

FIRST FARMERS & MERCHANTS CORP  
Form 10-Q  
November 09, 2009  
[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark one)

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

For the quarterly period ended September 30, 2009

or

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

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

Commission File Numbers: 000-10972

**First Farmers and Merchants Corporation**

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(Exact name of registrant as specified in its charter)

|  |                                      |
|--|--------------------------------------|
| <b>Tennessee</b>   | <b>62-1148660</b>                    |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| <b>816 South Garden Street</b>                                 |                                      |
| <b>Columbia, Tennessee</b>                                     | <b>38402-1148</b>                    |
| (Address of principal executive offices)                       | (Zip Code)                           |

**931-388-3145**

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer   
(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 Act).  Yes  No

As of November 5, 2009, the registrant had outstanding 5,506,993 shares of common stock.



Table of Contents

**PART I - FINANCIAL INFORMATION**

**Item 1. Financial Statements.**

The following unaudited consolidated financial statements of the Registrant and its subsidiaries are included in this Report:

Consolidated balance sheets - September 30, 2009 and December 31, 2008.

Consolidated statements of income - For the three months and nine months ended September 30, 2009 and September 30, 2008.

Consolidated statements of cash flows - For the nine months ended September 30, 2009 and September 30, 2008.

Selected notes to consolidated financial statements.

Table of Contents**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS**

| <b>(Dollars in Thousands, Except Per Share Data)</b>   | <b>September 30,<br/>2009<br/>(Unaudited)</b> | <b>December 31,<br/>2008<br/>(1)</b> |
|--|---|--------------------------------------|
| <b>ASSETS</b>  |   |                                      |
| Cash and due from banks  | \$ 14,324                                     | \$ 22,656                            |
| Interest-bearing due from banks  | 6,773   | 4,680                                |
| Federal funds sold   | 10,925  | 4,200                                |
| Total cash and cash equivalents  | 32,022  | 31,536                               |
| Securities   |   |                                      |
| Available-for-sale (amortized cost \$201,998 and \$171,891, respectively)  | 204,241                                       | 174,493                              |
| Held-to-maturity (fair market value \$51,857 and \$59,558, respectively)   | 49,903  | 59,427                               |
| Total securities   | 254,144                                       | 233,920                              |
| Loans, net of deferred fees  | 588,553                                       | 595,519                              |
| Allowance for loan losses  | (8,548)                                       | (8,625)                              |
| Net loans  | 580,005                                       | 586,894                              |
| Bank premises and equipment, at cost less allowance for depreciation   | 20,695  | 17,669                               |
| Core deposit and other intangibles   | 9,130   | 9,186                                |
| Other assets   | 35,478  | 31,932                               |
| <b>TOTAL ASSETS</b>  | <b>\$ 931,474</b>                             | <b>\$ 911,137</b>                    |
| <b>LIABILITIES</b>   |   |                                      |
| Deposits   |   |                                      |
| Noninterest-bearing  | \$ 108,777                                    | \$ 118,111                           |
| Interest-bearing (including certificates of deposits over \$100: 2009 - \$100,092; 2008 - \$107,607)   | 659,788                                       | 626,740                              |
| Total deposits   | 768,565                                       | 744,851                              |
| Federal funds purchased and securities sold under agreements to repurchase   | 6,386   | 2,645                                |
| Dividends payable  |   | 2,009                                |
| Short-term borrowings  | 432   | 294                                  |
| Accounts payable and accrued liabilities   | 14,650  | 12,985                               |
| Federal Home Loan Bank advances  | 34,177  | 41,177                               |
| <b>TOTAL LIABILITIES</b>   | <b>824,210</b>                                | <b>803,961</b>                       |
| <b>SHAREHOLDERS EQUITY</b>   |   |                                      |
| Common stock - \$10 par value per share, 8,000,000 shares authorized; 5,506,993 and 5,580,000 shares issued and outstanding as of September 30, 2009 and December 31, 2008, respectively | 55,070  | 55,800                               |
| Retained earnings  | 50,720  | 49,776                               |
| Accumulated other comprehensive income   | 1,379   | 1,600                                |
| <b>TOTAL FIRST FARMERS CORPORATION SHAREHOLDERS EQUITY</b>   | <b>107,169</b>                                | <b>107,176</b>                       |
| Non-controlling interest   | 95  | 95                                   |
| <b>TOTAL SHAREHOLDERS EQUITY</b>   | <b>107,264</b>                                | <b>107,271</b>                       |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>   | <b>\$ 931,474</b>                             | <b>\$ 911,137</b>                    |

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(1) Derived from audited financial statements.

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



Table of Contents**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME**

| (Dollars in Thousands Except Per Share Data)<br>(Unaudited)              | Three Months Ended<br>September 30, |                 | Nine Month Ended<br>September 30, |                 |
|--|-------------------------------------|-----------------|-----------------------------------|-----------------|
|  | 2009                                | 2008            | 2009                              | 2008            |
| <b>INTEREST AND DIVIDEND INCOME</b>                                      |                                     |                 |                                   |                 |
| Interest and fees on loans   | \$ 8,022                            | \$ 8,202        | \$ 23,799                         | \$ 24,680       |
| Income on investment securities  |                                     |                 |                                   |                 |
| Taxable interest   | 1,205                               | 1,690           | 3,650                             | 4,991           |
| Exempt from federal income tax   | 936                                 | 924             | 2,855                             | 2,882           |
| Dividends  | 51                                  | 4               | 157                               | 110             |
|  | 2,192                               | 2,618           | 6,663                             | 7,983           |
| Other interest income  | 10                                  | 106             | 55                                | 234             |
| <b>TOTAL INTEREST INCOME</b>   | <b>10,224</b>                       | <b>10,926</b>   | <b>30,516</b>                     | <b>32,897</b>   |
| <b>INTEREST EXPENSE</b>  |                                     |                 |                                   |                 |
| Interest on deposits   | 1,870                               | 2,749           | 6,196                             | 9,014           |
| Interest on other borrowings   | 278                                 | 279             | 881                               | 523             |
| <b>TOTAL INTEREST EXPENSE</b>  | <b>2,148</b>                        | <b>3,028</b>    | <b>7,077</b>                      | <b>9,537</b>    |
| <b>NET INTEREST INCOME</b>   | <b>8,076</b>                        | <b>7,898</b>    | <b>23,439</b>                     | <b>23,360</b>   |
| PROVISION FOR POSSIBLE LOAN AND LEASE<br>LOSSES                          | 405                                 | 50              | 1,830                             | 50              |
| <b>NET INTEREST INCOME AFTER PROVISION FOR<br/>LOAN AND LEASE LOSSES</b> | <b>7,671</b>                        | <b>7,848</b>    | <b>21,609</b>                     | <b>23,310</b>   |
| <b>NONINTEREST INCOME</b>  |                                     |                 |                                   |                 |
| Trust department income  | 475                                 | 625             | 1,469                             | 1,882           |
| Service fees on deposit accounts   | 1,854                               | 2,002           | 5,408                             | 5,839           |
| Other fees and commissions   | 106                                 | 91              | 346                               | 328             |
| Other operating income   | 225                                 | 416             | 592                               | 828             |
| Securities gains   |                                     | 177             | 2,482                             | 1,305           |
| <b>TOTAL NONINTEREST INCOME</b>  | <b>2,660</b>                        | <b>3,311</b>    | <b>10,298</b>                     | <b>10,182</b>   |
| <b>NONINTEREST EXPENSE</b>   |                                     |                 |                                   |                 |
| Salaries and employee benefits   | 4,269                               | 4,279           | 12,583                            | 12,858          |
| Net occupancy expense  | 728                                 | 670             | 1,997                             | 1,910           |
| Furniture and equipment expense  | 285                                 | 249             | 833                               | 752             |
| Other operating expenses   | 3,273                               | 2,674           | 9,359                             | 8,174           |
| <b>TOTAL NONINTEREST EXPENSES</b>  | <b>8,555</b>                        | <b>7,872</b>    | <b>24,772</b>                     | <b>23,694</b>   |
| <b>INCOME BEFORE PROVISION FOR INCOME TAXES</b>                          | <b>1,776</b>                        | <b>3,287</b>    | <b>7,135</b>                      | <b>9,798</b>    |
| PROVISION FOR INCOME TAXES   | 112                                 | 450             | 1,038                             | 1,696           |
| <b>NET INCOME</b>  | <b>\$ 1,664</b>                     | <b>\$ 2,837</b> | <b>\$ 6,097</b>                   | <b>\$ 8,102</b> |
| <b>BASIC EARNINGS PER SHARE</b>  |                                     |                 |                                   |                 |
| Weighted Average Shares Outstanding                                      | 5,522,498                           | 5,619,027       | 5,547,930                         | 5,662,428       |
|  | \$ 0.30                             | \$ 0.50         | \$ 1.10                           | \$ 1.43         |

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





Table of Contents**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF CASH FLOWS**

| (Dollars in Thousands)<br>(Unaudited)   | Nine Months Ended September<br>30, |           |
|---|------------------------------------|-----------|
|   | 2009                               | 2008      |
| <b>OPERATING ACTIVITIES</b>   |                                    |           |
| Net income  | \$ 6,097                           | \$ 8,102  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                    |           |
| Deficiency of provision for possible loan losses over net charge-offs             | (77)                               | (25)      |
| Provision for depreciation and amortization of premises and equipment             | 911                                | 763       |
| Securities gains  | (2,482)                            | (1,305)   |
| Loss from disposition of fixed assets   | 129                                |           |
| (Gain) loss from disposition of other real estate                                 | (8)                                | 300       |
| Amortization of deposit base intangibles  | 56                                 | 113       |
| Amortization of investment security premiums, net of accretion of discounts       | 990                                | 223       |
| Increase in cash surrender value of life insurance contracts                      | (177)                              | (1,141)   |
| (Increase) decrease in Deferred income taxes                                      | 15                                 | (304)     |
| Interest receivable   | (542)                              | 568       |
| Other assets  | (2,115)                            | 446       |
| Increase (decrease) in  |                                    |           |
| Interest payable  | (239)                              | (1,035)   |
| Other liabilities   | 1,999                              | 2,767     |
| Total adjustments   | (1,540)                            | 1,370     |
| Net cash provided by operating activities   | 4,557                              | 9,472     |
| <b>INVESTING ACTIVITIES</b>   |                                    |           |
| Proceeds from maturities, calls, and sales of available-for-sale securities       | 162,801                            | 109,290   |
| Proceeds from maturities and calls of held-to-maturity securities                 | 9,524                              | 11,991    |
| Purchases of investment securities Available-for-sale                             | (191,416)                          | (112,755) |
| Net increase (decrease) in loans  | 6,966                              | (57,627)  |
| Proceeds from sale of other real estate   | 37                                 | 406       |
| Purchase of life insurance premium  | (833)                              | (696)     |
| Purchases of premises and equipment   | (4,066)                            | (2,523)   |
| Net cash used in investing activities   | (16,987)                           | (51,914)  |
| <b>FINANCING ACTIVITIES</b>   |                                    |           |
| Net increase in noninterest-bearing and interest-bearing deposits                 | 23,715                             | 20,271    |
| Net increase (decrease) in short term borrowings                                  | 3,878                              | (855)     |
| Proceeds (payments) from FHLB borrowings  | (7,000)                            | 41,177    |
| Repurchase of Common Stock  | (3,650)                            | (3,750)   |
| Cash dividends  | (4,027)                            | (3,988)   |
| Net cash provided by financing activities   | 12,916                             | 52,855    |
| Increase in cash and cash equivalents   | 486                                | 10,413    |
| Cash and cash equivalents at beginning of period                                  | 31,536                             | 35,873    |
| Cash and cash equivalents at end of period  | \$ 32,022                          | \$ 46,286 |

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

Table of Contents

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 OTHER INFORMATION**

The interim unaudited consolidated financial statements of First Farmers and Merchants Corporation (the Corporation) presented in this report have been prepared on a consistent basis and in accordance with the instructions to Form 10-Q and do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. These adjustments were of a normal, recurring nature and consistent with generally accepted accounting principles. For further information, refer to the consolidated financial statements and notes included in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2008. The Corporation has evaluated subsequent events for potential recognition and/or disclosure through November 6, 2009, the date the consolidated financial statement included in this Quarterly Report on Form 10-Q were issued. Certain reclassifications have been made to prior year amounts to maintain consistency with the current year with no impact on net income and an increase of \$95,000 to total shareholders' equity, in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 810, Consolidation.

**NOTE 2 STOCK REPURCHASE**

During the third quarter of 2009, the Corporation repurchased, from third-party sellers, 23,007 shares of the Corporation's common stock at a previously negotiated price of \$50 per share for an aggregate purchase price of \$1.15 million.

**NOTE 3 ACCOUNTING STANDARDS CODIFICATION**

The FASB ASC became effective on July 1, 2009. At that date, the ASC became FASB's officially recognized source of authoritative U.S. generally accepted accounting principles (GAAP) applicable to all public and non-public non-governmental entities, superseding existing FASB, American Institute of Certified Public Accountants (AICPA), Emerging Issues Task Force (EITF) and related literature. Rules and interpretive releases of the SEC under the authority of federal securities laws are also sources of authoritative GAAP for Securities and Exchange Commission (SEC) registrants. All other accounting literature is considered non-authoritative. The switch to the ASC affects the way companies refer to GAAP in financial statements and accounting policies. Citing particular content in the ASC involves specifying the unique numeric path to the content through the Topic, Subtopic, Section and Paragraph structure.

**NOTE 4 FAIR VALUE MEASUREMENT**

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. In estimating fair value, the Corporation utilizes valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. Such valuation techniques are consistently applied. Inputs to valuation techniques include the assumptions that market participants would use in pricing an asset or liability. FASB ASC Topic 820, Fair Value Measurements and Disclosures, establishes a fair value hierarchy for valuation

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inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

- *Level 1 Inputs* - Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.
  
- *Level 2 Inputs* - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit

Table of Contents

risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

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

A description of the valuation methodologies used for instruments measured at fair value as well as the general classification of such instruments pursuant to the valuation hierarchy is set forth below. These valuation methodologies were applied to all of the financial assets and financial liabilities of the Corporation and its sole wholly-owned subsidiary, First Farmers and Merchants Bank (the *Bank*), carried at fair value effective September 30, 2009. If such quoted market prices are not available, fair value is based on internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the Corporation's creditworthiness among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Corporation's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Furthermore, the reported fair value amounts have not been comprehensively revalued since the presentation dates and, therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein.

Financial assets and financial liabilities measured at fair value on a recurring basis include the following:

*Federal funds sold* At September 30, 2009, all the Bank's federal funds sold were settled overnight. As a result, the fair value of the federal funds is their carrying amount and therefore this asset is classified as Level 1 of the valuation hierarchy.

*Securities available for sale* Securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, the Corporation obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

*Other assets* Included in other assets are certain assets carried at fair value, including the cash value of Bank-owned life insurance policies. The carrying amount of these assets is based on information received from the insurance carriers indicating the financial performance of the policies and the amount the Bank would receive should the policies be surrendered. The Bank reflects these investments within Level 2 of the valuation hierarchy.

*Securities sold under repurchase agreements, federal funds purchased and other borrowings* At September 30, 2009, all of the Bank's securities sold under repurchase agreements, federal funds purchased and other borrowings (e.g., overnight borrowings from the Federal Home Loan Bank of Cincinnati (the *FHLB*)) were settled on a short-term basis, usually daily. As a result, the fair value of the instruments approximates their carrying amount and such liabilities are classified as Level 2 within the valuation hierarchy.

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*Other liabilities* The Bank has certain liabilities carried at fair value. These include future obligations pursuant to a supplemental retirement plan and proceeds of split-dollar life insurance policies. For these obligations, the Bank discounts the anticipated future cash flows using current interest rates. The liabilities are classified as Level 2 within the valuation hierarchy.

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### Table of Contents

The following table summarizes financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2009, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

#### **Assets and liabilities measured at fair value on a recurring basis as of September 30, 2009**

|   | Level 1          | Level 2           | Level 3   | Total             |
|---|------------------|-------------------|-----------|-------------------|
| Federal funds sold                          | \$ 10,925        | \$                | \$        | \$ 10,925         |
| Available-for-sale securities               |                  | 204,241           |           | 204,241           |
| Other assets                                |                  | 21,157            |           | 21,157            |
| <b>Total assets at fair value</b>           | <b>\$ 10,925</b> | <b>\$ 225,398</b> | <b>\$</b> | <b>\$ 236,323</b> |
| Securities sold under repurchase agreements | \$               | \$ 6,386          | \$        | \$ 6,386          |
| Other liabilities                           |                  | 5,213             |           | 5,213             |
| <b>Total liabilities at fair value</b>      | <b>\$</b>        | <b>\$ 11,599</b>  | <b>\$</b> | <b>\$ 11,599</b>  |

Certain financial assets and liabilities are measured at fair value on a nonrecurring basis. These instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The only financial asset or liability measured at fair value on a non-recurring basis for the third quarter of 2009 was impaired loans.

*Impaired loans* Certain impaired loans are reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 2 inputs based on observable market data or Level 3 inputs based on customized discounting criteria. During the third quarter of 2009, certain impaired loans were re-measured and reported at fair value through a specific valuation allowance allocation of the allowance for possible loan losses based on the fair value of the underlying collateral. Impaired loans with a carrying value of \$17.5 million were reduced by specific valuation allowance allocations totaling \$1.2 million to a total reported fair value of \$16.3 million based on collateral valuations utilizing Level 3 valuation inputs.

FASB ASC Topic 825, *Financial Instruments*, requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis. A detailed description of the valuation methodologies used in estimating the fair value of financial instruments is set forth in Note 12 to the consolidated financial statements incorporated by reference into the Corporation's Annual Report on Form 10-K for the year ended December 31, 2008.

The estimated fair values of financial instruments were as follows:

|                                    | September 30, 2009 |            | December 31, 2008 |            |
|------------------------------------|--------------------|------------|-------------------|------------|
|                                    | Carrying Amount    | Fair Value | Carrying Amount   | Fair Value |
| <b>Financial assets</b>            |                    |            |                   |            |
| Cash and due from banks            | \$ 14,324          | \$ 14,324  | \$ 22,656         | \$ 22,656  |
| Interest-bearing deposits in banks | 6,773              | 6,773      | 4,680             | 4,680      |
| Federal funds sold                 | 10,925             | 10,925     | 4,200             | 4,200      |
| Securities available-for-sale      | 204,241            | 204,241    | 174,493           | 174,493    |
| Securities held-to-maturity        | 49,903             | 51,857     | 59,427            | 59,558     |

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|   |                |                |         |         |
|---|----------------|----------------|---------|---------|
| Loans, net  | <b>580,005</b> | <b>590,220</b> | 586,894 | 591,471 |
| Accrued interest receivable   | <b>4,873</b>   | <b>4,873</b>   | 4,331   | 4,331   |
| <b>Financial liabilities</b>  |                |                |         |         |
| Deposits  | <b>768,565</b> | <b>770,004</b> | 744,851 | 746,308 |
| Federal funds purchased and securities sold<br>under agreements to repurchase | <b>6,386</b>   | <b>6,386</b>   | 2,645   | 2,645   |
| Other short term liabilities  | <b>432</b>     | <b>432</b>     | 294     | 294     |
| Accrued interest payable  | <b>1,455</b>   | <b>1,455</b>   | 1,693   | 1,693   |
| Off-balance sheet credit related instruments:                                 |                |                |         |         |
| Commitments to extend credit  |                | <b>110</b>     |         | 108     |
| Stand-by letters of credit  |                | <b>9</b>       |         | 11      |

Table of Contents

**NOTE 5 FEDERAL HOME LOAN BANK CREDIT LINE**

The Bank has a Blanket Agreement for Advances and Security Agreement (the Blanket Agreement ) with the FHLB dated March 31, 2008. Advances made to the Bank under the Blanket Agreement are collateralized by FHLB stock and unidentified qualifying residential mortgage loans totaling 150% of the outstanding amount borrowed. The Bank made an annual principal payment of \$7.0 million to the FHLB under the Blanket Agreement on March 31, 2009.

Scheduled annual principal maturities of borrowings under this credit line as of September 30, 2009, are as follows:

|       |               |
|-------|---------------|
| 2010  | 10,077,052    |
| 2011  | 7,000,000     |
| 2012  | 7,000,000     |
| 2013  | 10,100,000    |
| Total | \$ 34,177,052 |

Stock held in the FHLB totaling \$3.0 million at September 30, 2009 is carried at cost. The stock is restricted and can only be sold back to the FHLB at par.

The Bank also has a Cash Management Advance Line of Credit Agreement (the CMA ) dated March 31, 2009, with the FHLB. The CMA is a component of the Blanket Agreement. The purpose of the CMA is to assist with short-term liquidity management. Under the terms of the CMA, the Bank may borrow a maximum of \$40.0 million, selecting a variable rate of interest for up to 90 days or a fixed rate for a maximum of 30 days. There were no borrowings outstanding under the CMA as of September 30, 2009.

**NOTE 6 SECURITIES**

Securities with an amortized cost of \$157.6 million at September 30, 2009, (fair value of \$159.5 million at September 30, 2009), were pledged to secure deposits and for other purposes as required or permitted by law. The fair value is established by an independent pricing service as of the approximate dates indicated. The differences between the amortized cost and fair value reflect current interest rates and represent the potential gain (or loss) if the portfolio had been liquidated on that date. Security gains (or losses) are realized only in the event of dispositions prior to maturity.

A summary of the amortized cost and estimated fair value of securities is presented below:

| Amortized<br>Cost | Gross Unrealized<br>Gains | Losses | Fair<br>Value |
|-------------------|---------------------------|--------|---------------|
|-------------------|---------------------------|--------|---------------|



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**September 30, 2009**

Available-for-sale securities

|                                   |    |         |    |       |    |     |    |         |
|-----------------------------------|----|---------|----|-------|----|-----|----|---------|
| U.S. Government agencies          | \$ | 85,404  | \$ | 99    | \$ | 706 | \$ | 84,797  |
| Mortgage backed securities        |    | 55,661  |    | 553   |    | 126 |    | 56,088  |
| States and political subdivisions |    | 45,554  |    | 1,947 |    |     |    | 47,501  |
| Other securities                  |    | 15,379  |    | 477   |    | 1   |    | 15,855  |
|                                   | \$ | 201,998 | \$ | 3,076 | \$ | 833 | \$ | 204,241 |

Held-to-maturity securities

|                                   |    |        |    |       |    |    |    |        |
|-----------------------------------|----|--------|----|-------|----|----|----|--------|
| U.S. Government agencies          | \$ | 3,027  | \$ | 35    | \$ |    | \$ | 3,062  |
| States and political subdivisions |    | 46,876 |    | 1,935 |    | 16 |    | 48,795 |
|                                   | \$ | 49,903 | \$ | 1,970 | \$ | 16 | \$ | 51,857 |

At September 30, 2009, the Bank did not hold investment securities of any single issuer, other than obligations of the U.S. Treasury and other U.S. government agencies, whose aggregate book value exceeded 10% of shareholders' equity.

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### Table of Contents

Proceeds from the maturity, call or sale of available-for-sale securities were \$162.8 million during the nine months ended September 30, 2009. Proceeds from the maturity or call of held-to-maturity securities were \$9.0 million during the nine months ended September 30, 2009.

The fair values of all securities at September 30, 2009 either equaled or exceeded the cost of those securities, or the decline in fair value is considered temporary. The information in the table below classifies the investments with unrealized losses at September 30, 2009 according to the term of the unrealized loss. Management evaluates securities for other-than-temporary impairment periodically, or more frequently when circumstances require an evaluation. An impairment judgment is based on (i) the amount of time and loss, (ii) the financial condition of the issuer and (iii) management's intent and ability to hold the investment long enough for any anticipated recovery in value.

Management has the ability and intent to hold the securities classified as held-to-maturity until they mature. Furthermore, as of September 30, 2009, management also had the ability to hold the securities classified as available for sale for a period of time sufficient for a recovery of cost. The unrealized losses are largely as a result of increases in market interest rates over the yield available at the time the underlying securities were purchased. The fair value is expected to recover as the bonds approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities are impaired because of reasons of credit quality. Accordingly, as of September 30, 2009, management believes the impairments detailed in the table below are temporary and no impairment loss has been realized in the Corporation's consolidated income statement.

The following table presents the Bank's investments with unrealized losses at September 30, 2009 according to the term of the unrealized loss:

| September 30, 2009<br>Type of Security | Less than 12 months |                   | 12 months or Greater |                   | Total      |                   |
|--|---------------------|-------------------|----------------------|-------------------|------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value           | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Government agencies               | \$ 61,326           | \$ 832            | \$                   | \$                | \$ 61,326  | \$ 832            |
| States and political subdivisions      | 412                 | 3                 | 436                  | 14                | 848        | 17                |
|  | \$ 61,738           | \$ 835            | \$ 436               | \$ 14             | \$ 62,174  | \$ 849            |

At September 30, 2009, one of 206 state and political subdivision securities had recorded unrealized losses for a period longer than 12 months. Because these securities, along with the corporate securities, declined in value when interest rates began to rise, and not because of the credit quality of the issuer, and because management had both the intent and ability to hold the investments, the securities were not considered other-than-temporarily impaired.

The table below shows the amortized cost and fair value of investment securities at September 30, 2009 by contractual or legal maturity. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations. Mortgage-backed securities and equity securities are shown separately since they are not due at a single maturity date.

| September 30, 2009      | Held to Maturity |                      | Available for Sale |                      |
|-------------------------|------------------|----------------------|--------------------|----------------------|
|                         | Amortized Cost   | Estimated Fair Value | Amortized Cost     | Estimated Fair Value |
| Due in one year or less | \$ 7,082         | \$ 7,164             | \$ 1,270           | 1,296                |

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|  |                  |                  |                   |                   |
|--|------------------|------------------|-------------------|-------------------|
| Due after one year through five years  | 9,892            | 10,210           | 33,389            | 34,006            |
| Due after five years through ten years | 11,843           | 12,377           | 70,026            | 69,486            |
| Due after ten years                    | 21,086           | 22,106           | 37,755            | 39,467            |
| Mortgage-backed securities             |                  |                  | 55,661            | 56,089            |
| Equity Securities                      |                  |                  | 3,897             | 3,897             |
| <b>Total</b>                           | <b>\$ 49,903</b> | <b>\$ 51,857</b> | <b>\$ 201,998</b> | <b>\$ 204,241</b> |

Table of Contents

**NOTE 7 RECENT ACCOUNTING PRONOUNCEMENTS**

As discussed in Note 3 Accounting Standards Codification, on July 1, 2009, the ASC became FASB's officially recognized source of authoritative GAAP applicable to all public and non-public non-governmental entities, superseding existing FASB, AICPA, EITF and related literature. Rules and interpretive releases of the SEC under the authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. All other accounting literature is considered non-authoritative. The switch to the ASC affects the away companies refer to U.S. GAAP in financial statements and accounting policies. Citing particular content in the ASC involves specifying the unique numeric path to the content through the Topic, Subtopic, Section and Paragraph structure.

FASB ASC Topic 320, Investments - Debt and Equity Securities. New authoritative accounting guidance under ASC Topic 320, Investments - Debt and Equity Securities, (i) changes existing guidance for determining whether an impairment is other than temporary to debt securities and (ii) replaces the existing requirement that the entity's management assert it has both the intent and ability to hold an impaired security until recovery with a requirement that management assert: (a) it does not have the intent to sell the security; and (b) it is more likely than not that it will not have to sell the security before recovery of its cost basis. Under ASC Topic 320, declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of the impairment related to other factors is recognized in other comprehensive income. The Corporation adopted the provisions of the new authoritative accounting guidance under ASC Topic 320 during the third quarter of 2009. Adoption of the new guidance did not significantly impact the Corporation's financial statements.

FASB ASC Topic 715, Compensation - Retirement Benefits. New authoritative accounting guidance under ASC Topic 715, Compensation Retirement Benefits, provides guidance related to an employer's disclosures about plan assets of defined benefit pension or other post-retirement benefit plans. Under ASC Topic 715, disclosures should provide users of financial statements with an understanding of how investment allocation decisions are made, the factors that are pertinent to an understanding of investment policies and strategies, the major categories of plan assets, the inputs and valuation techniques used to measure the fair value of plan assets, the effect of fair value measurements using significant unobservable inputs on changes in plan assets for the period and significant concentrations of risk within plan assets. The disclosures required by ASC Topic 715 will be included in the Corporation's financial statements beginning with the financial statements for the year ending December 31, 2009.

FASB ASC Topic 805, Business Combinations. On January 1, 2009, new authoritative accounting guidance under ASC Topic 805, Business Combinations, became applicable to the Corporation's accounting for business combinations closing on or after January 1, 2009. ASC Topic 805 applies to all transactions and other events in which one entity obtains control over one or more other businesses. ASC Topic 805 requires an acquirer, upon initially obtaining control of another entity, to recognize the assets, liabilities and any non-controlling interest in the acquiree at fair value as of the acquisition date. Contingent consideration is required to be recognized and measured at fair value on the date of acquisition rather than at a later date when the amount of that consideration may be determinable beyond a reasonable doubt. This fair value approach replaces the cost-allocation process required under previous accounting guidance whereby the cost of an acquisition was allocated to the individual assets acquired and liabilities assumed based on their estimated fair value. ASC Topic 805 requires acquirers to expense acquisition-related costs as incurred rather than allocating such costs to the assets acquired and liabilities assumed, as was previously the case under prior accounting guidance. Assets acquired and liabilities assumed in a business combination that arise from contingencies are to be recognized at fair value if fair value can be reasonably estimated. If fair value of such an asset or liability cannot be reasonably estimated, the asset or liability would generally be recognized in accordance with ASC Topic 450, Contingencies. Under ASC Topic 805, the requirements of ASC Topic 420, Exit or Disposal Cost Obligations, would have to be met in order to accrue for a restructuring plan in purchase accounting. Pre-acquisition contingencies are to be recognized at fair value, unless it is a non-contractual contingency that is not likely to materialize, in which case, nothing should be recognized in purchase accounting and, instead, that contingency would be subject to the probable and estimable recognition criteria of ASC Topic 450, Contingencies.

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FASB ASC Topic 810, Consolidation. New authoritative accounting guidance under ASC Topic 810, Consolidation, amended prior guidance to establish accounting and reporting standards for the non-controlling interest

Table of Contents

in a subsidiary and for the deconsolidation of a subsidiary. Under ASC Topic 810, a non-controlling interest in a subsidiary, which is sometimes referred to as minority interest, is an ownership interest in the consolidated entity that should be reported as a component of equity in the consolidated financial statements. Among other requirements, ASC Topic 810 requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the non-controlling interest. It also requires disclosure on the face of the consolidated income statement, of the amounts of consolidated net income attributable to the parent and to the non-controlling interest. The new authoritative accounting guidance under ASC Topic 810 became effective for the Corporation on January 1, 2009 and did not have a significant impact on the Corporation's financial statements. Further new authoritative accounting guidance under ASC Topic 810 amends prior guidance to change how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. The new authoritative accounting guidance requires additional disclosures about the reporting entity's involvement with variable-interest entities and any significant changes in risk exposure due to that involvement as well as its affect on the entity's financial statements. The new authoritative accounting guidance under ASC Topic 810 will be effective January 1, 2010 and is not expected to have a significant impact on the Corporation's financial statements.

FASB ASC Topic 820, Fair Value Measurements and Disclosures. New authoritative accounting guidance under ASC Topic 820, Fair Value Measurements and Disclosures, affirms that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction, and clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active. ASC Topic 820 requires an entity to base its conclusion about whether a transaction was not orderly on the weight of the evidence. The new accounting guidance amended prior guidance to expand certain disclosure requirements. The Corporation adopted the new authoritative accounting guidance under ASC Topic 820 during the first quarter of 2009. Adoption of the new guidance did not significantly impact the Corporation's financial statements. Further new authoritative accounting guidance (Accounting Standards Update No. 2009-5) under ASC Topic 820 provides guidance for measuring the fair value of a liability in circumstances in which a quoted price in an active market for the identical liability is not available. In such instances, a reporting entity is required to measure fair value utilizing a valuation technique that uses (i) the quoted price of the identical liability when traded as an asset, (ii) quoted prices for similar liabilities or similar liabilities when traded as assets, or (iii) another valuation technique that is consistent with the existing principles of ASC Topic 820, such as an income approach or market approach. The new authoritative accounting guidance also clarifies that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. The forgoing new authoritative accounting guidance under ASC Topic 820 will be effective for the Corporation's financial statements beginning October 1, 2009 and is not expected to have a significant impact on the Corporation's financial statements.

FASB ASC Topic 825 Financial Instruments. New authoritative accounting guidance under ASC Topic 825, Financial Instruments, requires an entity to provide disclosures about the fair value of financial instruments in interim financial information and amends prior guidance to require those disclosures in summarized financial information at interim reporting periods.

FASB ASC Topic 855, Subsequent Events. New authoritative accounting guidance under ASC Topic 855, Subsequent Events, establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued.

FASB ASC Topic 855 defines (i) the period after the balance sheet date during which a reporting entity's management should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, (ii) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and (iii) the disclosures an entity should make about events or transactions that occurred after the balance sheet date. The new authoritative accounting guidance under ASC Topic 855 became effective for the Corporation's financial statements for periods ending after June 15, 2009 and did not have a significant impact on the Corporation's financial statements.



Table of Contents

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

**FORWARD-LOOKING STATEMENTS**

Certain statements contained in this report may not be based on historical facts and are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). These forward-looking statements may be identified by, among other things, the use of forward-looking terminology such as could, would, expects, believes, may or will, or future or conditional verb tenses, and variations or negatives of such terms. These forward-looking statements include, without limitation, those relating to the Corporation's valuation methodologies, the effect of recent accounting pronouncements, loan portfolio concentrations, repayment of loans by borrowers, satisfaction of capital adequacy requirements, the repayment of FHLB borrowings, adequacy of capital resources and traditional sources of cash generated from operating activities to meet liquidity needs and the realization of deferred income tax assets. We caution you not to place undue reliance on such forward-looking statements in this report because results could differ materially from those anticipated due to a variety of factors. These factors include, but are not limited to, changes in economic conditions; fluctuations in prevailing interest rates and the effectiveness of our risk monitoring systems; the ability of our borrowers to repay loans; adverse changes in our special mention credits; our ability to meet regulatory capital adequacy requirements; our ability to meet liquidity needs from operating activities; the accuracy of assumptions in our rate risk analysis; our ability to recognize deferred tax assets; our ability to maintain credit quality; laws and regulations affecting financial institutions in general; our ability to control factors influencing net interest income; the geographic concentration of our assets; our ability to maintain sufficient asset quality and cost controls; and other factors generally understood to affect the financial results of financial services companies and other factors detailed from time to time in our filings with the SEC. We undertake no obligation to update these forward-looking statements to reflect events or circumstances that occur after the date of this report.

**EXECUTIVE OVERVIEW**

At September 30, 2009, the consolidated total assets of the First Farmers and Merchants Corporation (the Corporation) were \$931.5 million, its consolidated net loans were \$580.0 million, its total deposits were \$768.6 million and its total shareholders' equity was \$107.3 million. The Corporation's loan portfolio as of September 30, 2009 reflected a decrease of \$6.9 million, or 1.2%, compared to December 31, 2008. Total deposits increased \$23.7 million, or 3.2%, and shareholders' equity decreased by less than 0.1% during the first nine months of 2009. Total shareholders' equity includes an unrealized gain on available-for-sale securities of approximately \$1.4 million.



Table of Contents

**FINANCIAL CONDITION**

Average earning assets at September 30, 2009 were up 7.1%, or \$55.1 million, from average earning assets at December 31, 2008. Average overnight investments at September 30, 2009 were up \$6.1 million compared to December 31, 2008. Average investment securities at September 30, 2009 were down less than 1% compared to December 31, 2008, although total investment securities at September 30, 2009 were up \$20.2 million compared to December 31, 2008. Average total assets of \$918.0 million at September 30, 2009 increased 7.3% or \$62.7 million, compared to \$855.3 million at December 31, 2008.

**Securities**

Available-for-sale securities are an integral part of the asset/liability management process for First Farmers and Merchants Bank, the Corporation's sole direct subsidiary (the Bank). Accordingly, they represent an important source of liquidity available to fund loans and accommodate asset reallocation strategies dictated by changes in the Bank's operating and tax plans, shifting yield spread relationships and changes in configuration of the yield curve. At September 30, 2009, the Bank's investment securities portfolio had \$204.2 million available-for-sale securities, which are valued at fair market value, and \$49.9 million held-to-maturity securities, which are valued at cost on the balance sheet. These compare to \$174.5 million of available-for-sale securities and \$59.4 million of held-to-maturity securities as of December 31, 2008.

**Loans**

The loan portfolio is the largest component of earning assets for the Bank and, consequently, provides the highest amount of revenues for the Corporation. The loan portfolio also contains the highest exposure to risk as a result of the possibility of unexpected deterioration in the credit quality of borrowers. When analyzing potential loans, management of the Bank assesses both interest rate objectives and credit quality objectives in determining whether to make a given loan and the appropriate pricing for that loan. All loans are expected to be repaid from cash flow or proceeds from the sale of selected assets of the borrowers. Collateral requirements for the loan portfolio are based on credit evaluation of the borrowers.

The loan portfolio experienced some contraction during the third quarter, moving back into negative territory for the year. Loan growth has been sluggish in 2009, as both the commercial and retail portfolios have experienced some deterioration in the first nine months of the year. The Bank continues to carry a concentration in 1-4 family residential first mortgage lending, but this portfolio has been flat in the first nine months of the year. On the commercial side, the Bank has experienced growth in the non-farm, non-residential real estate portfolio. Over half of the Bank's exposure is in the owner-occupied real estate, rather than commercial real estate, which is dependent on the lease, sale, or refinancing of the underlying collateral. Higher reserves are being placed against property types which are perceived to be higher risk, such as retail and multi-family real estate.

Real estate loans represented 78.6% of total loans at September 30, 2009 compared to 78.7% at September 30, 2008 and 76.6% at December 31, 2008. Management of the Bank believes the risk of this concentration is acceptable given the quality of underwriting and the low level of historical loss experience. The Bank's construction and development portfolio has decreased by \$15.8 million in the last nine months, as existing

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construction projects have been completed and few new projects have been brought online to replace them. Construction and development loans represented only 5.0% of total loans as of September 30, 2009, compared to 7.5% at September 30, 2008 and 8.8% at December 31, 2008. However, the Bank continues to reserve more heavily against its construction and development portfolio than any other segment of the commercial portfolio, given the comparatively high level of losses that have been incurred within this segment of the portfolio over the previous year.

The analysis and review of asset quality by the Bank's credit administration includes a formal review that evaluates the adequacy of the allowance for possible loan and lease losses. This review is updated monthly and evaluated more completely quarterly in conjunction with loan review reports and evaluations that are discussed in meetings with loan officers, credit administration and the Bank's Board of Directors. No reserve is placed against loans that are risk

Table of Contents

rated 1, as these loans are all cash-secured. A separate methodology is used for the criticized and classified portfolios (risk ratings 6-8), thus the Bank's historical loss methodology is utilized for the pass-grade ratings (risk ratings 2-5) of the commercial portfolio. The only areas of the commercial portfolio in which significant losses have been incurred over the past year are the construction and development and non-farm, non-residential real estate portfolios, with four-quarter gross loss rates of 3.1% and 1.0%. Other large segments of the commercial portfolio have seen little to no charge-off activity during the past year. The Bank's gross loss rate for the construction and development portfolio decreased slightly in the third quarter, falling from 3.9% to 3.1%. The level of reserves against the pass grade construction and development portfolio decreased by 2.9%. The loss rate in the non-farm, non-residential portfolio remained unchanged in the third quarter at 1.0%. The methodology used to reserve for the Bank's non-farm, non-residential portfolio was modified in the second quarter. Previously, the only differentiation made within the non-farm, non-residential portfolio was that the loans were segmented by risk rating. Beginning in the second quarter, the portfolio is also being divided by property types such as owner-occupied and true commercial real estate components. Commercial real estate is further stratified by property type (e.g., office, retail, industrial/warehouse, residential, self-storage, etc). Property types which are deemed to be higher-risk forms of lending and present the highest likelihood of credit losses now carry correspondingly higher reserves. The allowance for possible loan and lease losses was \$8.5 million, or 1.5% of gross loans and leases, at September 30, 2009, compared to \$8.6 million, or 1.4%, at December 31, 2008. Net charge-offs through September 30, 2009 were \$1.9 million, which results in an annualized net charge-off ratio of 0.4%.

A formal process is in place to enhance control over the underwriting of loans and to monitor loan collectability. This process includes education and training of personnel about the Bank's loan policies and procedures, credit analysts to support lenders, timely identification of loans with adverse characteristics, control of corrective actions and objective monitoring of loan reviews. The Special Assets Department of the Bank identifies and monitors assets that need attention. At September 30, 2009, this process identified loans totaling \$9.2 million, or 1.6% of the portfolio, that were classified as other assets especially mentioned, compared to loans totaling \$9.9 million, or 1.7% of the portfolio, so classified at December 31, 2008. Loans totaling \$29.0 million, or 4.9% of the portfolio, were classified as substandard at September 30, 2009, compared to loans totaling \$26.1 million, or 4.4% of the portfolio, so classified at December 31, 2008. No loans were classified as doubtful at September 30, 2009 and December 31, 2008.

Deposits

The Bank does not have any foreign offices and all deposits are serviced in its 19 domestic offices. The Bank's average deposits increased 7.8% during the first nine months of 2009 compared to an increase of 2.8% in the first nine months of 2008. The increase resulted from the Bank offering more competitive rates on money market accounts. Average total noninterest-bearing deposits were 15.6% of total deposits at September 30, 2009, contributing to the Bank's low cost of deposits, compared to 17.1% at December 31, 2008.

Regulatory Requirements for Capital

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

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Quantitative measures established by the Board of Governors of the Federal Reserve System to ensure capital adequacy require the Corporation and the Bank to maintain minimum amounts and ratios of Tier 1 Capital and Total Capital (Tier 1 plus Tier 2 Capital) to risk-weighted assets and of Tier 1 Capital to average total assets (leverage capital ratio). Equity capital (net of certain adjustments for intangible assets and investments in non-consolidated subsidiaries and certain classes of preferred stock) is considered Tier 1 Capital. Tier 2 Capital consists of core capital plus subordinated debt, some types of preferred stock, and a defined percentage of the allowance for possible loan and lease losses. To be well-capitalized under federal bank regulations, a bank holding company must have a Tier 1 Capital ratio of at least 6%, a Total Capital ratio of at least 10%, and a leverage capital ratio of at least 5%. At September 30, 2009, the

Table of Contents

Corporation's Tier 1, Total Capital and leverage capital ratios were 15.1%, 16.3% and 10.6%, respectively. The ratios were 15.3%, 16.5% and 10.9%, respectively, at December 31, 2008. As of September 30, 2009, the Bank's Tier 1 Capital, Total Capital and leverage capital were 14.8%, 16.0%, and 10.3%, respectively, compared to 15.0%, 16.2%, and 10.6% at December 31, 2008. Management believes, as of September 30, 2009, that the Corporation and the Bank each met all capital adequacy requirements to which they are subject.

**LIQUIDITY AND CAPITAL RESOURCES**

Most of the capital needs of the Bank historically have been financed with retained earnings and deposits received, and the Corporation's primary source of liquidity has been dividends declared by the Bank. In March 2008, the Bank obtained five advances at \$7 million each from the FHLB. The first scheduled repayment of the advances was made in March 2009. The remaining payments will continue each March through 2013. In September 2008, the Bank obtained two additional advances of \$3.1 million each for a total borrowing in 2008 of \$41.2 million. The borrowings from the FHLB have been used generally for investment strategies to enhance the Bank's portfolio. Please refer to Note 5 in the notes to consolidated financial statements for additional information about borrowings from the FHLB and the repayment schedule of such borrowings.

The Bank is subject to Tennessee statutes and regulations that impose restrictions on the amount of dividends that may be declared. Furthermore, any dividend payments are subject to the continuing ability of the Bank to maintain its compliance with minimum federal regulatory capital requirements and to retain its characterization under federal regulations as a well-capitalized institution. The Bank declared a \$0.365 per share dividend in the second quarter of 2009, which was paid in the third quarter of 2009. Management believes that the Corporation's traditional sources of cash generated from the Bank's operating activities are adequate to meet the Corporation's liquidity needs for normal ongoing operations. The Bank's Board of Directors has adopted a liquidity policy that outlines specific liquidity target balances. Compliance with this policy is reviewed quarterly by the Bank's Asset/Liability Committee and results are reported to the Bank's Board of Directors.

The Bank's formal asset and liability management process is used to control interest rate risk and assist management in maintaining reasonable stability in the gross interest margin as a result of changes in the level of interest rates and/or the spread relationships among interest rates. The Bank uses an earnings simulation model to evaluate the impact of different interest rate scenarios on the gross margin. Each quarter, the Bank's Asset/Liability Committee monitors the relationship of rate sensitive earning assets to rate sensitive interest-bearing liabilities (interest rate sensitivity), which is the principal factor in determining the effect that fluctuating interest rates will have on future net interest income. Rate sensitive earning assets and interest bearing liabilities are financial instruments that can be repriced to current market rates within a defined time period.

**CRITICAL ACCOUNTING POLICIES**

The accounting principles the Bank follows and the methods of applying these principles conform with accounting principles generally accepted in the United States and with general practices within the banking industry. In connection with the application of those principles, the Bank's management has made judgments and estimates that, in the case of the determination of the allowance for loan and lease losses ( ALLL ) and the recognition of deferred income tax assets, have been critical to the determination of the Corporation's financial position, results of operations and cash flows. As of September 30, 2009, the deferred income tax asset was \$5.0 million, compared to \$4.9 million at December 31, 2008 and was included with other assets on the balance sheet.

*Allowance for Loan and Lease Losses*

The Bank's management assesses the adequacy of the ALLL prior to the end of each month and prepares a more formal review quarterly to assess the risk in the Bank's loan portfolio. This assessment includes procedures to estimate the allowance and test the adequacy and appropriateness of the resulting balance. The ALLL represents calculated amounts for specifically identified credit exposure and exposures readily predictable by historical or comparative experience. Even though this calculation considers specific credits, the entire allowance is available to absorb any credit losses.

Table of Contents

These calculated amounts are determined by assessing loans identified as not in compliance with loan agreements. These loans are generally in two different risk groups. One group is unique loans (commercial loans, including those loans considered impaired). The second group is pools of homogenous loans (generally retail and mortgage loans). The calculation for unique loans is based primarily on risk rating grades assigned to each of these loans as a result of the Bank's loan management and review processes. Each risk-rating grade is assigned a loss ratio, which is determined based on the experience of management, discussions with banking regulators and the independent loan review process. The amount allocated for an impaired loan is based on estimated cash flows discounted at the loan's original effective interest rate or the underlying collateral value. Historical data, including actual loss experience on specific types of homogenous loans, is used to allocate amounts for loans or groups of loans meeting the specified criteria. Management has implemented procedures that give more detailed historical data by category of retail and consumer credit and performance characteristics to broaden the analysis and improve monitoring of potential credit risk.

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

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

In assessing the adequacy of the ALLL, the risk characteristics of the entire loan portfolio are evaluated. This process includes the judgment of the Bank's management, input from independent loan reviews and reviews that may have been conducted by bank regulators as part of their usual examination process.

*Deferred Income Tax Assets*

Deferred income tax assets consist mainly of the tax effect of excess provisions for loan and lease losses over actual losses incurred and deferred compensation. Management believes that it is more likely than not that these assets will be realized in future years.

**OFF-BALANCE SHEET ARRANGEMENTS**

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and stand-by letters of credit. Those instruments involve, to

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varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the Bank has in those financial instruments. Loan commitments are agreements to lend to a customer as long as there is not a violation of any condition established in the contract. Stand-by letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing and similar transactions. The credit risk involved in issuing letters of credit is essentially the same as that involved in making a loan.

The total outstanding loan commitments and stand-by letters of credit in the normal course of business at September 30, 2009 were \$110.3 million and \$8.9 million, respectively, compared to \$110.9 million and \$11.1 million, respectively, at September 30, 2008.

At September 30, 2009, the Corporation and the Bank did not have any off-balance sheet arrangements other than commitments to extend credit and stand-by letters of credit.



Table of Contents

**RESULTS OF OPERATIONS**

Total interest income for the first nine months of 2009 was \$30.5 million compared to \$32.9 million for the first nine months of 2008 and \$10.2 million for the three months ended September 30, 2009 compared to \$10.9 million for the three months ended September 30, 2008. Interest and fees earned on loans and investments are the components of total interest income. Interest and fees earned on loans were \$23.8 million, a decrease of approximately \$881,000, or 3.6%, during the first nine months of 2009 compared to the first nine months of 2008, and \$8.0 million for the three months ended September 30, 2009, a decrease of approximately \$180,000, or 2.2%, compared to the three months ended September 30, 2008. Nominal interest earned on investment securities and other investments was \$6.7 million, a decrease of \$1.3 million, or 16.5%, during the first nine months of 2009 compared to the first nine months of 2008, and \$2.2 million for the three months ended September 30, 2009, a decrease of approximately \$426,000, or 16.3%, compared to the three months ended September 30, 2008.

Total interest expense in the first nine months of 2009 was \$7.1 million, a decrease of \$2.5 million, or 25.8%, compared to the first nine months of 2008, and \$2.1 million for the three months ended September 30, 2009, a decrease of approximately \$880,000 compared to the three months ended September 30, 2008. The lower interest rates for certificates of deposits and public funds during the third quarter of 2009 were the primary reason for the lower expense. As a policy, budgeted financial goals are monitored on a quarterly basis by the Bank's Asset/Liability Committee, which reviews the actual dollar change in net interest income for different interest rate movements. A negative dollar change in net interest income for a 12-month and 24-month period of less than 10.0% of net interest income given a 100 to 200 basis point shift in interest rates is considered an acceptable rate risk position. The rate risk analysis for the 12-month period beginning October 1, 2009 and ending September 30, 2010 showed a worst-case potential change to net interest income of 2.4%, or an increase in net interest income of approximately \$793,000 by the end of the period.

Net interest income of the Corporation on a fully taxable equivalent basis is influenced primarily by changes in:

- (1) the volume and mix of earning assets and sources of funding;
- (2) market rates of interest; and
- (3) income tax rates.

The impact of some of these factors can be controlled by management policies and actions. External factors also can have a significant impact on changes in net interest income from one period to another. Some examples of such factors are:

- (1) the strength of credit demands by customers;
- (2) Federal Reserve Board monetary policy; and
- (3) fiscal and debt management policies of the federal government, including changes in tax laws.

The net interest margin, on a tax equivalent basis, at September 30, 2009, September 30, 2008 and December, 31, 2008 was 4.06%, 4.36% and 4.40%, respectively.

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Additions of \$405,000 were made to the provision for possible loan and lease losses in the third quarter of 2009 as a result of an increase in the level of credit losses on both secured and unsecured consumer loans as well as the Bank having to downgrade the credit level on a few commercial loans.

Noninterest income was \$10.3 million, an increase of approximately \$116,000, or 1.1%, during the first nine months of 2009 compared to the first nine months of 2008, and \$2.7 million for the three months ended September 30, 2009, a decrease of approximately \$651,000 compared to the three months ended September 30, 2008. The gains on sales of available-for-sale securities, representing \$2.5 million in income, was the primary reason for the increase in the first nine months of 2009.

Noninterest expenses, excluding the provision for possible loan and lease losses was \$24.8 million, an increase of \$1.1 million, or 4.6%, in the first nine months of 2009 as compared to the first nine months of 2008. The Bank expensed \$1 million for the Federal Deposit Insurance Company ( FDIC ) special assessment and also the increase in the FDIC s regular assessment for the first nine months of 2009.

The Corporation does not have any long-term debt or other long-term obligations; however, in 2008, the Bank received a \$41.2 million advance from FHLB. The scheduled \$7.0 million annual principal maturities of borrowings

Table of Contents

under this credit line began in March 2009 and will end in 2013. Please refer to Note 5 in the notes to consolidated financial statements included in this report for additional information about borrowings from the FHLB.

The Bank also leases certain of its properties. There was no change during the nine-month period ended September 30, 2009 in the terms of these leases.

Net income for the nine months ended September 30, 2009 was \$6.1 million, compared to \$8.1 million for the nine months ended September 30, 2008. A decrease in interest income on loans and securities contributed to the period-over-period decrease. The Corporation earned \$1.10 per share in the third quarter of 2009 and \$1.43 per share in the third quarter of 2008.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

During the nine months ended September 30, 2009, there were no material changes in the quantitative and qualitative disclosures about market risk presented in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2008.

**Item 4. Controls and Procedures.**

(a) Evaluation of Disclosure Controls and Procedures. The Corporation, with the participation of its management, including the Corporation's Chief Executive Officer and Assistant Treasurer (principal financial officer), carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rules 13a-15 and 15d-15 under the Exchange Act) as of the end of the period covered by this report. Based upon that evaluation and as of the end of the period covered by this report, the Corporation's Chief Executive Officer and Assistant Treasurer (principal financial officer) concluded that the Corporation's disclosure controls and procedures were effective in ensuring that information required to be disclosed in its reports that the Corporation files or submits to the SEC under the Exchange Act is recorded, processed, summarized and reported on a timely basis.

(b) Changes in Internal Control Over Financial Reporting. There has been no change in the Corporation's internal control over financial reporting that occurred during the third quarter of 2009 that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

Table of Contents

**PART II - OTHER INFORMATION**

**Item 1A. Risk Factors.**

There have been no material changes in the risk factors previously disclosed in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2008.

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

The following table provides information regarding purchases of the Corporation's common stock made by the Corporation during the third quarter of 2009:

**CORPORATION'S PURCHASES OF EQUITY SECURITIES**

| Period                                 | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs |
|--|----------------------------------|------------------------------|--|--|
| July 1, 2009 - July 30, 2009           |                                  |                              |  |  |
| August 1, 2009 - August 31, 2009       |                                  |                              |  |  |
| September 1, 2009 - September 30, 2009 | 23,007*                          | \$ 50.00                     |  |  |
| Total                                  | 23,007                           | \$ 50.00                     |  |  |

\*Purchased from a third-party seller pursuant to a previously negotiated agreement to purchase.

**Item 6. Exhibits.**

| EXHIBIT NUMBER | DESCRIPTION                           |
|----------------|---------------------------------------|
| 3.1            | Charter. (1)                          |
| 3.2            | Articles of Amendment to Charter. (1) |

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- 3.3 Amended and Restated By-laws. (2)
- 31.1 Certification of the Chief Executive Officer of First Farmers and Merchants Corporation Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Assistant Treasurer (principal financial officer) of First Farmers and Merchants Corporation Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of the Chief Executive Officer and Assistant Treasurer (principal financial officer) of First Farmers and Merchants Corporation Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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(1) Incorporated by reference from the First Farmers and Merchants Corporation Amendment No. 1 to the Annual Report on Form 10-K/A for the year ended December 31, 2003, as filed with the Securities and Exchange Commission on May 7, 2004 (File Number 000-10972).

(2) Incorporated by reference from the First Farmers and Merchants Corporation Current Report on Form 8-K, as filed with the Securities and Exchange Commission on April 23, 2007 (File Number 000-10972).



Table of Contents

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