family <br> mortgage loans: <br> Closed end first <br> mortgage loans | 2,333 | 1,160 | 3,493 | 99,405 | 102,898 |
| :--- | ---: | :---: | ---: | ---: | ---: |
| Open end and junior <br> lien loans <br> Residential <br> construction loans | 237 | 267 | 504 | 182,395 | 182,899 |
| Other consumer loans | 0 | 0 | 0 | 4,136 | 4,136 |
|  | 145 | 32 | 177 | 50,934 | 51,111 |

$\begin{array}{llllllllll}\text { Total } & \$ & 3,204 & \$ & 36,913 & \$ & 40,117 & \$ & 2,049,842 & \$\end{array} 2,089,959$
The recorded investment in loans does not include accrued interest.

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## Troubled Debt Restructurings:

Troubled debt restructured loans are included in the totals for impaired loans. The Company has allocated $\$ 9.5$ million and $\$ 4.1$ million of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of September 30, 2011 and December 31, 2010. The Company is not committed to lend additional funds to debtors whose loans have been modified in a troubled debt restructuring.

|  | September 30, | December 31, |  |
| :--- | :---: | :---: | :---: |
|  | 2011 | 2010 |  |
| Accruing troubled debt restructured loans | $\$$ | 22,428 | $\$$ |
| Nonaccrual troubled debt restructured loans |  | 9,300 | 8,547 |
| Total troubled debt restructured loans | $\$$ | 31,728 | 6,091 |

During the three and nine month periods ending September 30, 2011, the terms of certain loans were modified as troubled debt restructurings. The modified terms of these loans included one or a combination of the following: a reduction of the stated interest rate of the loan; a modification of repayment terms that delays principal repayment for some period; or inadequate compensation for the terms of the restructure.

Renegotiated interest rates include loans with a reduction in rate for a short-term (part of the remaining life of the loan) or long-term (life of loan). Included are modifications to borrowers at a rate that is readily available in the market, but to borrowers who would not have qualified for the terms offered in the modification without a concession being granted. Also included are borrowers who received interest rate concessions that are below market rates.

Delays in principal repayment include loans which were intended to be amortizing during the period, but due to financial hardship these borrowers were unable to meet the original or intended repayment terms. These include loans with principal deferrals for a prolonged period or those with modified payments which are an exception to bank policy.

The following tables present loans by class modified as troubled debt restructurings that occurred during the three and nine month periods ending September 30, 2011:

## Modifications

Nine Months Ended September 30, 2011

All Modifications Interest Rate Reductions | Modifif |
| ---: |
| Repayment |

Pre-Modification Post-Modification

Outstanding Outstanding
Number
of Recorded
Loans Investment

Recorded Investment

Interest Rate Reductions
Repaymen

|  | Pre-Modification <br> Outstanding | Post-Modification <br> Outstanding |  | Interest at | Interest at | Ex |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Number |  |  | Number |  | Number |  |  |
| of | Recorded | Recorded | of | Pre-Modification | Post-Modification | of | Pe |
| Loans | Investment | Investment | Loans | Rate | Rate | Loans | I |

Troubled Debt
Restructurings
Commercial
and industrial
loans:
Working capital lines of

| credit loans | 3 | $\$$ | 639 | $\$$ | 639 | 0 | $\$$ | 0 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Non-working <br> capital loans | 4 | 5,551 | 5,625 | 0 | 0 | 0 | 3 |  |

Commercial real estate and multi-family residential
loans:
Owner

| occupied <br> loans | 5 | 1,788 | 1,787 | 0 | 0 | 0 | 5 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Nonowner <br> occupied <br> loans |  |  |  |  |  |  |  |

Agri-business
and
agricultural
loans:
Loans
secured by

| farmland | 1 | 270 | 270 | 0 | 0 | 0 | 1 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

Consumer 1-4
family loans:

| 5 | 394 | 399 | 5 | 402 | 324 | 0 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |

Closed end first mortgage loans

| Total | 21 | $\$$ | 17,192 | $\$$ | 17,270 | 5 | $\$$ | 402 | $\$$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

Modifications
Three Months Ended September 30, 2011

|  | All Modifications |  | Interest Rate Reductions |  |  | Modifie |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Pre-Modification Outstanding | Post-Modification Outstanding |  | Interest at | Interest at |  |
| Number of Loans | Recorded <br> Investment | Recorded Investment | Number of Loans | Pre-Modification Rate | Post-Modification Rate | Number of Loans |

Troubled Debt
Restructurings
Commercial
and industrial
loans:
Non-working

| capital loans | 2 | $\$$ | 3,545 | $\$$ | 3,546 | 0 | $\$$ | 0 |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

Commercial
real estate and
multi-family
residential
loans:
Nonowner

| occupied <br> loans | 2 | 7,493 | 7,493 | 0 | 0 | 0 | 2 |  |
| :--- | :--- | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Total | 4 | $\$$ | 11,038 | $\$$ | 11,039 | 0 | $\$$ | 0 |

All of the commercial and industrial loan troubled debt restructurings described above also had inadequate compensation of additional collateral as part of the restructuring.

For the three month period ending September 30, 2011 the commercial and industrial loan troubled debt restructurings described above increased the allowance for loan losses by $\$ 76,000$, the commercial real estate and multi-family residential loan troubled debt restructurings described above increased the allowance for loan losses by $\$ 378,000$, the agri-business and agricultural loan troubled debt restructurings described above increased the allowance for loan losses by $\$ 2,000$ and the consumer 1-4 family loan troubled debt restructurings described above increased the allowance for loan losses by $\$ 58,000$.

For the nine month period ending September 30, 2011 the commercial and industrial loan troubled debt restructurings described above increased the allowance for loan losses by $\$ 124,000$, the commercial real estate and multi-family residential loan troubled debt restructurings described above increased the allowance for loan losses by $\$ 674,000$, the agri-business and agricultural loan troubled debt restructurings described above increased the allowance for loan losses by $\$ 9,000$ and the consumer 1-4 family loan troubled debt restructurings described above increased the
allowance for loan losses by $\$ 88,000$.
The commercial real estate and multi-family residential loan troubled debt restructurings described above also resulted in charge offs of $\$ 0$ and $\$ 487,000$ during the three and nine month periods ending September 30, 2011. No charge offs resulted from any other troubled debt restructurings described above during the three and nine month periods ending September 30, 2011

The following table presents loans by class modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the three and nine month periods ending September 30, 2011:

Modifications
Three and Nine Months ended September 30, 2011
Three Months Ended
September 30, 2011

| Number |  |
| :---: | :---: |
| of | Recorded |
| Loans | Investment |

Number
of
Loans
Nine Months Ended
September 30, 2011

| Number |  |
| :---: | :---: |
| of | Recorded |
| Loans | Investment |

Recorded
Investment

Troubled Debt Restructurings that Subsequently Defaulted

Consumer 1-4 family loans: Closed end first mortgage $\begin{array}{lllllll}\text { loans } & 3 & \$ & 258 & 3 & \$ & 258\end{array}$

Total
$3 \quad \$ \quad 258$ 3 \$ 258

A loan is considered to be in payment default once it is 30 days contractually past due under the modified terms.
The troubled debt restructurings that subsequently defaulted described above increased the allowance for loan losses by $\$ 6,000$ and did not result in any charge offs during the three and nine month periods ending September 30, 2011.

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## Credit Quality Indicators:

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes commercial loans individually by classifying the loans as to credit risk. This analysis is performed on a quarterly basis for Special Mention, Substandard and Doubtful grade loans and annually on Pass grade loans over \$250,000.

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 characteristics 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 with the exception of consumer troubled debt restructurings which are evaluated and listed with Substandard commercial grade loans. Loans listed as not rated are consumer loans included in groups of homogenous loans. As of September 30, 2011 and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

|  | Pass |  | Special <br> Mention |  | Substandard |  | Doubtful |  | Not <br> Rated |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Commercial and industrial loans: |  |  |  |  |  |  |  |  |  |  |  |
| Non-impaired watch |  |  |  |  |  |  |  |  |  |  |  |
| list loans | \$ | 0 | \$ | 14,707 | \$ | 27,070 | \$ | 171 | \$ |  | 0 |
| Working capital lines |  |  |  |  |  |  |  |  |  |  |  |
| of credit loans |  | 361,935 |  | 0 |  | 5,947 |  | 150 |  |  | 16 |
| Non-working capital |  |  |  |  |  |  |  |  |  |  |  |
| loans |  | 331,759 |  | 8,758 |  | 10,111 |  | 94 |  |  |  |


| Commercial real estate and multi-family residential loans: |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Non-impaired watch |  |  |  |  |  |
| list loans | 2 | 21,557 | 42,507 | 0 | 0 |
| Construction and land |  |  |  |  |  |
| development loans | 91,656 | 0 | 988 | 0 | 0 |
| Owner occupied loans | 309,927 | 0 | 2,903 | 0 | 92 |
| Nonowner occupied |  |  |  |  |  |
| loans | 315,518 | 3,438 | 22,365 | 0 | 0 |
| Multifamily loans | 18,314 | 0 | 0 | 0 | 0 |

Agri-business and agricultural loans:

| Non-impaired watch | 0 | 70 | 1,003 | 0 | 0 |
| :--- | :---: | :---: | :---: | :---: | ---: |
| list loans |  |  |  |  |  |
| Loans secured by <br> farmland | 100,231 | 0 | 641 | 0 | 21 |
| Loans for agricultural <br> production | 91,952 | 0 | 230 | 0 | 222 |

Other commercial

| loans | 58,116 | 85 | 0 | 0 | 0 |
| :--- | :--- | :--- | :--- | :--- | :--- |


| Consumer 1-4 family |  |  |  |  |  |
| :--- | :---: | :---: | :---: | :---: | ---: |
| mortgage loans: |  |  |  |  |  |
| Closed end first <br> mortgage loans | 20,755 | 54 | 410 | 0 | 85,795 |
| Open end and junior <br> lien loans <br> Residential <br> construction loans | 11,525 | 300 | 0 | 0 | 166,094 |
|  | 0 | 0 | 0 | 0 | 4,390 |



The recorded investment in loans does not include accrued interest.

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As of December 31, 2010 the risk category of loans by class of loans is as follows:

|  | Special |  | Not |  |
| :---: | :---: | :---: | :---: | :---: |
| Pass | Mention | Substandard | Doubtful | Rated |

Commercial and industrial loans:

| Non-impaired watch list loans | \$ | 0 | \$ | 22,282 | \$ | 33,067 | \$ | 0 | \$ | 0 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Working capital lines of credit loans |  | 261,210 |  | 0 |  | 5,751 |  | 0 |  | 0 |
| Non-working capital loans |  | 325,976 |  | 0 |  | 15,327 |  | 0 |  | 1,926 |


| Commercial real estate and multi-family residential loans: |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Non-impaired watch |  |  |  |  |  |
| list loans | 0 | 23,722 | 36,777 | 0 | 0 |
| Construction and land development loans | 88,088 | 0 | 1,401 | 0 | 0 |
| Owner occupied loans | 304,661 | 0 | 2,911 | 0 | 92 |
| Nonowner occupied |  |  |  |  |  |
| loans | 314,247 | 0 | 19,047 | 0 | 0 |
| Multifamily loans | 24,127 | 0 | 0 | 0 | 0 |

Agri-business and
agricultural loans:

| Non-impaired watch |  |  |  |  |  |
| :--- | :---: | :---: | :---: | :---: | :---: |
| list loans |  |  |  |  |  |
| Loans secured by <br> farmland <br> Loans for agricultural <br> production | 0 | 2,008 | 2,123 | 0 | 0 |


| Other commercial |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- |
| loans | 38,400 | 0 | 339 | 0 |


| Consumer 1-4 family mortgage loans: |  |  |  |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Closed end first mortgage loans |  | 17,398 |  | 427 |  | 1,386 |  | 0 |  | 83,687 |
| Open end and junior lien loans |  | 13,380 |  | 0 |  | 178 |  | 0 |  | 169,341 |
| Residential construction loans |  | 0 |  | 0 |  | 0 |  | 0 |  | 4,136 |
| Other consumer loans |  | 9,394 |  | 0 |  | 497 |  | 0 |  | 41,220 |
| Total | \$ | 1,620,820 | \$ | 48,439 | \$ | 120,062 | \$ | 0 | \$ | 300,638 |

The recorded investment in loans does not include accrued interest.

## NOTE 5. SECURITIES

Information related to the fair value and amortized cost of securities available for sale and the related gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) is provided in the tables below.

|  | Fair <br> Value | Gross Unrealized Gain |  | Gross <br> Unrealized Losses | Amortized Cost |
| :---: | :---: | :---: | :---: | :---: | :---: |
| September 30, 2011 |  |  |  |  |  |
| U.S. Treasury securities | \$ 1,057 | \$ | 54 | \$ 0 | \$ 1,003 |
| U.S. Government sponsored agencies | 5,241 |  | 206 | 0 | 5,035 |
| Agency residential mortgage-backed securities | 345,941 |  | 11,526 | (366) | 334,781 |
| Non-agency residential mortgage-backed securities | 35,207 |  | 217 | $(2,356)$ | 37,346 |
| State and municipal securities | 76,626 |  | 4,414 | (10) | 72,222 |
| Total | \$ 464,072 | \$ | 16,417 | \$ $(2,732)$ | \$ 450,387 |
| December 31, 2010 |  |  |  |  |  |
| U.S. Treasury securities | \$ 1,036 | \$ | 32 | \$ 0 | \$ 1,004 |
| Agency residential mortgage-backed securities | 308,851 |  | 10,422 | (837) | 299,266 |
| Non-agency residential mortgage-backed securities | 62,773 |  | 331 | $(6,136)$ | 68,578 |
| State and municipal securities | 69,960 |  | 1,538 | (637) | 69,059 |
| Total | \$ 442,620 | \$ | 12,323 | \$ $(7,610)$ | \$ 437,907 |

Information regarding the fair value and amortized cost of available for sale debt securities by maturity as of September 30, 2011 is presented below. Maturity information is based on contractual maturity for all securities other than mortgage-backed securities. Actual maturities of securities may differ from contractual maturities because borrowers may have the right to prepay the obligation without prepayment penalty.

|  | Fair |  | Amortized |
| :--- | ---: | ---: | ---: |
|  | Value | Cost |  |
| Due in one year or less | $\$$ | 1,576 | $\$$ |

Information regarding security proceeds, gross gains and gross losses are presented below.

|  | Nine months ended September 30, |  |  |  |
| :---: | :---: | :---: | :---: | :---: |
|  | 2011 |  | 2010 |  |
| Sales of securities available for sale |  |  |  |  |
| Proceeds |  |  | \$ | 0 |
| Gross gains |  |  |  | 0 |
| Gross losses |  |  |  | 0 |
|  |  |  |  |  |
|  | Three months ended September 30, |  |  |  |
|  |  |  |  |  |
| Sales of securities available for sale |  |  |  |  |
| Proceeds | \$ | 0 | \$ | 0 |
| Gross gains |  | 0 |  | 0 |
| Gross losses |  | 0 |  | 0 |

The Company sold 36 securities with a total book value of $\$ 73.5$ million and a total fair value of $\$ 73.3$ million during the first nine months of 2011. The sales were related to a strategic realignment of the securities portfolio, and included six of the seven non-agency residential mortgage backed securities on which the Company had previously recognized other-than-temporary impairment. There were no securities sales during the first nine months of 2010.

Purchase premiums or discounts are recognized in interest income using the interest method over the terms of the securities or over estimated lives for mortgage-backed securities. Gains and losses on sales are based on the amortized cost of the security sold and recorded on the trade date.

Securities with carrying values of $\$ 249.8$ million and $\$ 243.9$ million were pledged as of September 30, 2011 and 2010, as collateral for deposits of public funds, securities sold under agreements to repurchase, borrowings from the FHLB and for other purposes as permitted or required by law.

Information regarding securities with unrealized losses as of September 30, 2011 and December 31, 2010 is presented below. The tables distribute the securities between those with unrealized losses for less than twelve months and those with unrealized losses for twelve months or more.

| Less than |  | 12 months | 12 months or more |  | Total |  |
| :--- | :---: | :---: | :---: | :---: | :---: | :---: |
| Fair | Unrealized | Fair | Unrealized | Fair | Unrealized |  |
| Value | Losses | Value | Losses | Value | Losses |  |

September 30, 2011

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| U.S. Treasury securities | $\$$ | 0 | $\$$ | 0 | $\$$ | 0 | $\$$ | 0 | $\$$ | 0 | $\$$ | 0 |
| Agency residential <br> mortgage-backed securities | 60,725 |  | 347 | 4,874 |  | 19 | 65,599 | 366 |  |  |  |  |
| Non-agency residential <br> mortgage-backed securities | 3,101 |  | 4 |  | 26,047 |  | 2,352 | 29,148 |  |  |  |  |
| State and municipal securities | 312 |  | 3 | 1,003 | 7 | 1,315 | 2,356 |  |  |  |  |  |
| Total temporarily impaired | $\$ 64,138$ | $\$$ | 354 | $\$ 31,924$ | $\$$ | 2,378 | $\$$ | 96,062 | $\$$ | 2,732 |  |  |


| Less than | 12 months | 12 months or more |  | Total |  |
| :--- | :---: | :---: | :---: | :---: | :---: |
| Fair | Unrealized | Fair | Unrealized | Fair | Unrealized |
| Value | Losses | Value | Losses | Value | Losses |

December 31, 2010

| U.S. Treasury securities | \$ | 0 | \$ | 0 | \$ 0 | \$ | 0 | \$ 0 | \$ | 0 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Agency residential mortgage-backed securities |  | 55,193 |  | 821 | 4,170 |  | 16 | 59,363 |  | 837 |
| Non-agency residential mortgage-backed securities |  | 1,607 |  | 2 | 50,786 |  | 6,134 | 52,393 |  | 6,136 |
| State and municipal securities |  | 15,811 |  | 577 | 422 |  | 60 | 16,233 |  | 637 |
| Total temporarily impaired | \$ | 72,611 | \$ | 1,400 | \$ 55,378 | \$ | 6,210 | \$ 127,989 | \$ | 7,610 |

The number of securities with unrealized losses as of September 30, 2011 and December 31, 2010 is presented below.

$$
\begin{array}{lll}
\text { Less than } & 12 \text { months } & \\
12 \text { months } & \text { or more } & \text { Total }
\end{array}
$$

September 30, 2011

| U.S. Treasury securities | 0 | 0 | 0 |
| :--- | ---: | ---: | ---: |
| Agency residential mortgage-backed securities | 18 | 1 | 19 |
| Non-agency residential mortgage-backed securities | 0 | 10 | 10 |
| State and municipal securities | 2 | 2 | 4 |
| Total temporarily impaired | 20 | 13 | 33 |

December 31, 2010

| U.S. Treasury securities | 0 | 0 | 0 |
| :--- | ---: | ---: | ---: |
| Agency residential mortgage-backed securities | 13 | 1 | 14 |
| Non-agency residential mortgage-backed securities | 1 | 18 | 19 |
| State and municipal securities | 35 | 1 | 36 |
| Total temporarily impaired | 49 | 20 | 69 |

All of the following are considered to determine whether or not the impairment of these securities is other-than-temporary. Ninety-four percent of the securities are backed by the U.S. Government, government agencies, government sponsored agencies or are A rated or better, except for certain non-local municipal securities which are not rated. Mortgage-backed securities which are not issued by the U.S. Government or government sponsored agencies (non-agency residential mortgage-backed securities) met specific criteria set by the Asset Liability Management Committee at their time of purchase, including having the highest rating available by either Moody's or S\&P. None of the securities have call provisions (with the exception of the municipal securities) and payments as originally agreed have been received. For the government, government-sponsored agency and municipal securities, management did not have concerns of credit losses and there was nothing to indicate that full principal will not be received. Management considered the unrealized losses on these securities to be primarily interest rate driven and does not expect material losses given current market conditions unless the securities are sold, which at this time management does not have the intent to sell nor will it more likely than not be required to sell these securities before the recovery of their amortized cost basis.

As of September 30, 2011, the Company had $\$ 35.2$ million of collateralized mortgage obligations which were not issued by the federal government or government sponsored agencies, but were rated AAA by S\&P and/or Aaa by Moody's at the time of purchase. At December 31, 2010, the Company had $\$ 62.8$ million of these collateralized mortgage obligations. During the first quarter of 2011, the Company sold eight of the non-agency residential mortgage backed securities as part of a strategic realignment of the investment portfolio. The securities sold had a book value of $\$ 21.9$ million and a fair value of $\$ 17.7$ million. The sales included six of the seven non-agency residential mortgage backed securities on which the Company had previously recognized other-than-temporary impairment. Two of the 15 remaining non-agency residential mortgage backed securities were still rated AAA/Aaa as of September 30, 2011, but 13 were downgraded by S\&P, Fitch and/or Moody's, including 10 which were ranked below investment grade by one or more rating agencies. Of the five securities rated AAA/Aaa at December 31, 2010, three have been downgraded, but were still rated as investment grade. Of the 10 that were below AAA/Aaa at December 31, 2010, three incurred further downgrades.

For these non-agency residential mortgage-backed securities, additional analysis is performed to determine if the impairment is temporary or other-than-temporary in which case impairment would need to be recorded for these securities. The Company performs an independent analysis of the cash flows of the individual securities based upon assumptions as to collateral defaults, prepayment speeds, expected losses and the severity of potential losses. Based upon the initial review, securities may be identified for further analysis computing the net present value using an appropriate discount rate (the current accounting yield) and comparing it to the book value of the security to determine if there is any other-than-temporary impairment that must be recorded. Based on this analysis of the non-agency residential mortgage-backed securities, the Company recorded an other-than-temporary impairment of $\$ 33,000$ and $\$ 154,000$, respectively, relating to one security in the three-months and nine-months ended September 30, 2011, which is equal to the credit loss, establishing a new, lower amortized cost basis. Because management did not have the intent to sell these securities nor did management believe that it was more likely than not they would be required to sell these securities before the recovery of their new, lower amortized cost basis, management did not consider the remaining unrealized losses of the investment securities to be other-than-temporarily impaired at September 30, 2011.

The following table provides information about debt securities for which only a credit loss was recognized in income and other losses are recorded in other comprehensive income. The table represents the three months and nine months ended September 30, 2011 and 2010.
Accumulated
Credit
Losses
Three Months Ended September 30, 2011 ..... \$ ..... 194
Sales of securities for which other-than-temporary impairment losses were previously recognized ..... 0
Additional increases to the amount of credit loss for which other-than-temporary impairment was previously recognized ..... 33
Balance September 30, 2011 \$ ..... 227
Accumulated Credit Losses Three Months Ended September 30, 2010 ..... \$ ..... 477
Additions related to other-than-temporary impairment losses not previously recognized ..... 61
Additional increases to the amount of credit loss for which other-than-temporary impairment was previously recognized ..... 24
Balance September 30, 2010 ..... \$ ..... 562
Nine Months Ended September 30, 2011
Accumulated
Balance January 1, 2011 ..... \$ ..... 1,812
Sales of securities for which other-than-temporary impairment losses were previously recognized ..... $(1,739)$
Additional increases to the amount of credit loss for which other-than-temporary impairment was previously recognized ..... 154
Balance September 30, 2011 ..... \$ ..... 227
Accumulated
Credit Nine Months Ended September 30, 2010 ..... Losses
Balance January 1, 2010 ..... \$ ..... 225
Additions related to other-than-temporary impairment losses not previously recognized ..... 113
Additional increases to the amount of credit loss for which other-than-temporary impairment was previously recognized ..... 224
Balance September 30, 2010 ..... \$ ..... 562

Information on securities with at least one rating below investment grade as of September 30, 2011 is presented below.


All of these securities are super senior or senior tranche non-agency residential mortgage-backed securities. The credit support is the credit support percentage for a tranche from other subordinated tranches, which is the amount of principal in the subordinated tranches expressed as a percentage of the remaining principal in the super senior/senior tranche. The super senior/senior tranches receive the prepayments and the subordinate tranches absorb the losses. The super senior/senior tranches do not absorb losses until the subordinate tranches are gone.

The Company does not have a history of actively trading securities, but keeps the securities available for sale should liquidity or other needs develop that would warrant the sale of securities. While these securities are held in the available for sale portfolio, it is management's current intent and ability to hold them until a recovery in fair value or maturity.

## NOTE 6. EMPLOYEE BENEFIT PLANS

Components of net periodic benefit cost

|  | Nine Months Ended September 30, |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Pension Benefits |  |  |  | SERP Benefits |  |  |  |
|  | 2011 |  | 2010 |  | 2011 |  | 2010 |  |
| Interest cost | \$ | 105 | \$ | 106 | \$ | 46 | \$ | 51 |
| Expected return on plan assets |  | (119) |  | (125) |  | (60) |  | (61) |
| Recognized net actuarial (gain) loss |  | 80 |  | 63 |  | 52 |  | 44 |
| Net pension expense (benefit) | \$ | 66 | \$ | 44 | \$ | 38 | \$ | 34 |
|  | Three Months Ended September 30, |  |  |  |  |  |  |  |
|  | Pension Benefits |  |  |  | SERP Benefits |  |  |  |
|  | 2011 |  | 2010 |  | 2011 |  | 2010 |  |
| Interest cost | \$ | 33 | \$ | 38 | \$ | 12 | \$ | 17 |
| Expected return on plan assets |  | (41) |  | (47) |  | (20) |  | (19) |
| Recognized net actuarial (gain) loss |  | 40 |  | 13 |  | 22 |  | 16 |
| Net pension expense (benefit) | \$ | 32 | \$ | 4 | \$ | 14 | \$ | 14 |

The Company previously disclosed in its financial statements for the year ended December 31, 2010 that it did not expect to contribute to its pension in 2011 and did expect to contribute $\$ 90,000$ to its SERP plan in 2011. No contributions were made to the pension plan and $\$ 90,000$ was contributed to the SERP plan as of September 30, 2011.

## NOTE 7. NEW ACCOUNTING PRONOUNCEMENTS

In January 2011, the FASB issued ASU No. 2011-01, "Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20." The provisions of ASU No. 2010-20 required the disclosure of more granular information on the nature and extent of troubled debt restructurings and their effect on the allowance for loan and lease losses effective for the Company's reporting period ended March 31, 2011. The amendments in ASU No. 2011-01 defer the effective date related to these disclosures, enabling creditors to provide such disclosures after the FASB completes their project clarifying the guidance for determining what constitutes a troubled debt restructuring. As the provisions of this ASU only deferred the effective date of disclosure requirements related to troubled debt restructurings, the adoption of this ASU did not have a material impact on the Company's statements of income and condition.

In April 2011, the FASB issued ASU No. 2011-02, "A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring." The provisions of ASU No. 2011-02 provide additional guidance related to determining whether a creditor has granted a concession, include factors and examples for creditors to consider in evaluating whether a restructuring results in a delay in payment that is insignificant, prohibit creditors from using the borrower's effective rate test to evaluate whether a concession has been granted to the borrower, and add factors for creditors to use in determining whether a borrower is experiencing financial difficulties. A provision in ASU No. 2011-02 also ends the FASB's deferral of the additional disclosures about troubled debt restructurings as required by ASU No. 2010-20. The provisions of ASU No. 2011-02 were effective for the Company's reporting period ending September 30, 2011. The adoption of ASU No. 2011-02 did not have a material impact on the Company's statements of income and condition.

In May 2011, the FASB issued ASU No. 2011-04, "Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs." ASU No. 2011-04 results in a consistent definition of fair value and common requirements for measurement of and disclosure about fair value between U.S. GAAP and International Financial Reporting Standards ("IFRS"). The changes to U.S. GAAP as a result of ASU No. 2011-04 are as follows: (1) The concepts of highest and best use and valuation premise are only relevant when measuring the fair value of nonfinancial assets (that is, it does not apply to financial assets or any liabilities); (2) U.S. GAAP currently prohibits application of a blockage factor in valuing financial instruments with quoted prices in active markets. ASU No. 2011-04 extends that prohibition to all fair value measurements; (3) An exception is provided to the basic fair value measurement principles for an entity that holds a group of financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk that are managed on the basis of the entity's net exposure to either of those risks. This exception allows the entity, if certain criteria are met, to measure the fair value of the net asset or liability position in a manner consistent with how market participants would price the net risk position; (4) Aligns the fair value measurement of instruments classified within an entity's shareholders' equity with the guidance for liabilities; and (5) Disclosure requirements have been enhanced for recurring Level 3 fair value measurements to disclose quantitative information about unobservable inputs and assumptions used, to describe the valuation processes used by the entity, and to describe the sensitivity of fair value measurements to changes in unobservable inputs and interrelationships between those inputs. In addition, entities must report the level in the fair value hierarchy of items that are not measured at fair value in the statement of condition but whose fair value must be disclosed. The provisions of ASU No. 2011-04 are effective for the Company's interim and annual periods beginning on or after December 15, 2011. The adoption of ASU No. 2011-04 is not expected to have a material impact on the Company's statements of income and condition.

In September 2011, the FASB issued ASU No. 2011-08, "Testing Goodwill for Impairment." The provisions of ASU No. 2011-08 permits an entity an option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity believes, as a result of its qualitative assessment, that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, the quantitative impairment test is required. Otherwise, no further impairment testing is required. ASU No. 2011-08 includes examples of events and circumstances that may indicate that a reporting unit's fair value is less than its carrying amount. The provisions of ASU No. 2011-08 are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The adoption of ASU No. 2011-08 is not expected to have a material impact on the Company's statements of income and condition.

## NOTE 8. FAIR VALUE DISCLOSURES

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

Level 3
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.

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 of each type of financial instrument:

Securities: Securities available for sale are valued primarily by a third party pricing service. The fair values of securities available for sale are determined on a recurring basis by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or pricing models utilizing significant observable inputs such as matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). These models utilize the market approach with standard inputs that include, but are not limited to benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data. There were no transfers from or into Level 1, Level 2 or Level 3 during the first nine months of 2011.

Mortgage banking derivatives: The fair value of derivatives are based on observable market data as of the measurement date (Level 2).

Impaired loans: Impaired loans with specific allocations of the allowance for loan losses are generally assessed against higher than normal discounted advance ratios of collateral as approved at the time of funding, with consideration given for any supplemental credit support from guarantors. Consideration is given for the type and nature of collateral, as well as the anticipated liquidation value to develop a discount for the advance ratios on each credit. Commercial real estate is generally discounted from its appraised value by $20-50 \%$ after various considerations including age of the appraisal, current net operating income realized, general market conditions where the property is located, type of property and potential buyer base. The 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. Raw and finished inventory is discounted from its cost or book value by $35-65 \%$, depending on the marketability of the goods. Finished goods are generally discounted by $30-60 \%$, depending on the ease of marketability, cost of transportation or scope of use of the finished good. Work in process inventory is typically discounted by $50-100 \%$, depending on the length of manufacturing time, types of components used in the completion process, and the breadth of the user base. Equipment is valued at a percentage of

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depreciated book value or recent appraised value, if available, and is typically discounted at 30-70\% after various considerations including age and condition of the equipment, marketability, breadth of use, and whether the equipment includes unique components or add-ons. Marketable securities are discounted by $10-30 \%$, depending on the type of investment, age of valuation report and general market conditions. This methodology is based on a market approach and typically results in a Level 3 classification of the inputs for determining fair value.

Mortgage servicing rights: As of September 30, 2011 the fair value of the Company's Level 3 servicing assets for residential mortgage loans was $\$ 1.9$ million, some of which are not currently impaired and therefore carried at amortized cost. These residential mortgage loans have a weighted average interest rate of $5.08 \%$, a weighted average maturity of 20 years and are secured by homes generally within the Company's market area of Northern Indiana. A valuation model is used to estimate fair value, which is based on an income approach. The inputs used include estimates of prepayment speeds, discount rate, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, late fees, and float income. The most significant assumption used to value mortgage servicing rights is prepayment rate. Prepayment rates are estimated based on published industry consensus prepayment rates. At September 30, 2011 the constant prepayment speed (PSA) used was 420 and the discount rate used was $9.2 \%$. At September 30, 2010 the constant prepayment speed (PSA) used was 433 and the discount rate used was $9.5 \%$.

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

Real estate mortgage loans held for sale: Real estate mortgage loans held for sale are carried at the lower of cost or fair value, as determined by outstanding commitments, from third party investors.

The table below presents the balances of assets measured at fair value on a recurring basis:

| Assets | September 30, 2011 |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  |  | el 2 |  |  | Assets at Fair Value |  |
| U.S. Treasury securities | \$ | 1,057 | \$ | 0 | \$ | 0 | \$ | 1,057 |
| U.S. Government sponsored agencies |  | 0 |  | 5,241 |  | 0 |  | 5,241 |
| Agency residential mortgage-backed securities |  | 0 |  | 345,941 |  | 0 |  | 345,941 |
| Non-agency residential mortgage-backed securities |  | 0 |  | 35,207 |  | 0 |  | 35,207 |
| State and municipal securities |  | 0 |  | 76,626 |  | 0 |  | 76,626 |
| Total Securities |  | 1,057 |  | 463,015 |  | 0 |  | 464,072 |
|  |  |  |  |  |  |  |  |  |
| Mortgage banking derivative |  | 0 |  | 535 |  | 0 |  | 535 |
|  |  |  |  |  |  |  |  |  |
| Total assets | \$ | 1,057 | \$ | 463,550 | \$ | 0 | \$ | 464,607 |

December 31, 2010

| Assets | Fair Value Measurements Using |  |  |  |  |  | Assets at Fair Value |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Level 1 |  | Level 2 |  | Level 3 |  |  |  |
| U.S. Treasury securities | \$ | 1,036 | \$ | 0 | \$ | 0 | \$ | 1,036 |
| Agency residential mortgage-backed securities |  | 0 |  | 308,851 |  | 0 |  | 308,851 |
| Non-agency residential mortgage-backed securities |  | 0 |  | 62,773 |  | 0 |  | 62,773 |
| State and municipal securities |  | 0 |  | 69,960 |  | 0 |  | 69,960 |
| Total Securities |  | 1,036 |  | 441,584 |  | 0 |  | 442,620 |
| Mortgage banking derivative |  | 0 |  | 357 |  | 0 |  | 357 |
| Total assets | \$ | 1,036 | \$ | 441,941 | \$ | 0 | \$ | 442,977 |

The table below presents the balances of assets measured at fair value on a nonrecurring basis:
September 30, 2011
Fair Value Measurements Using
Assets
Assets Level 1 Level 2 Level 3 at Fair Value
Impaired loans:

| Commercial and industrial loans: |  |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Working capital lines of credit |  |  |  |  |  |  |  |  |
| loans | \$ | 0 | \$ | 0 | \$ | 2,731 | \$ | 2,731 |
| Non-working capital loans |  | 0 |  | 0 |  | 11,595 |  | 11,595 |
| Commercial real estate and multi-family residential loans: |  |  |  |  |  |  |  |  |
| Construction and land development loans |  | 0 |  | 0 |  | 762 |  | 762 |
| Owner occupied loans |  | 0 |  | 0 |  | 1,829 |  | 1,829 |
| Nonowner occupied loans |  | 0 |  | 0 |  | 20,594 |  | 20,594 |
| Multifamily loans |  | 0 |  | 0 |  | 0 |  | 0 |

Agri-business and agricultural
loans:
Loans secured by farmland 000423
Loans for agricultural

| production | 0 | 0 | 211 |
| :--- | :--- | :--- | :--- | :--- |

$\begin{array}{lllll}\text { Other commercial loans } & 0 & 0 & 0 & 0\end{array}$
Consumer 1-4 family mortgage
loans:

| Closed end first mortgage loans | 0 | 0 | 1,672 | 1,672 |
| :--- | :--- | :--- | ---: | ---: |
| Open end and junior lien loans | 0 | 0 | 0 | 0 |
| Residential construction loans | 0 | 0 | 0 | 0 |
|  |  |  |  | 0 |

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| Total impaired loans | $\$$ | 0 | $\$$ | 0 | $\$$ | 39,817 | $\$$ | 39,817 |
| :--- | ---: | :--- | :--- | :--- | :--- | ---: | ---: | ---: |
| Mortgage servicing rights |  | 0 |  | 0 |  | 1,578 |  |  |
| Other real estate owned | 0 |  | 0 |  | 58 | 1,578 |  |  |
| Total assets | $\$$ | 0 | $\$$ | 0 | $\$$ | 41,453 | $\$$ | 41,453 |

December 31, 2010
Fair Value Measurements Using

Assets at Fair Value

Assets

Impaired loans:
Commercial and industrial
loans:
Working capital lines of credit

|  | $\$$ | 0 | $\$$ | 0 | $\$$ | 2,708 | $\$$ |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| loans | 0 |  | 0 |  | 4,990 |  | 4,708 |
| Non-working capital loans |  |  |  |  |  |  |  |

Commercial real estate and
multi-family residential loans:

| Construction and land |  |  |  |  |
| :--- | :--- | :--- | ---: | ---: |
| development loans | 0 | 0 | 1,207 | 1,207 |
| Owner occupied loans | 0 | 0 | 1,960 | 14,960 |
| Nonowner occupied loans | 0 | 0 | 14,666 | 14,666 |
| Multifamily loans | 0 | 0 | 0 | 0 |

Agri-business and agricultural
loans:

| Loans secured by farmland | 0 | 0 | 322 |
| :--- | :--- | :--- | :--- | :--- |

Loans for agricultural
$\begin{array}{lllll}\text { production } & 0 & 0 & 635 & 635\end{array}$

| Other commercial loans | 0 | 0 | 7 |
| :--- | :--- | :--- | :--- | :--- |

Consumer 1-4 family mortgage
loans:

| Closed end first mortgage loans | 0 | 0 | 815 | 815 |  |  |
| :--- | :--- | :--- | :--- | ---: | ---: | ---: |
| Open end and junior lien loans | 0 | 0 | 140 | 140 |  |  |
| Residential construction loans | 0 | 0 | 0 | 0 |  |  |
| Other consumer loans | 0 |  | 0 | 0 | 0 |  |
| Total impaired loans |  | 0 | $\$$ | 0 | $\$$ | 27,450 |
| Mortgage servicing rights |  | 0 |  | 0 |  | 11 |
| Total assets |  | 0 | $\$$ | 0 | $\$$ | 27,461 |

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a gross carrying amount of $\$ 56.4$ million, with a valuation allowance of $\$ 16.6$ million, resulting in additional provision for loan losses of $\$ 5.3$ million and $\$ 1.8$ million, respectively, for the nine months and three months ended September 30, 2011. In addition, $\$ 162,000$ and $\$ 169,000$, respectively, in impairment of mortgage servicing rights, measured using Level 3 inputs within the fair value hierarchy, was recognized during the nine months and three months ended September 30, 2011. The Company also recognized $\$ 76,000$ and $\$ 56,000$, respectively, in reduction in the value of other real estate owned during the nine months and three months ended September 30, 2011.

The following table contains the estimated fair values and the related carrying values of the Company's financial instruments. Items which are not financial instruments are not included.

|  | September 30, 2011 |  | December 31, 2010 |  |
| :---: | :---: | :---: | :---: | :---: |
|  | Carrying Value | Estimated Fair Value | Carrying Value | Estimated Fair Value |
| Financial Assets: |  |  |  |  |
| Cash and cash equivalents | \$ 101,278 | \$ 101,278 | 60,141 | 60,141 |
| Securities available for sale | 464,072 | 464,072 | 442,620 | 442,620 |
| Real estate mortgages held for sale | 5,444 | 5,512 | 5,606 | 5,661 |
| Loans, net | 2,128,935 | 2,140,317 | 2,044,952 | 2,041,812 |
| Federal Home Loan Bank stock | 7,313 | N/A | 8,511 | N/A |
| Federal Reserve Bank stock | 3,420 | N/A | 3,420 | N/A |
| Accrued interest receivable | 8,887 | 8,887 | 9,064 | 9,064 |
| Financial Liabilities: |  |  |  |  |
| Certificates of deposit | $(971,656)$ | $(983,571)$ | $(949,559)$ | $(962,456)$ |
| All other deposits | $(1,384,703)$ | $(1,384,703)$ | $(1,251,466)$ | $(1,251,466)$ |
| Securities sold under agreements to repurchase | $(139,016)$ | $(139,016)$ | $(142,015)$ | $(142,015)$ |
| Other short-term borrowings | $(2,560)$ | $(2,560)$ | $(32,037)$ | $(32,037)$ |
| Long-term borrowings | $(15,040)$ | $(16,186)$ | $(15,041)$ | $(15,991)$ |
| Subordinated debentures | $(30,928)$ | $(31,207)$ | $(30,928)$ | $(31,242)$ |
| Standby letters of credit | (291) | (291) | (321) | (321) |
| Accrued interest payable | $(5,315)$ | $(5,315)$ | $(4,978)$ | $(4,978)$ |

For purposes of the above disclosures of estimated fair value, the following assumptions were used as of September 30, 2011 and December 31, 2010. The estimated fair value for cash and cash equivalents, demand and savings deposits, variable rate loans, variable rate short term borrowings and accrued interest is considered to approximate cost. The fair value of Federal Home Loan Bank and Federal Reserve Bank stock is not determinable as there are restrictions on its transferability. The estimated fair value for fixed rate loans, certificates of deposit and fixed rate borrowings is based on discounted cash flows using current market rates applied to the estimated life. Real estate mortgages held for sale are based upon the actual contracted price for those loans sold but not yet delivered, or the current Federal Home Loan Mortgage Corporation price for normal delivery of mortgages with similar coupons and maturities at year-end. The fair value of subordinated debentures is based on the rates currently available to the Company with similar term and remaining maturity and credit spread. The fair value of off-balance sheet items is based on the current fees or costs that would be charged to enter into or terminate such arrangements. The estimated fair value of other financial instruments approximate cost and are not considered significant to this presentation.

## NOTE 9. COMPREHENSIVE INCOME

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains and losses on securities available-for-sale and changes in the funded status of pension plans which are also recognized as separate components of equity. Following is a summary of other comprehensive income for the three months and nine months ended September 30, 2011 and 2010:


The following table summarizes the changes within each classification of accumulated other comprehensive income for the nine months ended September 30, 2011 and 2010:

|  | Current |  |
| :---: | :---: | :---: |
| Balance | Period | Balance |
| at December 31, 2010 | Change | at September 30, 2011 |

Unrealized gain on securities available for sale

| without other than temporary impairment | $\$$ | 4,285 | $\$$ | 4,372 | $\$$ |
| :--- | :---: | :---: | :---: | :---: | :---: |
| Unrealized loss on securities available for <br> sale |  |  |  | 8,657 |  |
| with other than temporary impairment | $(1,425)$ | 1,138 | $(287)$ |  |  |
| Total unrealized loss on securities available <br> for sale | 2,860 | 5,510 | 8,370 |  |  |
| Unrealized loss on defined benefit pension <br> plans | $(1,510)$ | $(60)$ | $(1,570)$ |  |  |
| Total | $\$$ | 1,350 | $\$$ | 5,450 | $\$$ |


|  | Balance <br> at December 31, 2009 |  | Current <br> Period <br> Change |  | Balance <br> at September 30, 2010 |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Unrealized gain (loss) on securities available for sale |  |  |  |  |  |  |
| without other than temporary impairment | \$ | $(2,814)$ | \$ | 9,586 | \$ | 6,772 |
| Unrealized loss on securities available for sale |  |  |  |  |  |  |
| with other than temporary impairment |  | $(1,606)$ |  | 47 |  | $(1,559)$ |
| Total unrealized loss on securities available for sale |  | $(4,420)$ |  | 9,633 |  | 5,213 |
| Unrealized loss on defined benefit pension plans |  | $(1,573)$ |  | 42 |  | $(1,531)$ |
| Total | \$ | $(5,993)$ | \$ | 9,675 | \$ | 3,682 |

## NOTE 10. SUBSEQUENT EVENTS

There were no subsequent events that would have a material impact to the financial statements presented in this Form 10-Q.

## NOTE 11. RECLASSIFICATIONS

Certain amounts appearing in the financial statements and notes thereto for prior periods have been reclassified to conform with the current presentation. The reclassification had no effect on net income or stockholders' equity as previously reported.

# Part 1 <br> LAKELAND FINANCIAL CORPORATION ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION and RESULTS OF OPERATIONS 

September 30, 2011

## OVERVIEW

Lakeland Financial Corporation is the holding company for Lake City Bank. The Company is headquartered in Warsaw, Indiana and operates 43 offices in 12 counties in Northern Indiana and a loan production office in Indianapolis, Indiana. The Company earned $\$ 22.4$ million for the first nine months of 2011, versus $\$ 18.8$ million in the same period of 2010, an increase of $19.4 \%$. Net income was positively impacted by a $\$ 6.5$ million decrease in the provision for loan losses and an increase in noninterest income of $\$ 249,000$. Offsetting these positive impacts were an increase of $\$ 1.5$ million in noninterest expense and a decrease in net interest income of $\$ 30,000$. Basic earnings per common share for the first nine months of 2011 were $\$ 1.38$ per share, versus $\$ 0.97$ per share for the first nine months of 2010. Diluted earnings per common share reflect the potential dilutive impact of stock options, stock awards and warrants. Diluted earnings per common share for the first nine months of 2011 were $\$ 1.37$ per share, versus $\$ 0.96$ for the first nine months of 2010. Basic and diluted earnings per common share for the first nine months of 2010 were impacted by $\$ 3.2$ million in dividends and accretion of discount on preferred stock. The Company redeemed the preferred stock, which had been issued to the U.S. Treasury under the Capital Purchase Program, in the second quarter of 2010 .

Net income for the third quarter of 2011 was $\$ 8.4$ million, an increase of $29.5 \%$ versus $\$ 6.5$ million for the comparable period of 2010. The increase was driven by a $\$ 3.8$ million decrease in the provision for loan losses as well as a $\$ 150,000$ decrease in noninterest expense. Offsetting these positive impacts was a decrease of $\$ 396,000$ in net interest income, as well as a decrease of $\$ 289,000$ in noninterest income. Basic earnings per common share for the third quarter of 2011 were $\$ 0.52$ per share, versus $\$ 0.40$ per share for the third quarter of 2010 . Diluted earnings per common share for the third quarter of 2011 were $\$ 0.52$ per share, versus $\$ 0.40$ per share for the third quarter of 2010.

## RESULTS OF OPERATIONS

## Net Interest Income

For the nine-month period ended September 30, 2011, net interest income totaled $\$ 69.3$ million, substantially unchanged from the first nine months of 2010. During the nine-month period ended September 30, 2011, average earning assets increased by $\$ 119.7$ million, or $4.8 \%$, to $\$ 2.616$ billion. The Company's net interest margin was $3.60 \%$ for the nine-month period ended September 30, 2011, versus $3.77 \%$ for the comparable period in 2010. For the three-month period ended September 30, 2011, net interest income totaled $\$ 22.8$ million, a decrease of $1.7 \%$, or $\$ 396,000$, versus the third quarter of 2010 . This decrease was primarily due to a 22 basis point decrease in the Company's net interest margin to $3.48 \%$ for the three-month period ended September 30, 2011, versus $3.70 \%$ for the
comparable period of 2010. Average earning assets increased $\$ 111.0$ million, or $4.4 \%$, to $\$ 2.640$ billion in the third quarter of 2011, versus the third quarter of 2010.

Given the Company's mix of interest earning assets and interest bearing liabilities at September 30, 2011, the Company would generally be considered to have a relatively neutral balance sheet structure. The Company's balance sheet structure would normally be expected to produce a stable or declining net interest margin in a declining rate environment. As the Company's balance sheet has become more neutral in structure, management believes rate movements and other factors such as deposit mix, market deposit rate pricing and non-bank deposit products could have an impact on net interest margin. Over time, the Company's mix of deposits has shifted to more reliance on transaction accounts such as Rewards Checking, as well as the Rewards Savings product and corporate and public fund money market and repurchase agreements, which generally carry a higher interest rate cost than other types of interest bearing deposits.

During the first nine months of 2011, total interest and dividend income decreased by $\$ 463,000$, or $0.5 \%$, to $\$ 91.7$ million, versus $\$ 92.2$ million during the first nine months of 2010. This decrease was primarily the result of a 24 basis point decrease in the tax equivalent yield on average earning assets to $4.8 \%$, versus $5.0 \%$ for the same period of 2010. Average earning assets increased by $\$ 119.7$ million, or $4.8 \%$, during the first nine months of 2011 versus the same period of 2010. During the third quarter of 2011, total interest and dividend income decreased by $\$ 693,000$, or $2.2 \%$, to $\$ 30.4$ million, versus $\$ 31.1$ million during the third quarter of 2010. This decrease was primarily the result of a 31 basis point decrease in the tax equivalent yield on average earning assets to $4.6 \%$ in the third quarter of 2011, versus $4.9 \%$ for the same period of 2010. Average earning assets increased by $\$ 111.0$ million, or $4.4 \%$, in the third quarter of 2011 versus the same period of 2010.

During the first nine months of 2011, loan interest income increased by $\$ 1.2$ million, or $1.5 \%$, to $\$ 78.9$ million, versus $\$ 77.7$ million during the first nine months of 2010 . The increase was driven by a $\$ 93.5$ million, or $4.6 \%$, increase in average daily loan balances. During the third quarter of 2011, loan interest income increased by $\$ 101,000$, or $0.4 \%$, to $\$ 26.5$ million, versus $\$ 26.4$ million during the third quarter of 2010 . The increase was driven by a $\$ 99.8$ million, or $4.8 \%$, increase in average daily loan balances.

The average daily securities balances for the first nine months of 2011 increased $\$ 15.8$ million, or $3.7 \%$, to $\$ 441.8$ million, versus $\$ 426.0$ million for the same period of 2010 . During the same periods, income from securities decreased by $\$ 1.7$ million, or $11.8 \%$, to $\$ 12.7$ million versus $\$ 14.4$ million during the first nine months of 2010 . The decrease was primarily the result of a 67 basis point decrease in the tax equivalent yield on securities, to $4.2 \%$, versus $4.8 \%$ in the first nine months of 2010. The average daily securities balances for the third quarter of 2011 increased $\$ 21.1$ million, or $4.9 \%$, to $\$ 457.4$ million, versus $\$ 436.2$ million for the same period of 2010. During the same periods, income from securities decreased by $\$ 793,000$, or $16.9 \%$, to $\$ 3.9$ million versus $\$ 4.7$ million during the third quarter of 2010. The decrease was primarily the result of an 89 basis point decrease in the tax equivalent yield on securities, to $3.7 \%$, versus $4.6 \%$ in the third quarter of 2010 .

Despite the Company's change in deposit mix to include higher costing deposit types, total interest expense decreased $\$ 433,000$, or $1.9 \%$, to $\$ 22.4$ million for the nine-month period ended September 30, 2011, from $\$ 22.9$ million for the comparable period in 2010. The decrease was primarily the result of a ten basis point decrease in the Company's daily cost of funds to $1.4 \%$, versus $1.5 \%$ for the same period of 2010. This decrease was generally caused by lower competitive interest rates in the Company's market areas than were present in early 2010. Total interest expense decreased $\$ 297,000$, or $3.8 \%$, to $\$ 7.6$ million for the third quarter of 2011 , versus $\$ 7.9$ million for the third quarter of 2010. The decrease was primarily the result of a 10 basis point decrease in the Company's cost of funds to $1.4 \%$, from $1.5 \%$ for the same period of 2010.

On an average daily basis, total deposits (including demand deposits) increased $\$ 205.4$ million, or $9.8 \%$, to $\$ 2.292$ billion for the nine-month period ended September 30, 2011, versus $\$ 2.087$ billion during the same period in 2010. The average daily balances for the third quarter of 2011 increased $\$ 112.2$ million, or $5.1 \%$, to $\$ 2.316$ billion from $\$ 2.204$ billion during the third quarter of 2010 . On an average daily basis, noninterest bearing demand deposits were $\$ 302.2$ million for the nine-month period ended September 30 , 2011, versus $\$ 257.1$ million for the same period in 2010. The average daily noninterest bearing demand deposit balances for the third quarter of 2011 were $\$ 317.9$ million, versus $\$ 277.3$ million for the third quarter of 2010 . On an average daily basis, interest bearing transaction accounts increased $\$ 167.9$ million, or $24.8 \%$, to $\$ 844.5$ million for the nine-month period ended September 30, 2011, versus the same period in 2010. Average daily interest bearing transaction accounts increased $\$ 144.3$ million, or $20.4 \%$, to $\$ 850.3$ million for the third quarter of 2011, versus $\$ 706.0$ million for the third quarter of 2010 . When comparing the nine months ended September 30, 2011 with the same period of 2010, the average daily balance of time deposits, which pay a higher rate of interest compared to demand deposit and non-Rewards Checking transaction accounts, decreased $\$ 62.8$ million. The average rate paid on time deposit accounts decreased 15 basis points to $1.7 \%$ for the nine-month period ended September 30, 2011, versus the same period in 2010. During the third quarter of 2011, the average daily balance of time deposits decreased $\$ 114.8$ million, and the rate paid decreased five basis points to $1.7 \%$, versus the third quarter of 2010. Despite the low interest rate environment, the Company has been able to attract and retain retail deposit customers through offering innovative deposit products such as Rewards Checking and Savings. These products pay somewhat higher interest rates, but also encourage certain customer behaviors such as using debit cards and electronic statements, which have the effect of generating additional third-party fee income and reducing the Company's processing costs.

The Company's funding strategy is generally focused on leveraging its retail branch network to grow traditional retail deposits and on its presence with commercial customers and public fund entities in its Indiana markets to generate deposits. In addition, the Company has utilized the Certificate of Deposit Account Registry Service (CDARS) program and out-of-market deposit programs such as brokered certificates of deposit. Due to ongoing loan growth, the Company sought these deposits and has expanded its funding strategy over time to include these types of non-core deposit programs. The Company believes that these deposit programs represent an appropriate tool in the overall liquidity and funding strategy. On an average daily basis, total brokered certificates of deposit decreased $\$ 17.2$ million to $\$ 149.7$ million for the nine-month period ended September 30, 2011, versus $\$ 166.9$ million for the same period in 2010. During the third quarter of 2011, average daily brokered certificates of deposit were $\$ 125.1$ million, versus $\$ 223.0$ million during the third quarter of 2010 . On an average daily basis, total public fund certificates of deposit decreased $\$ 79.2$ million to $\$ 102.7$ million for the nine-month period ended September 30, 2011, versus $\$ 181.9$ million for the same period in 2010. During the third quarter of 2011, average daily public fund certificates of deposit were $\$ 104.6$ million, versus $\$ 191.9$ million during the third quarter of 2010. In addition, the Company had average public fund interest bearing transaction accounts of $\$ 105.6$ million and $\$ 108.9$ million, respectively, in the nine months and three months ended September 30, 2011, versus $\$ 80.8$ million and $\$ 85.3$ million for the comparable period of 2010. Availability of public fund deposits can be cyclical, primarily due to the timing differences between when real estate property taxes are collected versus when those tax revenues are spent, as well as the intense competition for these funds.

Average daily balances of borrowings were $\$ 193.2$ million during the nine months ended September 30, 2011, versus $\$ 256.0$ million during the same period of 2010, and the rate paid on borrowings decreased eight basis points to $1.1 \%$. During the third quarter of 2011 the average daily balances of borrowings decreased $\$ 4.0$ million to $\$ 193.7$ million, versus $\$ 197.7$ million for the same period of 2010, and the rate paid on borrowings decreased 36 basis points to $1.1 \%$. The decrease in average borrowings during 2011 was driven by the discontinuance of the Federal Reserve Bank's Term Auction Facility (TAF) during the first quarter of 2010. Average daily borrowings under the facility were $\$ 41.5$ million during the nine months ended September 30, 2010, and the Company's last borrowing matured on April 8, 2010. On an average daily basis, total deposits (including demand deposits) and purchased funds increased $6.1 \%$ and $4.5 \%$, respectively, during the nine-month and the three-month periods ended September 30, 2011 versus the same periods in 2010.

The Board of Directors and management recognize the importance of liquidity during times of normal operations and in times of stress. Therefore, during 2010, the Company formalized and expanded upon its extensive Contingency Funding Plan (CFP). The formal CFP was developed to ensure that the multiple liquidity sources available to the Company are detailed. The CFP identifies the potential funding sources, which include the Federal Home Loan Bank of Indianapolis, The Federal Reserve Bank, brokered certificates of deposit, certificates of deposit available from the CDARS program, repurchase agreements, and Fed Funds. The CFP also address the role of the securities portfolio in liquidity.

Further, the plan identifies CFP team members and expressly details their respective roles. Potential risk scenarios are identified and the plan includes multiple scenarios, including short-term and long-term funding crisis situations. Under the long-term funding crisis, two additional scenarios are identified: a moderate risk scenario and a highly stressed scenario. The CFP indicates the responsibilities and the actions to be taken by the CFP Team under each scenario. Monthly reports to management and the Board of Directors under the CFP include an early warning indicator matrix and pro forma cash flows for the various scenarios. The Company will continue to carefully monitor its liquidity planning and will consider adjusting its plans as circumstances warrant.

The following tables set forth consolidated information regarding average balances and rates:

DISTRIBUTION OF ASSETS, LIABILITIES AND STOCKHOLDERS' EQUITY;
INTEREST RATES AND INTEREST DIFFERENTIAL
(in thousands of dollars)
Nine Months Ended September 30,

2011
Average Interest

Yield
(1)

2010
Average Interest
Balance Income

Yield
(1)

ASSETS
Earning
assets:
Loans:

| Taxable <br> $(2)(3)$ | $\$$ | $2,121,294$ | $\$$ | 78,555 | $4.95 \%$ | $\$$ | $2,036,216$ | $\$$ | 77,676 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

Tax

| exempt |  |  |  |  |  |  |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: |
| (1) | 10,471 | 529 | 6.76 | 2,099 | 85 | 5.41 |
| Investments: <br> (1) |  |  |  |  |  |  |
| Available <br> for sale | 441,771 | 13,745 | 4.16 | 426,005 | 15,390 | 4.83 |
| Short-term <br> investments | 17,219 | 18 | 0.14 | 30,365 | 37 | 0.16 |
| Interest <br> bearing <br> deposits | 25,606 | 96 | 0.50 | 1,975 | 23 | 1.56 |

Total


Total
assets
(1) Tax exempt income was converted to a fully taxable equivalent basis at a 35 percent tax rate for 2011 and 2010. The tax equivalent rate for tax exempt loans and tax exempt securities included the TEFRA adjustment applicable to nondeductible interest expenses.
(2)Loan fees, which are immaterial in relation to total taxable loan interest income for the nine months ended September 30, 2011 and 2010, are included as taxable loan interest income.
(3)

Nonaccrual loans are included in the average balance of taxable loans.

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DISTRIBUTION OF ASSETS, LIABILITIES AND STOCKHOLDERS' EQUITY; INTEREST RATES AND INTEREST DIFFERENTIAL (Cont.)
(in thousands of dollars)
Nine Months Ended September 30,
2011
Average
Balance
Interest
LIABILITIES
AND
STOCKHOLDERS'
EQUITY
Interest
bearing
liabilities:

| Savings deposits | 166,740 | \$ | 686 | 0.55\% | \$ | 111,605 | \$ | 510 | 0.61\% |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Interest bearing checking accounts | 844,488 |  | 7,994 | 1.27 |  | 676,549 |  | 6,019 | 1.19 |
| Time deposits: |  |  |  |  |  |  |  |  |  |
| In denominations under \$100,000 | 348,557 |  | 5,125 | 1.97 |  | 321,180 |  | 5,596 | 2.33 |
| In denominations over \$100,000 | 630,820 |  | 7,063 | 1.50 |  | 720,964 |  | 8,517 | 1.58 |
| Miscellaneous short-term borrowings | 147,263 |  | 477 | 0.43 |  | 185,001 |  | 587 | 0.42 |
| Long-term borrowings |  |  |  |  |  |  |  |  |  |
| and subordinated debentures | 45,968 |  | 1,084 | 3.15 |  | 70,969 |  | 1,633 | 3.08 |
| Total interest bearing liabilities | 2,183,836 |  | 22,429 | 1.37\% |  | 2,086,268 |  | 22,862 | 1.47\% |
| Noninterest bearing liabilities |  |  |  |  |  |  |  |  |  |


| and stockholders' equity: |  |  |  |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Demand deposits |  | 302,170 |  | 0 |  |  | 257,126 |  | 0 |  |
| Other |  |  |  |  |  |  |  |  |  |  |
| liabilities |  | 14,931 |  | 0 |  |  | 16,037 |  | 0 |  |
| Stockholders' equity |  | 256,829 |  | 0 |  |  | 267,804 |  | 0 |  |
| Total liabilities and stockholders' |  |  |  |  |  |  |  |  |  |  |
| equity | \$ | 2,757,766 | \$ | 22,429 |  | \$ | 2,627,235 | \$ | 22,862 |  |
| Net interest differential yield on |  |  |  |  |  |  |  |  |  |  |
| average <br> daily <br> earning <br> assets |  |  | \$ | 70,514 | 3.60\% |  |  | \$ | 70,349 | 3.77\% |

DISTRIBUTION OF ASSETS, LIABILITIES AND STOCKHOLDERS' EQUITY; INTEREST RATES AND INTEREST DIFFERENTIAL
(in thousands of dollars)
Three Months Ended September 30,

2011
Average
Balance

Interest
Income

Yield
(1)

Average
Balance

2010
Interest
Income

Yield
(1)

ASSETS
Earning assets:
Loans:
Taxable

| $(2)(3)$ | $\$$ | $2,150,201$ | $\$$ | 26,390 | $4.87 \%$ | $\$$ | $2,057,899$ | $\$$ | 26,381 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |

Tax exempt

| $(1)$ | 9,806 | 170 | 6.88 | 2,353 | 31 | 5.29 |
| :--- | :---: | :---: | :---: | :---: | :---: | :---: |
| Investments: <br> $(1)$ |  |  |  |  |  |  |
| Available <br> for sale | 457,360 | 4,254 | 3.69 | 436,211 | 5,036 | 4.58 |
| Short-term <br> investments | 12,082 | 3 | 0.10 | 30,849 | 12 | 0.15 |
| Interest <br> bearing <br> deposits | 10,849 | 15 | 0.55 | 1,938 | 7 | 1.43 |

Total

| earning |  |  |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| assets | $2,640,298$ | 30,832 | $4.63 \%$ | $2,529,250$ | 31,467 | $4.94 \%$ |

Nonearning
assets:
Cash and due from
banks 77,111 $\quad 0 \quad 49,953 \quad 0$

Premises
and

| equipment | 31,203 | 0 | 29,333 | 0 |
| :--- | :--- | :--- | :--- | :--- |
| Other <br> nonearning <br> assets | 93,763 | 0 | 90,420 | 0 |

Less
allowance for
$\begin{array}{llll}\text { loan losses } & (52,184) & 0 & (38,961)\end{array}$
Total
assets $\quad \$ 2,790,191 \quad \$ \quad 30,832 \quad \$ 2,659,995 \quad \$ \quad 31,467$
(1)Tax exempt income was converted to a fully taxable equivalent basis at a 35 percent tax rate for 2011 and 2010. The tax equivalent rate for tax exempt loans and tax exempt securities included the TEFRA adjustment applicable to nondeductible interest expenses.
(2)Loan fees, which are immaterial in relation to total taxable loan interest income for the three months ended September 30, 2011 and 2010, are included as taxable loan interest income.
(3) Nonaccrual loans are included in the average balance of taxable loans.

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## DISTRIBUTION OF ASSETS, LIABILITIES AND STOCKHOLDERS' EQUITY; INTEREST RATES AND INTEREST DIFFERENTIAL (Cont.)

(in thousands of dollars)
Three Months Ended September 30,

2011
Average
Balance
LIABILITIES
AND
STOCKHOLDERS'
EQUITY

Interest
Expense

Yield
Average 2010

Balance Interest Expense

Yield

Interest
bearing
liabilities:

| $\begin{aligned} & \begin{array}{l} \text { Savings } \\ \text { deposits } \end{array} \quad \$ \end{aligned}$ | 169,281 | \$ | 239 | 0.56\% | \$ | 127,265 | \$ | 224 | 0.70\% |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Interest bearing checking accounts | 850,343 |  | 2,769 | 1.29 |  | 706,014 |  | 2,265 | 1.27 |
| Time deposits: |  |  |  |  |  |  |  |  |  |
| In denominations under \$100,000 | 360,060 |  | 1,773 | 1.95 |  | 321,494 |  | 1,720 | 2.12 |
| In denominations over \$100,000 | 618,718 |  | 2,309 | 1.48 |  | 772,085 |  | 2,986 | 1.53 |
| Miscellaneous short-term borrowings | 147,771 |  | 159 | 0.43 |  | 126,742 |  | 149 | 0.47 |
| Long-term borrowings |  |  |  |  |  |  |  |  |  |
| and subordinated debentures | 45,967 |  | 361 | 3.12 |  | 70,969 |  | 563 | 3.15 |
| Total interest bearing |  |  |  |  |  |  |  |  |  |
| liabilities | 2,192,140 |  | 7,610 | 1.38\% |  | 2,124,569 |  | 7,907 | 1.48\% |
| Noninterest bearing liabilities |  |  |  |  |  |  |  |  |  |



## Provision for Loan Losses

Based on management's review of the adequacy of the allowance for loan losses, provisions for loan losses of $\$ 10.9$ million and $\$ 2.4$ million were recorded during the nine-month and three-month periods ended September 30, 2011, versus provisions of $\$ 17.4$ million and $\$ 6.2$ million recorded during the same periods of 2010. Factors impacting the provision included the amount and status of classified and watch list credits, the level of charge-offs, management's overall view on current credit quality and the regional and national economic conditions impacting credit quality, the amount and status of impaired loans, the amount and status of past due accruing loans ( 90 days or more), and overall loan growth as discussed in more detail below in the analysis relating to the Company's financial condition.

Noninterest Income
Noninterest income categories for the nine-month and three-month periods ended September 30, 2011 and 2010 are shown in the following table:

|  | $\begin{array}{c}\text { Nine Months Ended } \\ \text { September 30, }\end{array}$ |  |  |
| :--- | :---: | :---: | :---: |
|  |  |  |  |
| Percent |  |  |  |
| Change |  |  |  |$]$


|  | Three Months Ended <br> September 30, |  |  |  |
| :--- | ---: | :---: | :---: | :---: |
|  | 2011 | 2010 | Percent <br> Change |  |
| Wealth advisory fees | $\$$ | 866 | $\$$ | 784 |
| Investment brokerage fees | 741 | 676 | $10.5 \%$ |  |
| Service charges on deposit accounts | 2,036 | 2,205 | $(7.7)$ |  |
| Loan, insurance and service fees | 1,259 | 1,100 | 14.5 |  |
| Merchant card fee income | 253 | 263 | $(3.8)$ |  |
| Other income | 362 | 491 | $(26.3)$ |  |
| Mortgage banking income | 440 | 774 | $(43.2)$ |  |
| Net securities gains (losses) | $(1)$ | 4 | $(125.0)$ |  |
|  |  |  |  |  |

Impairment on available-for-sale securities (includes total losses
of $\$ 33$ and $\$ 85$,

| both net of $\$ 0$ recognized in other comprehensive income, |
| :--- |
| pre-tax) |
| Total noninterest income | | $(33)$ | 5,923 | $\$$ | 6,212 |
| ---: | ---: | ---: | ---: |

Noninterest income increased $\$ 249,000$ and decreased $\$ 289,000$ respectively, for the nine-month and three-month periods ended September 30, 2011 versus the same periods in 2010. Loan, insurance and service fees increased by $\$ 501,000$ and $\$ 159,000$, respectively, driven by greater debit card usage and increases in other ancillary revenue sources. In addition, investment brokerage fees increased by $\$ 401,000$ and $\$ 65,000$, respectively, driven by greater trading activity. Wealth advisory fees increased due to the increased value of certain trust assets upon which many of the fees are based and expansion of business. Noninterest income was negatively impacted by decreases of $\$ 327,000$ and $\$ 169,000$ in service charges on deposit accounts due to fewer nonsufficient fund charges of $\$ 474,000$ and $\$ 219,000$, respectively. In addition, mortgage banking income decreased by $\$ 345,000$ and $\$ 334,000$, respectively, due primarily to lower mortgage loan volumes.

## Noninterest Expense

Noninterest expense categories for the nine-month and three-month periods ended September 30, 2011 and 2010 are shown in the following table:
$\left.\begin{array}{lccc} & & \begin{array}{c}\text { Nine Months Ended } \\ \text { September 30, }\end{array} & \text { Percent } \\ \text { Change }\end{array}\right]$

Three Months Ended
September 30,

|  |  |  | Percent <br> Change |
| :--- | ---: | ---: | ---: |
| Salaries and employee benefits | 2011 | 2010 | $12.4 \%$ |
| Occupancy expense | $\$ 8,611$ | 7,659 | 4.9 |
| Equipment costs | 746 | 511 | 3.7 |
| Data processing fees and supplies | 536 | 1,004 | $(27.4)$ |
| Credit card interchange | 729 | 31 | N/A |
| Other expense | 0 | 3,707 | $(22.9)$ |
| Total noninterest expense | 2,857 | $\$ 13,629$ | $(1.1) \%$ |

The Company's noninterest expense increased $\$ 1.5$ million and decreased $\$ 150,000$, respectively, in the nine-month and three-month periods ended September 30, 2011 versus the same periods of 2010. Salaries and employee benefits increased by $\$ 2.1$ million and $\$ 952,000$, respectively, in the nine-month and three-month periods ended September 30, 2011 versus the same period of 2010. These increases were driven by staff additions, normal merit increases and higher employee health insurance expense of $\$ 230,000$ in the nine-month period and $\$ 288,000$ in the three-month period. In addition, the Company's performance based compensation expense increased by $\$ 838,000$ and $\$ 265,000$, respectively, for the nine and three month periods due to performance versus corporate objectives and increased recognition levels. Data processing fees decreased by $\$ 110,000$ and $\$ 275,000$, respectively, due to the Company's completion of the conversion to a new core processor during the second quarter of 2011. In addition, other expense
decreased by $\$ 509,000$ and $\$ 850,000$, respectively, driven by lower FDIC deposit insurance premiums as well as lower professional fees and other costs associated with borrowers who are experiencing difficulties.

## Income Tax Expense

Income tax expense increased $\$ 1.6$ million, or $16.8 \%$, for the first nine months of 2011, compared to the same period in 2010. The combined state franchise tax expense and the federal income tax expense, as a percentage of income before income tax expense, decreased to $33.0 \%$ during the first nine months of 2011 compared to $33.5 \%$ during the same period of 2010. The combined tax expense increased to $34.3 \%$ in the third quarter of 2011 , versus $32.4 \%$ during the same period of 2010. The changes were driven by fluctuations in the percentage of revenue being derived from tax-advantaged sources in the nine-month and three-month periods of 2011, compared to the same periods in 2010

## CRITICAL ACCOUNTING POLICIES

Certain of the Company's accounting policies are important to the portrayal of the Company's financial condition, since they require management to make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Some of the facts and circumstances which could affect these judgments include changes in interest rates, in the performance of the economy or in the financial condition of borrowers. Management believes that its critical accounting policies include determining the allowance for loan losses, the valuation of mortgage servicing rights and the valuation and other-than-temporary impairment of investment securities. The Company's critical accounting policies are discussed in detail in the Annual Report for the year ended December 31, 2010 (incorporated by reference as part of the Company's $10-\mathrm{K}$ filing).

## FINANCIAL CONDITION

Total assets of the Company were $\$ 2.827$ billion as of September 30, 2011, an increase of $\$ 145.5$ million, or $5.4 \%$, when compared to $\$ 2.682$ billion as of December 31, 2010.

Total cash and cash equivalents increased by $\$ 41.1$ million, or $68.4 \%$, to $\$ 101.3$ million at September 30, 2011 from $\$ 60.1$ million at December 31, 2010. The increase resulted from an increase in total deposits, primarily transaction accounts.

Total securities available-for-sale increased by $\$ 21.5$ million, or $4.8 \%$, to $\$ 464.1$ million at September 30, 2011 from $\$ 442.6$ million at December 31, 2010. The increase was a result of a number of transactions in the securities portfolio. Securities purchases totaled $\$ 147.0$ million. Offsetting this increase were securities sales totaling $\$ 73.8$ million, paydowns totaling $\$ 52.8$ million, maturities and calls of securities totaling $\$ 5.8$ million and securities amortization net of accretion was $\$ 2.2$ million. In addition, the net unrealized gain/loss of the securities portfolio increased by $\$ 9.0$ million. The increase in fair market value was primarily driven by higher market values for agency residential mortgage-backed securities as well as state and municipal securities. The investment portfolio is generally managed to limit the Company's exposure to risk by containing mostly mortgage-backed securities, other securities which are either directly or indirectly backed by the federal government or a local municipal government and collateralized mortgage obligations rated AAA by S\&P and/or Aaa by Moody's at the time of purchase. As of September 30, 2011, the Company had $\$ 35.2$ million of collateralized mortgage obligations which were not backed by the federal government, but were rated AAA by S\&P and/or Aaa by Moody's at the time of purchase.

Two of the 15 non-agency collateralized mortgage obligations are still rated AAA/Aaa as of September 30, 2011, but 13 had been downgraded since the time of purchase by S\&P, Fitch and/or Moody's, including 10 which were ranked below investment grade by one or more rating agencies. On a quarterly basis, the Company performs an analysis of the cash flows of these securities based on assumptions as to collateral defaults, prepayment speeds, expected losses and the severity of potential losses. Based upon the initial analysis, securities may be identified for further analysis computing the net present value and comparing it to the book value to determine if there is any other-than-temporary impairment to be recorded. Based on the analyses as of September 30, 2011, the Company realized an additional $\$ 33,000$ in other-than-temporary impairment on one of the 15 non-agency residential mortgage backed securities.

Real estate mortgage loans held-for-sale decreased by $\$ 162,000$, or $2.9 \%$, to $\$ 5.4$ million at September 30, 2011 from $\$ 5.6$ million at December 31, 2010. The balance of this asset category is subject to a high degree of variability depending on, among other things, recent mortgage loan rates and the timing of loan sales into the secondary market. During the nine months ended September 30, 2011, $\$ 48.3$ million in real estate mortgages were originated for sale and $\$ 48.1$ million in mortgages were sold.

Total loans, excluding real estate mortgage loans held for sale, increased by $\$ 91.0$ million to $\$ 2.181$ billion at September 30, 2011 from $\$ 2.090$ billion at December 31, 2010. The portfolio breakdowns at both September 30, 2011 reflected $85 \%$ commercial and industrial, including commercial real estate and agri-business, $13 \%$ residential real estate and home equity and $2 \%$ consumer loans compared to $84 \%$ commercial and industrial, including commercial real estate and agri-business, $14 \%$ residential real estate and home equity and $2 \%$ consumer loans at December 31, 2010.

The Company has a high percentage of commercial and commercial real estate loans, most of which are extended to small or medium-sized businesses. Commercial loans represent higher dollar loans to fewer customers and therefore higher credit risk than other types of loans. Pricing is adjusted to manage the higher credit risk associated with these types of loans. The Company also generally requires new and renewed variable rate commercial loans to have floor rates. The majority of fixed rate residential mortgage loans, which represent increased interest rate risk, are sold in the secondary market, as well as some variable rate mortgage loans. The remainder of the variable rate mortgage loans and a small number of fixed rate mortgage loans are retained.

Loans are charged against the allowance for loan losses when management believes that the principal is uncollectible. Subsequent recoveries, if any, are credited to the allowance. The allowance is an amount that management believes will be adequate to absorb probable incurred credit losses relating to specifically identified loans based on an evaluation, as well as other probable incurred losses inherent in the loan portfolio. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans and current economic conditions that may affect the borrower's ability to repay. Management also considers trends in adversely classified loans based upon a monthly review of those credits. An appropriate level of general allowance is determined after considering the following factors: application of historical loss percentages, emerging market risk, commercial loan focus and large credit concentrations, new industry lending activity and current economic conditions. Federal regulations require insured institutions to classify their own assets on a regular basis. The regulations provide for three categories of classified loans - substandard, doubtful and loss. The regulations also contain a special mention category. Special mention is defined as loans that do not currently expose an insured institution to a sufficient degree of risk to warrant classification, but do possess credit deficiencies or potential weaknesses deserving management's close attention. The Company's policy is to establish a specific allowance for loan losses for any assets classified as substandard or doubtful. If an asset or portion thereof is classified as loss, the Company's policy is to either establish specified allowances for loan losses in the amount of $100 \%$ of the portion of the asset classified loss, or charge off such amount. At September 30, 2011, on the basis of management's review of the loan portfolio, the Company had loans totaling $\$ 166.5$ million on the classified loan list versus $\$ 169.3$ million on December 31, 2010. As of September 30, 2011, the Company had $\$ 49.3$ million of assets classified special mention, $\$ 114.7$ million classified as substandard, $\$ 415,000$ classified as doubtful and $\$ 0$ classified as loss as compared to

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$\$ 48.4$ million, $\$ 120.1$ million, $\$ 0$ and $\$ 0$ at December 31, 2010. In addition, the Company has allocated $\$ 9.5$ million and $\$ 4.1$ million of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of September 30, 2011 and December 31, 2010. The Company is not committed to lend additional funds to debtors whose loans have been modified in a troubled debt restructuring.

|  | September 30, | December 31, |  |  |
| :--- | :---: | ---: | ---: | ---: |
|  | 2011 | 2010 |  |  |
| Accruing troubled debt restructured loans | $\$$ | 22,428 | $\$$ | 8,547 |
| Nonaccrual troubled debt restructured loans |  | 9,300 |  | 6,091 |
| Total troubled debt restructured loans | $\$$ | 31,728 | $\$$ | 14,638 |

Allowance estimates are developed by management taking into account actual loss experience, adjusted for current economic conditions. The Company generally has regular discussions regarding this methodology with regulatory authorities. Allowance estimates are considered a prudent measurement of the risk in the Company's loan portfolio and are applied to individual loans based on loan type. In accordance with current accounting guidance, the allowance is provided for losses that have been incurred as of the balance sheet date and is based on past events and current economic conditions, and does not include the effects of expected losses on specific loans or groups of loans that are related to future events or expected changes in economic conditions.

Net charge-offs totaled $\$ 1.6$ million in the third quarter of 2011, versus $\$ 1.5$ million during the third quarter of 2010 and $\$ 136,000$ during the second quarter of 2011.

The allowance for loan losses increased $15.7 \%$, or $\$ 7.1$ million, from $\$ 45.0$ million at December 31, 2010 to $\$ 52.1$ million at September 30, 2011. Pooled loan allocations increased $\$ 3.3$ million from $\$ 12.9$ million at December 31, 2010 to $\$ 16.2$ million at September 30, 2011, which was primarily a result of management's overall view on current credit quality. Impaired loan allocations increased $\$ 4.6$ million from $\$ 12.1$ million at December 31, 2010 to $\$ 16.7$ million at September 30, 2011 and other specifically reviewed loan allocations decreased to $\$ 15.9$ million at September 30, 2011 from $\$ 16.3$ million at December 31, 2010. This increase in impaired allocations was primarily due to increases in the allocations of existing impaired loans as well as additions to the impaired loans category. The unallocated component of the allowance for loan losses decreased $\$ 410,000$ from $\$ 3.7$ million at December 31, 2010 to $\$ 3.3$ million at September 30, 2011, based on management's assessment of economic and other qualitative factors impacting the loan portfolio, including the ongoing general economic challenges in the Company's market areas. While management has begun to see some positive trends, including stabilization in watchlist credits and a decline in non-performing loans, management anticipates a slow recovery and therefore recognized only a slight decrease in the unallocated component of the allowance for loan losses. Management believed the allowance for loan losses at September 30, 2011 was at a level commensurate with the overall risk exposure of the loan portfolio. However, if economic conditions do not continue to improve, certain borrowers may experience difficulty and the level of nonperforming loans, charge-offs and delinquencies could rise and require further increases in the provision for loan losses.

Total impaired loans increased by $\$ 9.7$ million to $\$ 57.7$ million at September 30, 2011 from $\$ 48.0$ million at December 31, 2010. A loan is impaired when full payment under the original loan terms is not expected. Impairment is evaluated in the aggregate for smaller-balance loans of similar nature such as residential mortgage, and consumer loans, and on an individual loan basis for other loans. If a loan is impaired, a portion of the allowance may be 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. The increase in the impaired loans category was primarily due to the addition of four commercial credits totaling $\$ 12.2$ million. One borrower is engaged in the health care field, two are engaged in commercial real estate development and one is a manufacturer. The increase in impaired loans was partially offset by pay-offs and charge-offs. Of the $\$ 57.7$ million in impaired loans, $\$ 32.7$ million were on nonaccrual status at September 30, 2011. The following table summarizes nonperforming assets at September 30, 2011 and December 31, 2010.


Total nonperforming assets decreased by $\$ 4.5$ million, or $11.1 \%$, to $\$ 36.2$ million during the nine-month period ended September 30, 2011. The decrease was primarily due to the aforementioned charge-offs and pay-offs as well as the sale of other real estate. Six commercial relationships represented $81.5 \%$ of total nonperforming loans. Three of the six relationships are each less than $\$ 2.0$ million. A $\$ 14.6$ million commercial relationship consisting of four loans represents the largest exposure in the nonperforming category. The borrower is engaged in real estate development. Borrower collateral, including real estate and the personal guarantees of its principals, support the credit. The Company took a $\$ 1.7$ million charge-off related to this credit in the fourth quarter of 2009, and no charge-offs were taken in 2010 or have been taken in 2011.

A $\$ 5.9$ million credit to a manufacturer tied to the housing industry represented the second largest exposure in the nonperforming category. The credit is accounted for as a troubled debt restructuring. Borrower collateral including real estate, receivables, inventory and equipment support the credit, however, there are no guarantors. The Company took a $\$ 906,000$ charge-off related to this credit in 2008, and no charge-offs were taken in 2009 or 2010, or have been taken in 2011.

A commercial relationship consisting of two loans totaling $\$ 2.7$ million represented the third largest exposure in the nonperforming category. The borrower is engaged in sales tied to the recreational vehicle industry as well as residential real estate development. Borrower collateral, including real estate and the personal guarantees of its principals, support the credit. The Company took $\$ 1.3$ million in charge-offs related to this relationship during 2008, and no charge-offs were taken in 2009 or 2010, or have been taken in 2011.

There can be no assurances that full repayment of the loans discussed above will result. Although economic conditions in the Company's markets have stabilized and in some areas improved, management does not foresee a rapid recovery as certain industries, including residential and commercial real estate development, recreational vehicle and mobile home manufacturing and other regional industries continue to experience slow growth. The Company's growth strategy has promoted diversification among industries as well as a continued focus on enforcement of a strong credit environment and an aggressive position on loan work-out situations. While the Company believes that the impact on the Company of these industry-specific issues affecting real estate development and recreational vehicle and mobile home manufacturers will be somewhat mitigated by the Company's overall growth strategy, the economic factors impacting its entire geographic footprint will continue to present challenges. Additionally, the Company's overall asset quality position can be influenced by a small number of credits due to the focus on commercial lending activity and the granularity inherent in this strategy.

Total deposits increased by $\$ 155.3$ million, or $7.1 \%$, to $\$ 2.356$ billion at September 30, 2011 from $\$ 2.201$ billion at December 31, 2010. The increase resulted from increases of $\$ 63.3$ million in money market accounts, $\$ 45.1$ million in certificates of deposit of $\$ 100,000$ and over, $\$ 41.8$ million in interest bearing transaction accounts, $\$ 36.2$ million in other certificates of deposit, $\$ 18.6$ million in demand deposits, $\$ 9.6$ million in savings accounts and $\$ 5.5$ million in public fund certificates of deposit of $\$ 100,000$ or more. Offsetting these increases were decreases of $\$ 50.4$ million in brokered deposits and $\$ 14.3$ million in CDARS certificates of deposit.

Total short-term borrowings decreased by $\$ 32.5$ million, or $18.7 \%$, to $\$ 141.6$ million at September 30, 2011 from $\$ 174.1$ million at December 31, 2010. The decrease resulted primarily from decreases of $\$ 30.0$ million in other borrowings, primarily from short-term advances from the Federal Home Loan Bank of Indianapolis. In addition, securities sold under agreements to repurchase decreased by $\$ 3.0$ million.

Total equity increased by $\$ 21.8$ million, or $8.8 \%$, to $\$ 268.8$ million at September 30, 2011 from $\$ 247.1$ million at December 31, 2010. The increase in total equity resulted from net income of $\$ 22.4$ million, plus the increase in the accumulated other comprehensive income of $\$ 5.5$ million, less dividends of $\$ 7.5$ million, plus $\$ 1.1$ million in stock compensation expense, plus $\$ 395,000$ for stock issued through options exercised (including tax benefit).

The FDIC's risk-based capital regulations require that all insured banking organizations maintain an $8.0 \%$ total risk-based capital ratio. The FDIC has also established definitions of "well capitalized" as a $5.0 \%$ Tier I leverage capital ratio, a $6.0 \%$ Tier I risk-based capital ratio and a $10.0 \%$ total risk-based capital ratio. All of the Bank's ratios continue to be above these "well capitalized" levels. The Federal Reserve also has established minimum regulatory capital requirements for bank holding companies. As of September 30, 2011, the Company had regulatory capital in excess of these minimum requirements with a Tier 1 leverage capital ratio, Tier 1 risk-based capital ratio and total risk-based capital ratio of $10.3 \%, 12.3 \%$ and $13.6 \%$, respectively.

## FORWARD-LOOKING STATEMENTS

This document (including information incorporated by reference) contains, and future oral and written statements of the Company and its management may contain, forward-looking statements, within the meaning of such term in the Private Securities Litigation Reform Act of 1995, with respect to the financial condition, results of operations, plans, objectives, future performance and business of the Company. Forward-looking statements, which may be based upon beliefs, expectations and assumptions of the Company's management and on information currently available to management, are generally identifiable by the use of words such as "believe," "expect," "anticipate," "plan," "intend," "estima "may," "will," "would," "could," "should" or other similar expressions. Additionally, all statements in this document, includins forward-looking statements, speak only as of the date they are made, and the Company undertakes no obligation to update any statement in light of new information or future events.

The Company's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. The factors, which could have a material adverse effect on the operations and future prospects of the Company and its subsidiaries are detailed in the "Risk Factors" section included under Item 1a. of Part I of our Form 10-K. In addition to the risk factors described in that section, there are other factors that may impact any public company, including ours, which could have a material adverse effect on the operations and future prospects of the Company and its subsidiaries. These additional factors include, but are not limited to, the following:

- Legislative or regulatory changes or actions, including the "Dodd-Frank Wall Street Reform and Consumer Protection Act" and the regulations required to be promulgated there under, which may adversely affect the business of the Company and its subsidiaries.
- The costs, effects and outcomes of existing or future litigation.
- Changes in accounting policies and practices, as may be adopted by state and federal regulatory agencies, the Financial Accounting Standards Board, the Securities and Exchange Commission and the Public Company Accounting Oversight Board.
- The ability of the Company to manage risks associated with the foregoing as well as anticipated.

These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements.

## ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest rate risk represents the Company's primary market risk exposure. The Company does not have a material exposure to foreign currency exchange risk, does not have any material amount of derivative financial instruments and does not maintain a trading portfolio. The board of directors annually reviews and approves the policy used to manage interest rate risk. The policy was last reviewed and approved in May 2011. The policy sets guidelines for balance sheet structure, which are designed to protect the Company from the impact that interest rate changes could have on net income, but does not necessarily indicate the effect on future net interest income. The Company, through its Asset/Liability Committee, manages interest rate risk by monitoring the computer simulated earnings impact of various rate scenarios and general market conditions. The Company then modifies its long-term risk parameters by attempting to generate the type of loans, investments, and deposits that currently fit the Company's needs, as determined by the Asset/Liability Committee. This computer simulation analysis measures the net interest income impact of various interest rate scenario changes during the next 12 months. If the change in net interest income is less than $3 \%$ of primary capital, the balance sheet structure is considered to be within acceptable risk levels. As of September 30, 2011, the Company's potential pretax exposure was within the Company's policy limit, and not significantly different from December 31, 2010.

## ITEM 4 - CONTROLS AND PROCEDURES

As required by Rules 13a-15(b) and 15d-15(b) under the Securities Exchange Act of 1934, management has evaluated, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures (as defined in Securities Exchange Act Rules 13a-15(e) and 15d-15(e)) were effective as of September 30, 2011. Disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. These disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure.

During the quarter ended September 30, 2011, there were no changes to the Company's internal control over financial reporting that have materially affected or are reasonably likely to materially affect its internal control over financial reporting.

# LAKELAND FINANCIAL CORPORATION 

FORM 10-Q
September 30, 2011
Part II - Other Information

## Item 1. Legal proceedings

There are no material pending legal proceedings to which the Company or its subsidiaries is a party other than ordinary routinelitigation incidental to their respective businesses.

Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in Item 1A of Part I of the Company's 2010 Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
The following table provides information as of September 30, 2011 with respect to shares of common stock repurchased by the Company during the quarter then ended:

Issuer Purchases of Equity Securities(a)

| Period | Total Number of Shares Purchased |  |  | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs |  | Maximum Number (or Appropriate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| July 1-31 | 4,656 | \$ | 23.46 |  | 0 | \$ | 0 |
| August 1-31 | 473 |  | 23.03 |  | 0 |  | 0 |
| $\begin{aligned} & \text { September } \\ & 1-30 \end{aligned}$ | 0 |  | 0 |  | 0 |  | 0 |
| Total | 5,129 | \$ | 23.42 |  | 0 | \$ | 0 |

(a) The shares purchased during the periods were credited to the deferred share accounts of non-employee directors under the Company's directors' deferred compensation plan. These shares were purchased in the ordinary course of business and consistent with past practice.

Item 3. Defaults Upon Senior Securities
None

Item 4. Removed and Reserved

Item 5. Other Information
None

Item 6. Exhibits
31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a)
31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a)
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.

# LAKELAND FINANCIAL CORPORATION 

FORM 10-Q
September 30, 2011
Part II - Other Information
Signatures

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

## LAKELAND FINANCIAL CORPORATION <br> (Registrant)

Date: November 9, 2011 /s/ Michael L. Kubacki
Michael L. Kubacki - Chief Executive Officer

Date: November 9, 2011 /s/ David M. Findlay David M. Findlay -President and Chief Financial Officer

Date: November 9, 2011 /s/ Teresa A. Bartman
Teresa A. Bartman - Senior Vice President-
Finance and Controller

