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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2008

Commission File Number: 0-18832

FIRST FINANCIAL SERVICE CORPORATION

(Exact name of registrant as specified in its charter)

Kentucky

(State or other jurisdiction of
incorporation or organization)

61-1168311

(I.R.S. Employer
Identification No.)

2323 Ring Road, Elizabethtown,

Kentucky

(Address of principal executive offices)

42701

Zip Code

Registrant's telephone number, including area code: **(270) 765-2131**

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

Common Stock, par value \$1.00 per share

(Title of Class)

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

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

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 ninety days. 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 definition of "accelerated filer", "large 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

The aggregate market value of the outstanding voting stock held by non-affiliates of the registrant based on a June 30, 2008 closing price of \$18.14 as quoted on the NASDAQ Global Market was \$69,387,668. Solely for purposes of this calculation, the shares held by directors and executive officers of the registrant and by any stockholder beneficially owning more than 5% of the registrant's outstanding common stock are deemed to be shares held by affiliates.

As of February 28, 2009 there were issued and outstanding 4,679,443 shares of the registrant's common stock.

DOCUMENTS INCORPORATED BY REFERENCE

1. Portions of the Registrant's Definitive Proxy Statement for the 2009 Annual Meeting of Shareholders to be held May 20, 2009 are incorporated by reference into Part III of this Form 10-K.
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**FIRST FINANCIAL SERVICE CORPORATION
2008 ANNUAL REPORT AND FORM 10-K**

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PRELIMINARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Statements in this report that are not statements of historical fact are forward-looking statements. First Financial Service Corporation (the "Corporation") may make forward-looking statements in future filings with the Securities and Exchange Commission ("SEC"), in press releases, and in oral and written statements made by or with the approval of the Corporation. Forward-looking statements include, but are not limited to: (1) projections of revenues, income or loss, earnings or loss per share, capital structure and other financial items; (2) plans and objectives of the Corporation or its management or Board of Directors; (3) statements regarding future events, actions or economic performance; and (4) statements of assumptions underlying such statements. Words such as "estimate," "strategy," "believes," "anticipates," "expects," "intends," "plans," "targeted," and similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements.

Various risks and uncertainties may cause actual results to differ materially from those indicated by our forward-looking statements. In addition to those risks described under "Item 1A Risk Factors," of this report and our Annual Report on Form 10-K, the following factors could cause such differences: changes in general economic conditions and economic conditions in Kentucky and the markets we serve, any of which may affect, among other things, our level of non-performing assets, charge-offs, and provision for loan loss expense; changes in interest rates that may reduce interest margins and impact funding sources; changes in market rates and prices which may adversely impact the value of financial products including securities, loans and deposits; changes in tax laws, rules and regulations; various monetary and fiscal policies and regulations, including those determined by the Federal Reserve Board, the Federal Deposit Insurance Corporation ("FDIC") and the Kentucky Office of Financial Institutions ("KOFI"); competition with other local and regional commercial banks, savings banks, credit unions and other non-bank financial institutions; our ability to grow core businesses; our ability to develop and introduce new banking-related products, services and enhancements and gain market acceptance of such products; and management's ability to manage these and other risks.

Our forward-looking statements speak only as of the date on which they are made, and we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date of the statement to reflect the occurrence of unanticipated events.

PART I

ITEM 1. Business

First Financial Service Corporation was incorporated in August 1989 under Kentucky law and became the holding company for First Federal Savings Bank of Elizabethtown (the "Bank"), effective on June 1, 1990. Since that date, we have engaged in no significant activity other than holding the stock of the Bank and directing, planning and coordinating its business activities. Unless the text clearly suggests otherwise, references to "us," "we," or "our" include First Financial Service Corporation and its wholly owned subsidiary, the Bank. Accordingly, the information set forth in this report, including financial statements and related data, relates primarily to the Bank and its subsidiaries. In 2004 we amended our articles of incorporation to change our name from First Federal Financial Corporation of Kentucky to First Financial Service Corporation.

We are headquartered in Elizabethtown, Kentucky and were originally founded in 1923 as a state-chartered institution and became federally chartered in 1940. In 1987, we converted to a federally chartered savings bank and converted from mutual to stock form. We are a member of the FHLB of Cincinnati and, since converting to a state charter in 2003, have been subject to regulation, examination and supervision by the FDIC and the KOFI. Our deposits are insured by the Deposit Insurance Fund administered by the FDIC.

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On June 25, 2008, we expanded our operations into southern Indiana with the acquisition of FSB Bancshares, Inc., the bank holding company for The Farmers State Bank. The Farmers State Bank had approximately \$65.7 million in total assets and \$55.8 million in deposits. The Farmers State Bank had four banking offices in Harrison and Floyd Counties in Indiana, which are adjacent to four Kentucky counties where we currently operate and are part of the Louisville MSA. Upon completion of the acquisition, these four offices became branches of First Federal Savings Bank.

General Business Overview

We serve the needs and cater to the economic strengths of the local communities in which we operate, and we strive to provide a high level of personal and professional customer service. We offer a variety of financial services to our retail and commercial banking customers. These services include personal and corporate banking services and personal investment financial counseling services.

Our full complement of lending services includes:

- a broad array of residential mortgage products, both fixed and adjustable rate;
- consumer loans, including home equity lines of credit, auto loans, recreational vehicle, and other secured and unsecured loans;
- specialized financing programs to support community development;
- mortgages for multi-family real estate;
- commercial real estate loans;
- commercial loans to businesses, including revolving lines of credit and term loans;
- real estate development;
- construction lending; and
- agricultural lending.

We also provide a broad selection of deposit instruments. These include:

- multiple checking and NOW accounts for both personal and business accounts;
- various savings accounts, including those for minors;
- money market accounts;
- tax qualified deposit accounts such as Health Savings Accounts and Individual Retirement Accounts; and
- a broad array of certificate of deposit products.

We also support our customers by providing services such as:

- acting as a federal tax depository;
- providing access to merchant bankcard services;
- supplying various forms of electronic funds transfer;
- providing debit cards and credit cards; and

- providing telephone and Internet banking.

Through our personal investment financial counseling services, we offer a wide variety of mutual funds, equity investments, and fixed and variable annuities. We invest in the wholesale capital markets to manage a portfolio of securities and use various forms of wholesale funding. The security portfolio

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contains a variety of instruments, including callable debentures, taxable and non-taxable debentures, fixed and adjustable rate mortgage backed securities, and collateralized mortgage obligations.

Our results of operations depend primarily on net interest income, which is the difference between interest income from interest-earning assets and interest expense on interest-bearing liabilities. Our operations are also affected by non-interest income, such as service charges, insurance agency revenue, loan fees, gains and losses from the sale of mortgage loans and gains from the sale of real estate held for development. Our principal operating expenses, aside from interest expense, consist of compensation and employee benefits, occupancy costs, data processing expense and provisions for loan losses.

Market Area

We operate 21 banking centers in eight contiguous counties in Central Kentucky along the Interstate 65 corridor and the Louisville Metropolitan area, including southern Indiana. Our markets range from the major metropolitan area of Louisville in Jefferson County, Kentucky approximately 40 miles north of our headquarters in Elizabethtown, Kentucky to Hart County, Kentucky, approximately 30 miles south of Elizabethtown to Harrison County, Indiana approximately 60 miles northwest of our headquarters. Our markets are supported by a diversified industry base and have a regional population of over 1 million. Louisville and Jefferson County comprise the 16th largest city in the United States. Our core markets have experienced a growth rate of 14% in deposits for the past three years. Based on the current economic slow-down, management anticipates that our markets may not continue to grow at a similar rate experienced over the last few years. However, we believe we will still be well positioned to benefit from growth in our local markets when the economy rebounds in the future.

We operate in Hardin, Nelson, Hart, Bullitt, Meade and Jefferson counties in Kentucky and in Harrison and Floyd counties in southern Indiana. We control in the aggregate over 23% of the deposit market share in our central Kentucky markets outside of Jefferson County with the next largest competitor having just 8% of the market share. Over the past three years, these counties have demonstrated a growth rate in deposits of 14%. According to the most recent census data, our core markets have experienced a population increase of 4%, an 18% increase in the median home price, and a growth in median family income of 8% over the past four census reporting years.

Since 2004, we have expanded our presence in the Louisville market, primarily through our commercial lending operations. At December 31, 2008, over 27% of our total loan portfolio was located in this market. In an effort to better serve these customers and to enhance our retail branch network in Louisville, we opened our third new full-service state of the art retail facility in 2007 and anticipate opening a fourth new facility in the second quarter of 2009. These facilities represent our state of the art prototype branch with a retail-focused design. This design features an internet café with access to online banking and bill payment services. Large plasma screens in the lobby provide customers with current news and information about bank products and services as well as upcoming community events. The facilities are staffed to offer a full range of financial services to the growing retail and commercial customer base. We also opened a new commercial private banking center in Louisville during 2007. It is the first of its type for our company designed to better serve our high net worth commercial customers. We also plan on expanding our retail branch network in this market over the coming years. We have a combined \$60.7 million in deposits in these three facilities, representing a 12% increase in deposits in this market during 2008. Our current deposit market share in Louisville remains under 1% of the current \$15.0 billion deposit base. Based on our service-focused operating strategy, we believe we can increase our presence in Louisville, where six large out-of-state holding companies hold the largest deposit market shares.

All of our market areas will likely benefit from the Fort Knox Military Base Realignment passed into law during 2006. Fort Knox is located in Hardin County, where we have a 24% market share. With

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the base realignment, Fort Knox will receive several additional military units including the Light Infantry Brigade Combat Team, the Combat Service Support Units and the Human Resource Command. These military units will bring an estimated 2,000 additional civilian positions and 2,000 additional military positions with an estimated \$300 million in annual payroll to this area beginning in late 2009 through 2011. Over \$900 million in renovations to Fort Knox are planned to accommodate these units, including the construction of approximately 800,000 square feet of office space to house the Human Resource Command. We anticipate the base realignment will result in substantial growth in the retail, housing, and service industries in our area. During the fourth quarter of 2008, we began construction on a new full-service facility at the main entrance to the Fort Knox Military Base for completion in the second quarter of 2009. We have already experienced commercial loan growth as a result of ongoing development and have active retail and commercial strategies prepared in anticipation of the new personnel arriving in our market area.

General and Operating Strategies

Our operating strategy is to serve the needs and cater to the economic strengths of the local communities in which we operate and strive to provide a high level of personal and professional customer service. We offer a variety of financial services to our retail and commercial banking customers.

Our growth strategy is focused on a combination of acquisitions and expansion in our existing markets through internal growth as well as establishing new branches.

Branch Expansion. Management continues to consider markets for branch expansion. Because of the economic growth in our markets over the past several years, we may consider further branch expansion in our current or surrounding market areas. However, we do not rule out branch expansion in other areas experiencing economic growth.

During 2008, we completed construction and opened our twentieth full-service banking center in Bullitt County. As we progress into 2009, we will open a full-service banking center at the main entrance to Fort Knox in our Hardin County market and open another full-service banking center in the Middletown area of Jefferson County. We are also considering other possible locations within our core market area as we continue to identify future branch sites. Negotiations continue on several locations, contingent upon successful rezoning efforts.

Internal Growth. Management believes that its largest source of internal growth is through our ongoing solicitation program conducted by branch managers and lending officers, followed by referrals from customers. The primary source for referrals is positive customer endorsements regarding our customer service and response time.

Our goal in continuing our expansion is to maintain a profitable, customer-focused financial institution. We believe that our existing structure, management, data and operational systems are sufficient to achieve further internal growth in asset size, revenues and capital without proportionate increases in operating costs. This growth should also allow us to increase the lending limits, thereby enabling us to increase our ability to serve the needs of existing and new customers. Our operating strategy has always been to provide high quality community banking services to our customers and increase market share through active solicitation of new business, repeat business and referrals from customers, and continuation of selected promotional strategies.

We believe that our banking customers seek a banking relationship with a service-oriented community banking organization. Our operational systems have been designed to facilitate personalized service. Management believes our banking locations have an atmosphere that encourages personalized services and decision-making, plus we are of sufficient financial size to offer broad product lines to meet customers' needs. We also believe that economic expansion in our market areas will continue to

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contribute to internal growth. Through our primary emphasis on customer service and our management's banking experience, we intend to continue internal growth by attracting customers and primarily focusing on the following:

- *Products Offered*—We offer personal and corporate banking services, mortgage origination, mortgage servicing, personal investment, and financial counseling services as well as internet and telephone banking. We offer a full range of commercial banking services, including cash management and remote deposit, checking accounts, ATM's, checking accounts with interest, savings accounts, money market accounts, certificates of deposit, NOW accounts, Health Savings Accounts, Individual Retirement Accounts, brokerage and residential mortgage services, branch banking, and debit and credit cards. We also offer installment loans, including auto, recreational vehicle, and other secured and unsecured loans sourced directly by our branches. See "Lending Activities" below for a discussion of products we provide to commercial accounts.
- *Operational Efficiencies*—We seek to maximize operational and support efficiencies consistent with maintaining high quality customer service. We share a common information system designed to enhance customer service and improve efficiencies by providing system-wide voice and data communication connections. We have consolidated loan processing, bank balancing, financial reporting, investment management, information systems, payroll and benefit management, loan review, and audits to operate more efficiently.
- *Marketing Activities*—We focus on a proactive solicitation program for new business, as well as identifying and developing products and services that satisfy customer needs. We actively sponsor community events within our branch areas. We believe that active community involvement enhances our reputation and contributes to our long-term success.

Acquisitions. Management believes that the consolidation in the banking industries, along with the easing of restrictions on bank branching, increased regulatory burdens, and concerns about technology and marketing are likely to lead owners of community banks and agencies within the Bank's market areas to explore the possibility of sale or combination with a broader-based financial service companies such as ourselves.

In addition, branching opportunities have arisen from time to time as a result of divestiture of branches by large national and regional bank holding companies of certain overlapping branches resulting from consolidations. As a result, branch locations become available for purchase from time to time.

Management's strategy in assimilating acquisitions is to emphasize revenue growth as well as to continuously review the operations of the acquired entities and streamline operations where feasible. Management does not believe that implementing wholesale administrative cost reductions in acquired institutions, particularly reducing customer focused personnel, is beneficial to our long-term growth, because significant administrative changes in community banks can have an adverse impact on customer satisfaction in the acquired institution's community. However, management believes that certain human resource and accounting functions can be consolidated immediately upon acquisition to achieve higher productivity levels without compromising customer service. We emphasize revenue growth by offering customers a broader product line consistent with full service banking.

Management is very selective when evaluating a potential acquisition based upon factors such as the operating strategy, market, financial condition, and the culture of the acquisition candidate. Our most recent acquisition, completed during the second quarter of 2008, was the acquisition of FSB Bancshares, Inc. and its wholly owned subsidiary, The Farmers State Bank. As of June 25, 2008, the Farmers State Bank had approximately \$65.7 million in total assets and \$55.8 million in deposits with offices in Harrison and Floyd County, Indiana. These counties are adjacent to our Kentucky counties where we currently operate and are part of the Louisville MSA.

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Lending Activities

Commercial Real Estate & Construction Lending. The largest portion of our lending activity is the origination of commercial loans that are primarily secured by real estate, including construction loans. We generate loans primarily in our market area. In recent years, we have put greater emphasis on originating loans for small and medium-sized businesses from our various locations. We make commercial loans to a variety of industries. Substantially all of the commercial real estate loans we originate have adjustable interest rates with maturities of 25 years or less or are loans with fixed interest rates and maturities of five years or less. At December 31, 2008, we had \$563.3 million outstanding in commercial real estate loans. The security for commercial real estate loans includes retail businesses, warehouses, churches, apartment buildings and motels. In addition, the payment experience of loans secured by income producing properties typically depends on the success of the related real estate project and thus may be more vulnerable to adverse conditions in the real estate market or in the economy generally.

Loans secured by multi-family residential property, consisting of properties with more than four separate dwelling units, amounted to \$31.3 million of the loan portfolio at December 31, 2008. These loans are included in the \$563.3 million outstanding in commercial real estate loans discussed above. We generally do not lend above 75% of the appraised values of multi-family residences on first mortgage loans. The mortgage loans we currently offer on multi-family dwellings are generally one or five year ARMs with maturities of 25 years or less.

Construction loans involve additional risks because loan funds are advanced upon the security of the project under construction, which is of uncertain value before the completion of construction. The uncertainties inherent in estimating construction costs, delays arising from labor problems, material shortages, and other unpredictable contingencies make it relatively difficult to evaluate accurately the total loan funds required to complete a project and related loan-to-value ratios. The analysis of prospective construction loan projects requires significantly different expertise from that required for permanent residential mortgage lending. At December 31, 2008, we had \$17.4 million outstanding in construction loans.

Our underwriting criteria are designed to evaluate and minimize the risks of each construction loan. Among other things, we consider evidence of the availability of permanent financing or a takeout commitment to the borrower; the reputation of the borrower and his or her financial condition; the amount of the borrower's equity in the project; independent appraisals and cost estimates; pre-construction sale and leasing information; and cash flow projections of the borrower.

Commercial Business Lending. The commercial business loan portfolio has grown in recent years as a result of our focus on small business lending. We make secured and unsecured loans for commercial, corporate, business, and agricultural purposes, including issuing letters of credit and engaging in inventory financing and commercial leasing activities. Commercial loans generally are made to small-to-medium size businesses located within our defined market area. Commercial loans generally carry a higher yield and are made for a shorter term than real estate loans. Commercial loans, however, involve a higher degree of risk than residential real estate loans due to potentially greater volatility in the value of the assigned collateral, the need for more technical analysis of the borrower's financial position, the potentially greater impact that changing economic conditions may have on the borrower's ability to retire debt, and the additional expertise required for commercial lending personnel. Commercial business loans outstanding at December 31, 2008, totaled \$56.9 million.

Residential Real Estate. Residential mortgage loans are secured primarily by single-family homes. The majority of our mortgage loan portfolio is secured by real estate in our markets outside of Louisville and our residential mortgage loans do not have sub-prime characteristics. Fixed rate residential real estate loans we originate have terms ranging from ten to thirty years. Interest rates are competitively priced within the primary geographic lending market and vary according to the term for

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which they are fixed. At December 31, 2008, we had \$165.3 million in residential mortgage loans outstanding.

We generally emphasize the origination of adjustable-rate mortgage loans ("ARMs") when possible. We offer seven ARM products with an annual adjustment, which is tied to a national index with a maximum adjustment of 2% annually, and a lifetime maximum adjustment cap of 6%. As of December 31, 2008, approximately 32.6% of our residential real estate loans were adjustable rate loans with adjustment periods ranging from one to seven years and balloon loans of seven years or less. The origination of these ARMs can be more difficult in a low interest rate environment where there is a significant demand for fixed rate mortgages. We limit the maximum loan-to-value ratio on one-to-four-family residential first mortgages to 90% of the appraised value and generally limit the loan-to-value ratio on second mortgages on one-to-four-family dwellings to 90%.

Consumer Lending. Consumer loans include loans on automobiles, boats, recreational vehicles and other consumer goods, as well as loans secured by savings accounts, home improvement loans, and unsecured lines of credit. As of December 31, 2008, consumer loans outstanding were \$101.4 million. These loans involve a higher risk of default than loans secured by one-to-four-family residential loans. We believe, however, that the shorter term and the normally higher interest rates available on various types of consumer loans help maintain a profitable spread between the average loan yield and cost of funds. Home equity lines of credit as of December 31, 2008, totaled \$42.9 million.

Our underwriting standards reflect the greater risk in consumer lending than in residential real estate lending. Among other things, the capacity of individual borrowers to repay can change rapidly, particularly during an economic downturn, collection costs can be relatively higher for smaller loans, and the value of collateral may be more likely to depreciate. Our Consumer Lending Policy establishes the appropriate consumer lending authority for all loan officers based on experience, training, and past performance for approving high quality loans. Loans beyond the authority of individual officers must be approved by additional officers, the Executive Loan Committee or the Board of Directors, based on the size of the loan. We require detailed financial information and credit bureau reports for each consumer loan applicant to establish the applicant's credit history, the adequacy of income for debt retirement, and job stability based on the applicant's employment records. Co-signers are required for applicants who are determined marginal or who fail to qualify individually under these standards. Adequate collateral is required on the majority of consumer loans. The Executive Loan Committee monitors and evaluates unsecured lending activity by each loan officer.

The indirect consumer loan portfolio is comprised of new and used automobile, motorcycle and all terrain vehicle loans originated on our behalf by a select group of auto dealers within the service area. Indirect consumer loans are considered to have greater risk of loan losses than direct consumer loans due to, among other things: borrowers may have no existing relationship with us; borrowers may not be residents of the lending area; less detailed financial statement information may be collected at application; collateral values can be more difficult to determine; and the condition of vehicles securing the loan can deteriorate rapidly. To address the additional risks associated with indirect consumer lending, the Executive Loan Committee continually evaluates data regarding the dealers enrolled in the program, including monitoring turn down and delinquency rates. All applications are approved by specific lending officers, selected based on experience in this field, who obtain credit bureau reports on each application to assist in the decision. Aggressive collection procedures encourage more timely recovery of late payments. At December 31, 2008, total loans under the indirect consumer loan program totaled \$31.8 million.

Subsidiary Activities

First Service Corporation of Elizabethtown ("First Service"), our licensed brokerage affiliate, provides investment services to our customers and offers tax-deferred annuities, government securities,

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mutual funds, and stocks and bonds. First Service employs four full-time employees. The net income of First Service was \$65,622 for the year ended December 31, 2008.

First Federal Office Park, LLC, holds commercial lots adjacent to our home office on Ring Road in Elizabethtown, that are available for sale. Currently, one of the original nine lots held for sale remains unsold.

We provide title insurance coverage for mortgage borrowers through two subsidiaries: First Heartland Title, LLC, and First Federal Title Services, LLC. First Heartland Title is a joint venture with a title insurance company in Hardin County and First Federal Title Services is a joint venture with a title insurance company in Louisville. We hold a 48% interest in First Heartland Title and a 49% interest in First Federal Title Services. The subsidiaries generated \$206,406 in income for the year ended December 31, 2008, of which our portion was \$99,351.

In 2008, we created Heritage Properties, LLC. The subsidiary holds real estate acquired through foreclosure which is available for sale. Currently, twenty-one properties valued at \$4.1 million are held for sale.

Competition

We face substantial competition both in attracting and retaining deposits and in lending. Direct competition for deposits comes from commercial banks, savings institutions, and credit unions located in north-central Kentucky and southern Indiana, and less directly from money market mutual funds and from sellers of corporate and government debt securities.

The primary competitive factors in lending are interest rates, loan origination fees and the range of services offered by the various financial institutions. Competition for origination of real estate loans normally comes from commercial banks, savings institutions, mortgage bankers, mortgage brokers, and insurance companies. Retail establishments effectively compete for loans by offering credit cards and retail installment contracts for the purchase of goods, merchandise and services (for example, Home Depot, Lowe's, etc.). We believe that we have been able to compete effectively in our primary market area.

We have offices in nine cities in six central Kentucky counties and offices in four cities in two southern Indiana counties. In addition to the financial institutions with offices in these counties, we compete with several commercial banks and savings institutions in surrounding counties, many of which have assets substantially greater than we have. These competitors attempt to gain market share through their financial product mix, pricing strategies, internet banking and banking center locations. In addition, Kentucky's interstate banking statute, which permits banks in all states to enter the Kentucky market if they have reciprocal interstate banking statutes, has further increased competition for us. We believe that competition from both bank and non-bank entities will continue to remain strong in the near future.

The following table shows our market share and rank in terms of deposits as of June 30, 2008, in each Kentucky and Indiana county where we have offices. We have three offices in Jefferson County, which is Louisville, Kentucky. The Louisville metropolitan area has a population of more than one million.

<u>County</u>	<u>Number of Offices</u>	<u>FFKY Market Share %</u>	<u>FFKY Rank</u>
Hardin	4	24.0	1
Nelson	2	7.0	6
Hart	1	22.0	2
Bullitt	3	27.0	1
Meade	3	55.0	1
Jefferson	3	<1.0	N/M
Harrison	3	9.0	5
Floyd	1	1.0	14

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Employees

As of December 31, 2008, we had 321 employees, of which 310 were full-time and 11 part-time. None of our employees are subject to a collective bargaining agreement, and we believe that we enjoy good relations with our personnel.

Regulation

General Regulatory Matters. We are a Kentucky chartered commercial bank and are subject to supervision and regulation, which involves regular bank examinations, by both the FDIC and the KOFL. Our deposits are insured by the FDIC. Kentucky's banking statutes contain a "super-parity" provision that permits a well-rated Kentucky bank to engage in any banking activity in which a national bank operating in any state, a state bank, thrift or savings bank operating in any other state, or a federally chartered thrift or federal savings association meeting the qualified thrift lender test and operating in any state could engage, provided the Kentucky bank first obtains a legal opinion specifying the statutory or regulatory provisions that permit the activity.

In connection with our conversion, we registered to become a bank holding company under the Bank Holding Company Act of 1956, and are subject to supervision and regulation by the Federal Reserve Board. As a bank holding company, we are required to file with the Federal Reserve Board annual and quarterly reports and other information regarding our business operations and the business operations of our subsidiaries. We are also subject to examination by the Federal Reserve Board and to its operational guidelines. We are subject to the Bank Holding Company Act and other federal laws on the types of activities in which we may engage, and to other supervisory requirements, including regulatory enforcement actions for violations of laws and regulations.

Acquisitions and Change in Control. As a bank holding company, we must obtain Federal Reserve Board approval before acquiring, directly or indirectly, ownership or control of more than 5% of the voting stock of a bank, and before engaging, or acquiring a company that is not a bank but is engaged in certain non-banking activities. In approving these acquisitions, the Federal Reserve Board considers a number of factors, and weighs the expected benefits to the public such as greater convenience, increased competition and gains in efficiency, against the risks of possible adverse effects such as undue concentration of resources, decreased or unfair competition, conflicts of interest or unsound banking practices. The Federal Reserve Board also considers the financial and managerial resources of the bank holding company, its subsidiaries and any company to be acquired, and the effect of the proposed transaction on these resources. It also evaluates compliance by the holding company's financial institution subsidiaries and the target institution with the Community Reinvestment Act. The Community Reinvestment Act generally requires each financial institution to take affirmative action to ascertain and meet the credit needs of its entire community, including low and moderate income neighborhoods.

Federal law also prohibits a person or group of persons from acquiring "control" of a bank holding company without notifying the Federal Reserve Board in advance, and then only if the Federal Reserve Board does not object to the proposed transaction. The Federal Reserve Board has established a rebuttable presumptive standard that the acquisition of 10% or more of the voting stock of a bank holding company with a class of securities registered under the Securities Exchange Act of 1934 (the "Exchange Act") would constitute an acquisition of control of the bank holding company. In addition, any company is required to obtain the approval of the Federal Reserve Board before acquiring 25% (5% in the case of an acquirer that is a bank holding company) or more of any class of a bank holding company's voting securities, or otherwise obtaining control or a "controlling influence" over a bank holding company.

Other Financial Activities. The Gramm-Leach-Bliley Act of 1999 permits a bank holding company to elect to become a financial holding company, which permits the holding company to conduct

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activities that are "financial in nature." To become and maintain its status as a financial holding company, the bank holding company and all of its affiliated depository institutions must be well-capitalized, well managed, and have at least a satisfactory Community Reinvestment Act rating. We have not filed an election to become a financial holding company.

Other Holding Company Regulations. Federal law substantially restricts transactions between financial institutions and their affiliates. As a result, a bank is limited in extending credit to its holding company (or any non-bank subsidiary), in investing in the stock or other securities of the bank holding company or its non-bank subsidiaries, and/or in taking such stock or securities as collateral for loans to any borrower. Moreover, transactions between a bank and a bank holding company (or any non-bank subsidiary) must generally be on terms and under circumstances at least as favorable to the bank as those prevailing in comparable transactions with independent third parties or, in the absence of comparable transactions, on terms and under circumstances that in good faith would be available to nonaffiliated companies.

Under Federal Reserve Board policy, a bank holding company is expected to act as a source of financial strength to, and to commit resources to support, its bank subsidiaries. This support may be required at times when, absent such a policy, the bank holding company may not be inclined to provide it. In addition, any capital loans by the bank holding company to its bank subsidiaries are subordinate in right of payment to deposits and to certain other indebtedness of the bank subsidiary. In the event of a bank holding company's bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of subsidiary banks will be assumed by the bankruptcy trustee and entitled to a priority of payment.

Capital Requirements. The Federal Reserve Board and the FDIC have substantially similar risk-based and leverage capital guidelines applicable to the banking organizations they supervise. Under the risk-based capital requirements, we are generally required to maintain a minimum ratio of total capital to risk-weighted assets (including certain off-balance sheet activities, such as standby letters of credit) of 8%. At least half of the total capital must be composed of common equity, retained earnings and qualifying perpetual preferred stock and certain hybrid capital instruments, less certain intangibles ("Tier 1 capital"). The remainder may consist of certain subordinated debt, certain hybrid capital instruments, qualifying preferred stock and a limited amount of the loan loss allowance ("Tier 2 capital" which, together with Tier 1 capital, composes "total capital"). To be considered well-capitalized under the risk-based capital guidelines, an institution must maintain a total risk-weighted capital ratio of at least 10% and a Tier 1 risk-weighted ratio of 6% or greater. For further information, see "Item 7—Management's Discussion and Analysis of Financial Condition and Results of Operations-Capital."

The Federal Deposit Insurance Corporation Act of 1991 ("FDICIA"), among other things, identifies five capital categories for insured depository institutions: well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. The Corporation and the Bank are classified as "well-capitalized." FDICIA also requires the bank regulatory agencies to implement systems for "prompt corrective action" for institutions that fail to meet minimum capital requirements within these five categories, with progressively more severe restrictions on operations, management and capital distributions according to the category in which an institution is placed. Failure to meet capital requirements can also cause an institution to be directed to raise additional capital. FDICIA also mandates that the agencies adopt safety and soundness standards relating generally to operations and management, asset quality and executive compensation, and authorizes administrative action against an institution that fails to meet such standards.

In addition, the Federal Reserve Board and the FDIC have each adopted risk-based capital standards that explicitly identify concentrations of credit risk and the risk arising from non-traditional activities, as well as an institution's ability to manage these risks, as important factors to be taken into account by each agency in assessing an institution's overall capital adequacy. The capital guidelines also

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provide that an institution's exposure to a decline in the economic value of its capital due to changes in interest rates be considered by the agency as a factor in evaluating a banking organization's capital adequacy. In addition to the "prompt corrective action" directives, failure to meet capital guidelines can subject a banking organization to a variety of other enforcement remedies, including additional substantial restrictions on its operations and activities, termination of deposit insurance by the FDIC, and under some conditions the appointment of a conservator or receiver.

Dividends. The Corporation is a legal entity separate and distinct from the Bank. The majority of our revenue is from dividends we receive from the Bank. The Bank is subject to laws and regulations that limit the amount of dividends it can pay. If, in the opinion of a federal regulatory agency, an institution under its jurisdiction is engaged in or is about to engage in an unsafe or unsound practice, the agency may require, after notice and hearing, that the institution cease and desist from such practice. The federal banking agencies have indicated that paying dividends that deplete an institution's capital base to an inadequate level would be an unsafe and unsound banking practice. Under FDICIA, an insured institution may not pay a dividend if payment would cause it to become undercapitalized or if it already is undercapitalized. Moreover, the Federal Reserve and the FDIC have issued policy statements providing that bank holding companies and banks should generally pay dividends only out of current operating earnings.

Under Kentucky law, dividends by Kentucky banks may be paid only from current or retained net profits. Before any dividend may be declared for any period (other than with respect to preferred stock), a bank must increase its capital surplus by at least 10% of the net profits of the bank for the period until the bank's capital surplus equals the amount of its stated capital attributable to its common stock. Moreover, the KOFI Commissioner must approve the declaration of dividends if the total dividends to be declared by a bank for any calendar year would exceed the bank's total net profits for such year combined with its retained net profits for the preceding two years, less any required transfers to surplus or a fund for the retirement of preferred stock or debt. We are also subject to the Kentucky Business Corporation Act, which generally prohibits dividends to the extent they result in the insolvency of the corporation from a balance sheet perspective or if becoming unable to pay debts as they come due.

Consumer Protection Laws. We are subject to a number of federal and state laws designed to protect borrowers and promote lending to various sectors of the economy and population. These laws include the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Truth in Lending Act, the Home Mortgage Disclosure Act, and the Real Estate Settlement Procedures Act, and state law counterparts.

Federal law currently contains extensive customer privacy protections provisions. Under these provisions, a financial institution must provide to its customers, at the inception of the customer relationship and annually thereafter, the institution's policies and procedures regarding the handling of customers' nonpublic personal financial information. These provisions also provide that, except for certain limited exceptions, an institution may not provide such personal information to unaffiliated third parties unless the institution discloses to the customer that such information may be so provided and the customer is given the opportunity to opt out of such disclosure. Federal law makes it a criminal offense, except in limited circumstances, to obtain or attempt to obtain customer information of a financial nature by fraudulent or deceptive means.

The Community Reinvestment Act ("CRA") requires the FDIC to assess our record in meeting the credit needs of the communities we serve, including low- and moderate-income neighborhoods and persons. The FDIC's assessment of our record is made available to the public. The assessment also is part of the Federal Reserve Board's consideration of applications to acquire, merge or consolidate with another banking institution or its holding company, to establish a new branch office or to relocate an office. The Federal Reserve Board will also assess the CRA record of the subsidiary banks of a bank

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holding company in its consideration of any application to acquire a bank or other bank holding company, which may be the basis for denying the application.

Bank Secrecy Act. The Bank Secrecy Act of 1970 ("BSA") was enacted to deter money laundering, establish regulatory reporting standards for currency transactions and improve detection and investigation of criminal, tax and other regulatory violations. BSA and subsequent laws and regulations require us to take steps to prevent the use of the Bank in the flow of illegal or illicit money, including, without limitation, ensuring effective management oversight, establishing sound policies and procedures, developing effective monitoring and reporting capabilities, ensuring adequate training and establishing a comprehensive internal audit of BSA compliance activities.

In recent years, federal regulators have increased the attention paid to compliance with the provisions of BSA and related laws, with particular attention paid to "Know Your Customer" practices. Banks have been encouraged by regulators to enhance their identification procedures prior to accepting new customers in order to deter criminal elements from using the banking system to move and hide illegal and illicit activities.

USA Patriot Act. The USA PATRIOT Act of 2001 (the "Patriot Act") contains anti-money laundering measures affecting insured depository institutions, broker-dealers and certain other financial institutions. The Patriot Act requires financial institutions to implement policies and procedures to combat money laundering and the financing of terrorism, including standards for verifying customer identification at account opening, and rules to promote cooperation among financial institutions, regulators and law enforcement entities in identifying parties that may be involved in terrorism or money laundering. The Patriot Act also grants the Secretary of the Treasury broad authority to establish regulations and to impose requirements and restrictions on financial institutions' operations. In addition, the Patriot Act requires the federal bank regulatory agencies to consider the effectiveness of a financial institution's anti-money laundering activities when reviewing bank mergers and bank holding company acquisitions.

Federal Deposit Insurance Assessments. The deposits of our bank subsidiary are insured up to applicable limits by the Deposit Insurance Fund, or the DIF, of the FDIC and are subject to deposit insurance assessments to maintain the DIF. The FDIC utilizes a risk-based assessment system that imposes insurance premiums based upon a risk matrix that takes into account a bank's capital level and supervisory rating.

Effective January 1, 2007, the FDIC imposed deposit assessment rates based on the risk category of the bank subsidiary. Risk Category I is the lowest risk category while Risk Category IV is the highest risk category. Because of favorable loss experience and a healthy reserve ratio in the Bank Insurance Fund, or the BIF, of the FDIC, well-capitalized and well-managed banks, have in recent years paid minimal premiums for FDIC insurance. With the additional deposit insurance, a deposit premium refund, in the form of credit offsets, was granted to banks that were in existence on December 31, 1996 and paid deposit insurance premiums prior to that date. For 2007 and the first half of 2008, our subsidiary bank utilized the credits to offset a majority of its FDIC insurance assessment.

For 2007 and 2008, our subsidiary bank qualified for the best rating, Risk Category I. For banks under \$10 billion in total assets in Risk Category I, the 2007 and 2008 deposit assessment ranged from 5 to 7 basis points of total qualified deposits. The actual assessment is dependent upon certain risk measures as defined in the final rule.

On October 16, 2008, the FDIC published a restoration plan designed to replenish the Deposit Insurance Fund over a period of five years and to increase the deposit insurance reserve ratio, which decreased to 1.01% of insured deposits on June 30, 2008, to the statutory minimum of 1.15% of insured deposits by December 31, 2013. In order to implement the restoration plan, the FDIC proposes to change both its risk-based assessment system and its base assessment rates. For the first quarter of

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2009 only, the FDIC increased all FDIC deposit assessment rates by 7 basis points. These new rates range from 12 to 14 basis points for Risk Category I institutions to 50 basis points for Risk Category IV institutions.

Under the FDIC's restoration plan, the FDIC proposes to establish new initial base assessment rates that will be subject to adjustment as described below. Beginning April 1, 2009, the base assessment rates would range from 10 to 14 basis points for Risk Category I institutions to 45 basis points for Risk Category IV institutions.

Changes to the risk-based assessment system would include increasing premiums for institutions that rely on excessive amounts of brokered deposits, increasing premiums for excessive use of secured liabilities (including Federal Home Loan Bank advances), lowering premiums for smaller institutions with very high capital levels, and adding financial ratios and debt issuer ratings to the premium calculations for banks with over \$10 billion in assets, while providing a reduction for their unsecured debt.

Either an increase in the Risk Category of the Company's bank subsidiary or adjustments to the base assessment rates could result in a material increase in our expense for federal deposit insurance.

In addition, all institutions with deposits insured by the FDIC are required to pay assessments to fund interest payments on bonds issued by the Financing Corporation (FICO), a mixed-ownership government corporation established to recapitalize a predecessor to the Deposit Insurance Fund. The current annualized assessment rate is 1.14 basis points, or approximately .285 basis points per quarter. These assessments will continue until the Financing Corporation bonds mature in 2019.

Emergency Economic Stabilization Act. In October 2008, the Emergency Economic Stabilization Act of 2008 ("EESA") was enacted. The EESA authorizes the Treasury Department to purchase from financial institutions and their holding companies up to \$700 billion in mortgage loans, mortgage-related securities and certain other financial instruments, including debt and equity securities issued by financial institutions and their holding companies in a troubled asset relief program ("TARP"). The purpose of TARP is to restore confidence and stability to the U.S. banking system and to encourage financial institutions to increase their lending to customers and to each other. The Treasury Department has allocated \$250 billion towards the TARP Capital Purchase Program ("CPP"). Under the CPP, Treasury will purchase debt or equity securities from participating institutions. The TARP also is expected to include direct purchases or guarantees of troubled assets of financial institutions. Participants in the CPP are subject to executive compensation limits and are encouraged to expand their lending and mortgage loan modifications. For details regarding First Financial Service Corporation's sale of \$20 million of preferred stock to the Treasury Department through the CPP, see Item 8—Financial Statements and Supplementary Data.

EESA also increased FDIC deposit insurance on most accounts from \$100,000 to \$250,000. This increase is in place until December 31, 2009 and is not covered by deposit insurance premiums paid by the banking industry.

Temporary Liquidity Guarantee Program. The FDIC established a Temporary Liquidity Guarantee Program ("TLGP") on October 14, 2008. The TLGP includes the Transaction Account Guarantee Program ("TAGP"), which provides unlimited deposit insurance coverage through December 31, 2009 for noninterest-bearing transaction accounts (typically business checking accounts) and certain funds swept into noninterest-bearing savings accounts. Institutions participating in the TAGP pay a 10 basis points fee (annualized) on the balance of each covered account in excess of \$250,000, while the extra deposit insurance is in place. The TLGP also includes the Debt Guarantee Program ("DGP"), under which the FDIC guarantees certain senior unsecured debt of FDIC-insured institutions and their holding companies. The unsecured debt must be issued on or after October 14, 2008 and not later than October 31, 2009, and the guarantee is effective through the earlier of the maturity date or June 30,

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2012. The DGP coverage limit is generally 125% of the eligible entity's eligible debt outstanding on September 30, 2008 and scheduled to mature on or before June 30, 2009 or, for certain insured institutions, 2% of their liabilities as of September 30, 2008. Depending on the term of the debt maturity, the nonrefundable DGP fee ranges from 50 to 100 basis points (annualized) for covered debt outstanding until the earlier of maturity or June 30, 2012. The TAGP and DGP are in effect for all eligible entities, unless the entity opted out on or before December 5, 2008. First Financial Service Corporation's bank subsidiary elected to participate in the TAGP and both the bank subsidiary and the holding company are eligible to participate in DGP.

American Recovery and Reinvestment Act. On February 17, 2009, the American Recovery and Reinvestment Act of 2009 ("ARRA") was signed into law by President Obama. ARRA includes a wide variety of programs intended to stimulate the economy and provide for extensive infrastructure, energy, health, and education needs. In addition, ARRA imposes certain new executive compensation and corporate expenditure limits on all current and future CPP recipients, including First Financial Service Corporation, until the institution has repaid the Treasury. ARRA also permits CPP participants to redeem the preferred shares held by the Treasury Department without penalty and without the need to raise new capital, subject to the Treasury's consultation with the recipient's appropriate regulatory agency.

Available Information

The periodic reports that we file with the SEC are available at the SEC's website at <http://www.sec.gov>. Additionally, all reports we file with the SEC, plus ownership reports filed by our directors and executive officers and additional shareholder information is available free of charge on our website at <http://www.ffsbky.com>. We post these reports to our website as soon as reasonably practicable after filing them with the SEC.

ITEM 1A. Risk Factors

The risks identified below, as well as in the other cautionary statements made throughout this report, identify factors that could materially and adversely affect our business, future results of operations, and future cash flows.

Our business has been and may continue to be adversely affected by current conditions in the financial markets and by economic conditions generally.

The capital and credit markets have been experiencing unprecedented levels of volatility and disruption for more than a year. In some cases, the markets have produced downward pressure on stock prices and credit availability for certain issuers without regard to those issuers' underlying financial strength. Reduced consumer spending and the absence of liquidity in the global credit markets during the current recession have depressed business activity across a wide range of industries. Unemployment has also increased significantly.

A sustained weakness or weakening in business and economic conditions generally or specifically in our markets could have one or more of the following adverse effects on our business:

- A decrease in the demand for loans and other products and services that we offer;
- A decrease in the value of our loans held for sale or other assets secured by consumer or commercial real estate;
- An impairment of certain intangible assets, such as goodwill;
- An increase in the number of clients who become delinquent, file for protection under bankruptcy laws or default on their loans or other obligations to us.

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An increase in the number of delinquencies, bankruptcies or defaults could result in a higher level of nonperforming assets, net charge-offs, provision for loan losses, and valuation adjustments on loans held for sale.

Overall, during the past year, the general business environment has had an adverse effect on our business, and there can be no assurance that the environment will improve in the near term. Until conditions improve, we expect our businesses, financial condition and results of operations to be adversely affected.

Current market developments may adversely affect our industry, businesses and results of operations.

Since mid-2007, the financial services industry as a whole, as well as the securities markets generally, have been materially and adversely affected by very significant declines in the values of nearly all asset classes and by a very serious lack of liquidity. Financial institutions in particular have been subject to increased volatility and an overall loss in investor confidence. Concerns about the stability of the financial markets generally and the strength of counterparties have caused many lenders and institutional investors to reduce, and in some cases, cease to provide funding to borrowers including financial institutions.

The lack of available credit, loss of confidence in the financial sector, increased volatility in the financial markets and reduced business activity could materially and adversely affect our business, financial condition and results of operations. Further negative market developments may affect consumer confidence levels and may cause adverse changes in payment patterns, causing increases in delinquencies and default rates, which may impact our charge-offs and provisions for credit losses. A worsening of these conditions would likely exacerbate the adverse effects of these difficult market conditions on us and others in the financial services industry.

Our decisions regarding credit risk may not be accurate, and our allowance for loan losses may not be sufficient to cover actual losses, which could adversely affect our business, financial condition and results of operations.

We maintain an allowance for loan losses at a level we believe is adequate to absorb any inherent losses in our loan portfolio based on historical loan loss experience, specific problem loans, value of underlying collateral and other relevant factors. If our assessment of these factors is ultimately inaccurate, the allowance may not be sufficient to cover actual future loan losses, which would adversely affect our operating results. Our estimates are subjective and their accuracy depends on the outcome of future events. Changes in economic, operating and other conditions that are generally beyond our control, including changes in interest rates, could cause actual loan losses to increase significantly. In addition, bank regulatory agencies, as an integral part of their supervisory functions, periodically review the adequacy of our allowance for loan losses. Regulatory agencies may require us to increase our provision for loan losses or to recognize further loan charge-offs if their judgment differs from ours, which could have a material negative impact on our operating results.

A large percentage of our loans are collateralized by real estate, and an adverse change in the real estate market may result in losses and adversely affect our profitability.

Approximately 86.3% of our loan portfolio as of December 31, 2008 was comprised of loans collateralized by real estate. An adverse change in the economy affecting values of real estate generally or in our primary markets specifically could significantly impair the value of our collateral and our ability to sell the collateral upon foreclosure. The real estate collateral in each case provides an alternate source of repayment in the event of default by the borrower and may deteriorate in value during the time the credit is extended. If real estate values decline, it is also more likely that we would be required to increase our allowance for loan losses. If during a period of reduced real estate values

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we are required to liquidate the collateral securing a loan to satisfy the debt or to increase our allowance for loan losses, it could materially reduce our profitability and adversely affect our financial condition.

Our profitability depends significantly on local economic conditions.

Because most of our business activities are conducted in central Kentucky and adjacent counties of Indiana, and most of our credit exposure is in that region, we are at risk from adverse economic or business developments affecting this area, including declining regional and local business activity, a downturn in real estate values and agricultural activities and natural disasters. To the extent the central Kentucky economy declines, the rates of delinquencies, foreclosures, bankruptcies and losses in our loan portfolio would likely increase. Moreover, the value of real estate or other collateral that secures our loans could be adversely affected by economic downturn or a localized natural disaster. An economic downturn or other events that affect our markets could, therefore, result in losses that may materially and adversely affect our business, financial condition, results of operations and future prospects.

Our small to medium-sized business target market may have fewer resources to weather the downturn in the economy.

Our strategy includes lending to small and medium-sized businesses and other commercial enterprises. Small and medium-sized businesses frequently have smaller market shares than their competitors, may be more vulnerable to economic downturns, often need substantial additional capital to expand or compete and may experience substantial variations in operating results, any of which may impair a borrower's ability to repay a loan. In addition, the success of a small and medium-sized business often depends on the management talents and efforts of one or two persons or a small group of persons, and the death, disability or resignation of one or more of these persons could have a material adverse impact on the business and its ability to repay our loan. Economic downturns and other events could have a more pronounced negative impact on our target market, which could cause us to incur substantial credit losses that could materially harm our operating results.

Our profitability is vulnerable to fluctuations in interest rates.

Changes in interest rates could harm our financial condition or results of operations. Our results of operations depend substantially on net interest income, the difference between interest earned on interest-earning assets (such as investments and loans) and interest paid on interest-bearing liabilities (such as deposits and borrowings). Interest rates are highly sensitive to many factors, including governmental monetary policies and domestic and international economic and political conditions. Factors beyond our control, such as inflation, recession, unemployment, and money supply may also affect interest rates. If our interest-earning assets mature or reprice more quickly than our interest-bearing liabilities in a given period, as a result of decreasing interest rates, our net interest income may decrease. Likewise, our net interest income may decrease if interest-bearing liabilities mature or reprice more quickly than interest-earning assets in a given period as a result of increasing interest rates.

Fixed-rate loans increase our exposure to interest rate risk in a rising rate environment because interest-bearing liabilities would be subject to repricing before assets become subject to repricing. Adjustable-rate loans decrease the risk associated with changes in interest rates but involve other risks, such as the inability of borrowers to make higher payments in an increasing interest rate environment. At the same time, for secured loans, the marketability of the underlying collateral may be adversely affected by higher interest rates. In a declining interest rate environment, there may be an increase in prepayments on loans as the borrowers refinance their loans at lower interest rates, which could reduce net interest income and harm our results of operations.

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We may need to raise additional capital in the future, but that capital may not be available when needed or at all.

We may need to raise additional capital in the future to provide us with sufficient capital resources and liquidity to meet our commitments and business needs. Our ability to raise additional capital, if needed, will depend on, among other things, conditions in the capital markets at that time, which are outside of our control, and our financial performance. We cannot assure you that capital will be available to us on acceptable terms or at all. An inability to raise additional capital on acceptable terms when needed could have a materially adverse effect on our businesses, financial condition and results of operations.

If we cannot borrow funds through access to the capital markets, we may not be able to meet the cash flow requirements of our depositors and borrowers, or meet the operating cash needs of the Corporation to fund corporate expansion or other activities.

Our liquidity policies and limits are established by the Board of Directors, with operating limits set by the Asset Liability Committee ("ALCO"), based upon analyses of the ratio of loans to deposits, the percentage of assets funded with non-core or wholesale funding. The ALCO regularly monitors the overall liquidity position of the Bank and the Corporation to ensure that various alternative strategies exist to cover unanticipated events that could affect liquidity. Liquidity is the ability to meet cash flow needs on a timely basis at a reasonable cost. If our liquidity policies and strategies don't work as well as intended, then we may be unable to make loans and to repay deposit liabilities as they become due or are demanded by customers. The ALCO follows established board approved policies and monitors guidelines to diversify our wholesale funding sources to avoid concentrations in any one-market source. Wholesale funding sources include Federal funds purchased, securities sold under repurchase agreements, non-core brokered deposits, and medium and long-term debt, which includes Federal Home Loan Bank ("FHLB") advances that are collateralized with mortgage-related assets.

We maintain a portfolio of securities that can be used as a secondary source of liquidity. There are other available sources of liquidity, including the sale or securitization of loans, the ability to acquire additional non-core brokered deposits, additional collateralized borrowings such as FHLB advances, the issuance of debt securities, and the issuance of preferred or common securities in public or private transactions. If we were unable to access any of these funding sources when needed, we might not be able to meet the needs of our customers, which could adversely impact our financial condition, our results of operations, cash flows, and our level of regulatory-qualifying capital. For further discussion, see the "Liquidity" section of Management's Discussion and Analysis of Financial Condition and Results of Operations.

We face strong competition from other financial institutions and financial service companies, which could adversely affect our results of operations and financial condition.

We compete with other financial institutions in attracting deposits and making loans. Our competition in attracting deposits comes principally from commercial banks, credit unions, savings and loan associations, securities brokerage firms, insurance companies, money market funds and other mutual funds. Our competition in making loans comes principally from in the Louisville metropolitan area has grown in recent years as changes in banking law have allowed several banks to enter the market by establishing new branches. Likewise, competition is increasing in our other markets, which may adversely affect our ability to maintain our market share.

Competition in the banking industry may also limit our ability to attract and retain banking clients. We maintain smaller staffs of associates and have fewer financial and other resources than larger institutions with which we compete. Financial institutions that have far greater resources and greater efficiencies than we do may have several marketplace advantages resulting from their ability to:

- offer higher interest rates on deposits and lower interest rates on loans than we can;

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- offer a broader range of services than we do;
- maintain numerous branch locations; and
- mount extensive promotional and advertising campaigns.

In addition, banks and other financial institutions with larger capitalization and other financial intermediaries may not be subject to the same regulatory restrictions as we are and may have larger lending limits than we do. Some of our current commercial banking clients may seek alternative banking sources as they develop needs for credit facilities larger than we can accommodate. If we are unable to attract and retain customers, we may not be able to maintain growth and our results of operations and financial condition may otherwise be negatively impacted.

While management continually monitors and improves our system of internal controls, data processing systems, and corporate wide processes and procedures, there can be no assurance that we will not suffer losses from operational risk in the future.

Management maintains internal operational controls and we have invested in technology to help us process large volumes of transactions. However, there can be no assurance that we will be able to continue processing at the same or higher levels of transactions. If our systems of internal controls should fail to work as expected, if our systems were to be used in an unauthorized manner, or if employees were to subvert the system of internal controls, significant losses could occur.

We process large volumes of transactions on a daily basis and are exposed to numerous types of operation risk, which could cause us to incur substantial losses. Operational risk resulting from inadequate or failed internal processes, people, and systems includes the risk of fraud by employees or persons outside of our company, the execution of unauthorized transactions by employees, errors relating to transaction processing and systems, and breaches of the internal control system and compliance requirements. This risk of loss also includes potential legal actions that could arise as a result of the operational deficiency or as a result of noncompliance with applicable regulatory standards.

We establish and maintain systems of internal operational controls that provide management with timely and accurate information about our level of operational risk. While not foolproof, these systems have been designed to manage operational risk at appropriate, cost effective levels. We have also established procedures that are designed to ensure that policies relating to conduct, ethics, and business practices are followed. Nevertheless, we experience loss from operational risk from time to time, including the effects of operational errors, and these losses may be substantial.

We operate in a highly regulated environment and, as a result, are subject to extensive regulation and supervision that could adversely affect our financial performance and our ability to implement our growth and operating strategies.

We are subject to examination, supervision and comprehensive regulation by federal and state regulatory agencies, which is describer under "Item 1 Business—Regulation." Regulatory oversight of banks is primarily intended to protect depositors, the federal deposit insurance funds, and the banking system as a whole, not our shareholders. Compliance with these regulations is costly and may make it more difficult to operate profitably.

Federal and state banking laws and regulations govern numerous matters including the payment of dividends, the acquisition of other banks and the establishment of new banking offices. We must also meet specific regulatory capital requirements. Our failure to comply with these laws, regulations and policies or to maintain our capital requirements could affect our ability to pay dividends on common stock, our ability to grow through the development of new offices and our ability to make acquisitions. These limitations may prevent us from successfully implementing our growth and operating strategies.

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In addition, the laws and regulations applicable to banks could change at any time, which could significantly impact our business and profitability. For example, new legislation or regulation could limit the manner in which we may conduct our business, including our ability to attract deposits and make loans. Events that may not have a direct impact on us, such as the bankruptcy or insolvency of a prominent U.S. corporation, can cause legislators and banking regulators and other agencies such as the Financial Accounting Standards Board, the SEC, the Public Company Accounting Oversight Board and various taxing authorities to respond by adopting and or proposing substantive revisions to laws, regulations, rules, standards, policies, and interpretations. The nature, extent, and timing of the adoption of significant new laws and regulations, or changes in or repeal of existing laws and regulations may have a material impact on our business and results of operations. Changes in regulation may cause us to devote substantial additional financial resources and management time to compliance, which may negatively affect our operating results.

Our issuance of securities to the US Department of the Treasury may limit our ability to return capital to our shareholders and is dilutive to our common shares. In addition, the dividend rate increases substantially after five years if we cannot redeem the shares by that time.

On January 9, 2009, as part of the Capital Purchase Program established by the U.S. Department of the Treasury under the Emergency Economic Stabilization Act of 2008 ("EESA"), we sold \$20 million of senior preferred stock to the Department of the Treasury. We also issued the Department of the Treasury a warrant to purchase approximately 216,000 shares of our common stock at \$13.89 per share. The terms of the transaction with the Department of the Treasury limit our ability to pay dividends and repurchase our shares. For three years after issuance or until the Department of the Treasury no longer holds any preferred shares, we will not be able to increase our dividends above the most recent level before October 14, 2008 (\$.19 per common share on a quarterly basis) nor repurchase any of our shares without the Department of the Treasury's approval with limited exceptions, most significantly purchases in connection with benefit plans. Also, we will not be able to pay any dividends at all unless we are current on our dividend payments on the preferred shares. These restrictions, as well as the dilutive impact of the warrant, may have an adverse effect on the market price of our common stock.

Unless we are able to redeem the preferred stock during the first five years, the dividends on this capital will increase substantially at that point, from 5% (approximately \$1 million annually) to 9% (approximately \$1.8 million annually). Depending on market conditions and our financial performance at the time, this increase in dividends could significantly impact our capital and liquidity.

The US Department of the Treasury has the unilateral ability to change some of the restrictions imposed on us by virtue of our sale of securities to it.

Our agreement with the US Department of the Treasury under which it purchased our securities imposes restrictions on our conduct of our business, including restrictions related to our payment of dividends and repurchase of our stock and related to our executive compensation and governance. The US Department of the Treasury has the right under this agreement to unilaterally amend it to the extent required to comply with any future changes in federal statutes. The American Recovery and Reinvestment Act of 2009 amended provisions of EESA relating to compensation and governance as they affect companies that have sold securities to the US Department of the Treasury. In some cases, these amendments require action by the US Department of the Treasury to implement them. These amendments could have an adverse impact on the conduct of our business, as could additional amendments in the future that impose further requirements or amend existing requirements.

ITEM 1B. Unresolved Staff Comments

We have no unresolved SEC staff comments.

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Our executive offices and principal support are located at 2323 Ring Road in Elizabethtown, Kentucky. Our operational functions are located at 2323 Ring Road and 101 Financial Place in Elizabethtown, Kentucky. All of our banking centers are located in Kentucky and Southern Indiana. The location of our 20 full-service banking centers, an operations building and a commercial private banking center, whether owned or leased, and their respective approximate square footage is described in the following table.

	OWNED OR LEASED	APPROXIMATE SQUARE FOOTAGE
<u>BANKING CENTERS IN KENTUCKY</u>		
ELIZABETHTOWN		
2323 Ring Road	Owned	57,295
325 West Dixie Avenue	Owned	5,880
2101 North Dixie Avenue	Owned	3,150
101 Financial Place	Owned	20,619
RADCLIFF		
475 West Lincoln Trail	Owned	2,728
BARDSTOWN		
401 East John Rowan Blvd.	Leased	4,500
315 North Third Street	Owned	1,271
MUNFORDVILLE		
925 Main Street	Owned	2,928
SHEPHERDSVILLE		
395 N. Buckman Street	Owned	7,600
1707 Cedar Grove Road, Suite 1	Leased	3,425
MT. WASHINGTON		
279 Bardstown Road	Owned	6,310
BRANDENBURG		
416 East Broadway	Leased	4,395
50 Old Mill Road	Leased	575
FLAHERTY		
4055 Flaherty Road	Leased	1,216
LOUISVILLE		
11810 Interchange Drive	Owned	4,675
3650 South Hurstbourne Parkway	Owned	4,428
12629 Taylorsville Road	Leased	3,479
4965 U.S. Highway 42, Suite 2100	Leased	2,035
<u>BANKING CENTERS IN INDIANA</u>		
CORYDON		
2030 Hwy 337 NW	Leased	2,000
ELIZABETH		
8160 Beech Street NE	Owned	2,442
GEORGETOWN		
6500 State Road 64	Owned	3,536
LANESVILLE		

7340 Main Street

Owned

4,230

21

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ITEM 3. Legal Proceedings

Although, from time to time, we are involved in various legal proceedings in the normal course of business, there are no material pending legal proceedings to which we are a party, or to which any of our property is subject.

ITEM 4. Submission of Matters to a Vote of Security Holders

There were no matters submitted for shareholder approval during the fourth quarter of 2008.

[Table of Contents](#)**PART II****ITEM 5. Market Price of and Dividends on the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities****(a) Market Information**

Our common stock is traded on the Nasdaq Global Market ("NASDAQ") under the symbol "FFKY". The following table shows the high and low closing prices of our Common Stock and the dividends paid.

	<u>Quarter Ended</u>			
	<u>3/31</u>	<u>6/30</u>	<u>9/30</u>	<u>12/31</u>
2008:				
High	\$24.42	\$23.96	\$21.00	\$20.50
Low	20.88	18.14	15.83	10.25
Cash dividends	0.190	0.190	0.190	0.190
	<u>3/31</u>	<u>6/30</u>	<u>9/30</u>	<u>12/31</u>
2007:(1)				
High	\$29.05	\$26.37	\$29.49	\$27.75
Low	25.68	25.36	23.64	21.53
Cash dividends	0.173	0.173	0.190	0.190

(1) Adjusted to reflect the impact of stock dividends declared August 16, 2007.

(b) Holders

At December 31, 2008, the number of shareholders was approximately 1,095.

(c) Dividends

It is currently the policy of our Board of Directors to continue to pay quarterly dividends, but any future dividends are subject to the Board's discretion based on its consideration of the our operating results, financial condition, capital, income tax considerations, regulatory restrictions and other factors. Under our agreement with the Treasury Department, until the earlier of January 9, 2012 or until we redeem all of the preferred shares sold under the CPP, we will not be able to increase our dividends above the most recent level (\$.19 per common share on a quarterly basis).

(d) Securities Authorized for Issuance Under Equity Compensation Plans

The following table summarizes the securities authorized for issuance under our equity compensation plans as of December 31, 2008. We have no equity compensation plans that have not been approved by our shareholders.

<u>Plan category</u>	<u>Number of securities to be issued upon exercise of outstanding options, warrants and rights</u>	<u>Weighted-average exercise price of outstanding options, warrants and rights</u>	<u>Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column(1))</u>
Equity compensation plans approved by security holders	208,517	\$ 19.19	590,750

See Note 14 of the Notes to Consolidated Financial Statements for additional information required by this item.

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We did not repurchase any shares of our common stock during the quarter ended December 31, 2008.

ITEM 6. Selected Consolidated Financial and Other Data

	At December 31,			
	2008	2007	2006	2005
Financial Condition Data:				
Total assets	\$1,017,047	\$872,691	\$822,826	\$766,513
Net loans outstanding(1)	899,436	760,114	698,026	635,740
Investments	22,797	39,685	52,447	61,555
Deposits	775,399	689,243	641,037	591,106
Borrowings	165,816	105,883	106,724	107,875
Stockholders' equity	72,952	73,460	72,098	64,741
Number of:				
Real estate loans outstanding	13,170	11,258	11,015	10,130
Deposit accounts	62,810	55,106	53,165	50,790
Offices	20	15	14	14
Full time equivalent employees	316	284	270	254
	Year Ended December 31,			
	2008	2007	2006	2005
Operations Data:				
Interest income	\$57,564	\$60,545	\$53,832	\$45,368
Interest expense	24,799	29,751	24,108	17,862
Net interest income	32,765	30,794	29,724	27,506
Provision for loan losses	5,947	1,209	540	1,258
Non-interest income	8,449	8,203	7,739	8,067
Non-interest expense	28,286	23,790	21,952	20,759
Income tax expense	2,184	4,646	4,634	4,412
Net income	4,797	9,352	10,337	9,144
Earnings per share:(2)				
Basic	\$ 1.03	\$ 1.98	\$ 2.14	\$ 1.89
Diluted	1.02	1.96	2.12	1.88
Book value per share(2)	15.63	15.76	14.95	13.43
Dividends paid per share(2)	0.76	0.73	0.66	0.59
Dividend payout ratio	74%	37%	31%	31%
Return on average assets	0.51%	1.10%	1.31%	1.22%
Average equity to average assets	8.02%	8.54%	8.71%	8.33%
Return on average equity	6.37%	12.88%	15.03%	14.60%
Efficiency ratio	69%	61%	59%	58%

(1) Includes loans held for sale.

(2) Amounts adjusted to reflect 10% stock dividends declared September 20, 2005, August 15, 2006, and August 16, 2007.

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ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Management's Discussion and Analysis of Financial Condition and Results of Operations analyzes the major elements of our balance sheets and statements of income. This section should be read in conjunction with our Consolidated Financial Statements and accompanying Notes and other detailed information.

OVERVIEW

We operate 21 banking centers in eight contiguous counties in Central Kentucky along the Interstate 65 corridor and the Louisville Metropolitan area, including Southern Indiana. Our markets range from the major metropolitan area of Louisville in Jefferson County, Kentucky approximately 40 miles north of our headquarters in Elizabethtown, Kentucky to Hart County, Kentucky, approximately 30 miles south of Elizabethtown to Harrison County, Indiana approximately 60 miles northwest of our headquarters. Our core markets have experienced a growth rate of 14% in deposits for the past three years. Based on the current economic slow-down, management anticipates that our markets may not continue to grow at a similar rate experienced over the last few years. However, we believe we will still be well positioned to benefit from growth in our local markets when the economy rebounds in the future.

During the second quarter of 2008, we completed the acquisition of FSB Bancshares, Inc. and its wholly owned subsidiary, The Farmers State Bank. The Farmers State Bank had approximately \$65.7 million in total assets and \$55.8 million in deposits with offices in Harrison and Floyd County, Indiana. These counties are adjacent to four of our Kentucky counties and are part of the Louisville MSA. The acquisition is anticipated to be accretive to our earnings during the first full year of the combined operations.

During the third quarter, we opened our twentieth full-service banking center, which expanded our current footprint in Bullitt County, Kentucky. The Cedar Grove Banking Center complements our existing branches located in Shepherdsville and Mt. Washington, Kentucky. We will continue our expansion efforts in 2009 with two additional banking centers under development. One will be in Hardin County, Kentucky located at the entrance to the Fort Knox military base. The other will be our fourth site in Louisville, Kentucky and located in the Middletown area.

Over the past several years we have focused on enhancing and expanding our retail and commercial banking network in our core markets as well as establishing our presence in the Louisville market. Our core markets, where we have a combined 23% market share, have become increasingly competitive as several new banks have entered those markets during the past few years. In order to protect and grow our market share, we are replacing existing branches with newer, enhanced facilities and anticipate constructing several new facilities over the next few years. In addition to the enhancement and expansion in our core markets, we have been increasing our presence in the Louisville market. Our acquisition of FSB Bancshares, Inc. has broadened our retail branch network in the Louisville market, which now extends into Southern Indiana. Approximately 73% of the deposit base in the Louisville market is controlled by six out-of-state banks. While the market is very competitive, we believe this creates an opportunity for smaller community banks with more power to make decisions locally. We believe our investment in these initiatives along with our continued commitment to a high level of customer service will enhance our market share in our core markets and our development in the Louisville market.

Our retail branch network continues to generate encouraging results. Total deposits have grown 31% over the past three years. Total deposits were \$775.4 million at December 31, 2008, an increase of \$86.2 million from December 31, 2007. The continued development of the retail branch network into the Louisville market also yielded positive results. We have a combined \$60.7 million in deposits in our three full-service banking centers in the Louisville market. We opened two of these facilities in the

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second quarter of 2004 to support our growing customer base in this market. In June 2007 we opened our third new full service banking center in Louisville. Additional sites within the Louisville market are under development with our fourth location scheduled to open in the second quarter of 2009. Competition for deposits continues to be challenging in all of the markets we serve. This intense competition and actions by the FOMC could add to additional margin compression as the interest rate environment continues to be volatile.

We have developed a strong commercial real estate niche in our markets. We have an experienced team of bankers who are focused on providing service and convenience to our customers. It is quite common for our bankers to close loans at a customer's place of business or even the customer's personal residence. This high level of service has been especially well received in our Louisville market, which is dominated by regional banks. Currently, 27% of our loan portfolio resides in the Louisville market. To further develop our commercial banking relationships in Louisville, we opened a private banking office in April 2007. This office is an upscale facility complementing our full service centers in Louisville allowing us to further attract commercial deposit relationships in conjunction with our commercial lending relationships.

This emphasis on commercial lending generated 42% growth in the total loan portfolio and 58% growth in commercial loans over the past three years. Commercial loans were \$637.6 million at December 31, 2008, an increase of \$92.7 million, or 17% from December 31, 2007.

Although we had substantial growth in the loan portfolio during the year, credit quality remained challenging in 2008. There was a significant migration of loans into the Special Mention and Substandard loan categories during the second half of the year resulting in higher provision for loan losses. At December 31, 2008, the allowance for loan losses was \$13.6 million compared to \$7.9 million at December 31, 2007. Allowance for loan loss to total loans increased to 1.50% at December 31, 2008 compared to 1.03% at December 31, 2007. The allowance for loan losses to non-performing loans fell to 81% from 89% at December 31, 2008 compared to December 31, 2007.

Despite the continued deterioration in economic conditions during the fourth quarter, the Corporation's capital position remained well-capitalized as defined by regulatory standards. Our capital position was further bolstered in the first quarter of 2009 by our participation in the U.S. Treasury Department Capital Purchase Program. Under the Capital Purchase Program, we sold \$20 million of cumulative perpetual preferred shares to the U.S. Treasury in a transaction that closed on January 9, 2009.

It is our belief that the economy is in a very deep and long lasting recession. During the last quarter of 2008, the continued economic slowdown moved to sectors not previously impacted including consumer, commercial, industrial among others. Credit issues are broadening in these sectors and economic recovery is most likely several quarters away. We will continue to monitor credit quality very closely in 2009 as this recession persists. As the economy and the financial sector continue to struggle, probable losses in the loan portfolio could increase, resulting in higher provision for loan losses during 2009.

Subsequent Development

On January 9, 2009, we sold \$20 million of cumulative perpetual preferred shares, with a liquidation preference of \$1,000 per share (the "Senior Preferred Shares") to the U.S. Treasury under the terms of its Capital Purchase Plan. Pursuant to CPP, the U.S. Treasury will purchase up to \$250 billion of senior preferred shares on standardized terms from qualifying financial institutions as part of the Troubled Asset Relief Program authorized by the Emergency Economic Stabilization Act of 2008. The Senior Preferred Shares constitute Tier 1 capital and rank senior to our common shares. The Senior Preferred Shares pay cumulative dividends at a rate of 5% per annum for the first five years and will reset to a rate of 9% per annum after five years.

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Under the terms of the CPP stock purchase agreement, we also issued the U.S. Treasury a warrant to purchase an amount of our common stock equal to 15% of the aggregate amount of the Senior Preferred Shares, or \$3 million. The warrant entitles the U.S. Treasury to purchase 215,983 common shares at a purchase price of \$13.89 per share. The initial exercise price for the warrant and the number of shares subject to the warrant were determined by reference to the market price of our common stock calculated on a 20-day trailing average as of December 8, 2008, the date the U.S. Treasury approved our application. The warrant has a term of 10 years.

The CPP is voluntary and requires a participating institution to comply with a number of restrictions and provisions, including standards for executive compensation and corporate governance and limitations on share repurchases and the declaration and payment of dividends on common shares. The standard terms of the CPP provide that a participating financial institution may not (without the consent of the U.S. Treasury) pay regular quarterly dividends in an amount greater than the most recent quarterly dividend paid before October 14, 2008, which is \$0.19 per share in our case. This dividend limitation will remain in effect for the earlier of three years or until such time that the preferred shares are redeemed.

CRITICAL ACCOUNTING POLICIES

Our accounting and reporting policies comply with U.S. generally accepted accounting principles and conform to general practices within the banking industry. The accounting policy relating to the allowance for loan losses is critical to the understanding of our results of operations since the application of this policy requires significant management assumptions and estimates that could result in materially different amounts to be reported if conditions or underlying circumstances were to change.

Allowance for Loan Losses—We maintain an allowance sufficient to absorb probable incurred credit losses existing in the loan portfolio. Our Allowance for Loan Loss Review Committee, which is comprised of senior officers, evaluates the allowance for loan losses on a quarterly basis. We estimate the allowance using past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of the underlying collateral, and current economic conditions. While we estimate the allowance for loan losses based in part on historical losses within each loan category, estimates for losses within the commercial real estate portfolio are more dependent upon credit analysis and recent payment performance. Allocations of the allowance may be made for specific loans or loan categories, but the entire allowance is available for any loan that, in management's judgment, should be charged off.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired or loans otherwise classified as substandard or doubtful. The general component covers non-classified loans and is based on historical loss experience adjusted for current factors. Allowance estimates are developed with actual loss experience adjusted for current economic conditions. Allowance estimates are considered a prudent measurement of the risk in the loan portfolio and are applied to individual loans based on loan type.

Based on our calculation, an allowance of \$13.6 million or 1.50% of total loans was our estimate of probable losses within the loan portfolio as of December 31, 2008. This estimate resulted in a provision for loan losses on the income statement of \$5.9 million for the 2008 period. If the mix and amount of future charge off percentages differ significantly from those assumptions used by management in making its determination, the allowance for loan losses and provision for loan losses on the income statement could be materially increased.

Goodwill and Other Intangible Assets—Costs in excess of the estimated fair value of identified assets acquired through purchase transactions are recorded as an asset. As per Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets", an annual impairment analysis

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is required to be performed to determine if the asset is impaired and needs to be written down to its fair value. This assessment is conducted annually or more frequently if conditions warrant. Per the December 31, 2008 analysis, no impairment was identified as a result of these tests. In making these impairment analyses, management must make subjective assumptions regarding the fair value of our assets and liabilities. It is possible that these judgments may change over time as market conditions or our strategies change, and these changes may cause us to record impairment changes to adjust the goodwill to its estimated fair value.

Impairment of Investment Securities—All unrealized losses are reviewed to determine whether the losses are other-than-temporary. Investment securities are evaluated for other-than-temporary impairment on at least a quarterly basis and more frequently when economic or market conditions warrant such an evaluation to determine whether a decline in their value below amortized cost is other-than-temporary. We evaluate a number of factors including, but not limited to: valuation estimates provided by investment brokers; how much fair value has declined below amortized cost; how long the decline in fair value has existed; the financial condition of the issuer; significant rating agency changes on the issuer; and management's intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.

The term "other-than-temporary" is not intended to indicate that the decline is permanent, but indicates that the possibility for a near-term recovery of value is not necessarily favorable, or that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Once a decline in value is determined to be other than temporary, the cost basis of the security is written down to fair value and a corresponding charge to earnings is recognized.

RESULTS OF OPERATION

Net income for the period ended December 31, 2008 was \$4.8 million or \$1.02 per share diluted compared to \$9.4 million or \$1.96 per share diluted for the same period in 2007. Earnings decreased for 2008 compared to 2007 due to a decrease in our net interest margin, an increase in provision for loan loss expense, a higher level of non-interest expense related to our expansion efforts, a write down taken on investment securities that were other-than-temporarily impaired and a write down on real estate acquired through foreclosure. Our book value per common share decreased from \$15.76 at December 31, 2007 to \$15.63 at December 31, 2008. Net income for 2008 generated a return on average assets of 0.51% and a return on average equity of 6.37%. These compare with a return on average assets of 1.10% and a return on average equity of 12.88% for the 2007 period.

Net income for the period ended December 31, 2007 was \$9.4 million or \$1.96 per share diluted compared to \$10.3 million or \$2.12 per share diluted for the same period in 2006. Earnings decreased for 2007 compared to 2006 due to a decrease in our net interest margin, an increase in provision for loan loss expense and a higher level of non-interest expense related to our expansion efforts. Our book value per common share increased from \$14.95 at December 31, 2006 to \$15.76 at December 31, 2007. Net income for 2007 generated a return on average assets of 1.10% and a return on average equity of 12.88%. These compare with a return on average assets of 1.31% and a return on average equity of 15.03% for the 2006 period.

Net Interest Income—The principal source of our revenue is net interest income. Net interest income is the difference between interest income on interest-earning assets, such as loans and securities and the interest expense on liabilities used to fund those assets, such as interest-bearing deposits and borrowings. Net interest income is affected by both changes in the amount and composition of interest-earning assets and interest-bearing liabilities as well as changes in market interest rates.

The growth in our commercial loan portfolio has increased net interest income. The increase in the volume of interest earning assets increased net interest income by \$2.0 million for 2008 compared to a year ago. Average interest earning assets increased \$75.7 million for 2008 compared to 2007.

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Despite the increase in interest earning assets, our net interest margin realized a modest decline of eleven basis points. The yield on earning assets averaged 6.63% for 2008 compared to an average yield on earning assets of 7.63% for the same period in 2007. This decrease was offset by a decrease in our cost of funds. Net interest margin as a percent of average earning assets decreased to 3.78% for 2008 compared to 3.89% for the 2007 period.

Our cost of funds averaged 3.10% for the 2008 period compared to an average cost of funds of 4.10% for the same period in 2007. Going forward, our cost of funds is expected to continue to decrease as certificates of deposit re-price and roll off into new certificates of deposit at lower interest rates.

Our net interest margin is likely to compress in future quarters as a result of the Federal Open Market Committee (FOMC) decreasing the Federal Funds rate by 500 basis points since September 2007. The current Federal Funds rate is a range of 0.00% to 0.25%. Correspondingly, variable rate loans that are tied to the federal prime rate are immediately re-priced downward with these rate cuts. However, interest rates paid on customer deposits, which are priced off of the London Interbank Offering Rate (LIBOR), have not adjusted downward proportionately with the declining interest yields on loans and investments. LIBOR, which is a market driven rate, did not decline in rate as much as the prime rate. Therefore, we do not expect our deposit costs to decline as fast as our yield on loans. Sixty percent of deposits are time deposits that re-price over a longer period of time. This difference in the timing of the repricing of our assets and deposits is expected to continue to lower our net interest margin.

Comparative information regarding net interest income follows:

(Dollars in thousands)	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2008/2007</u> <u>Change</u>	<u>2007/2006</u> <u>Change</u>
Net interest income, tax equivalent basis	\$ 32,970	\$ 31,009	\$ 29,879	6.3%	3.8%
Net interest spread	3.53%	3.53%	3.72%	—bp	(19)bp
Net interest margin	3.78%	3.89%	4.04%	(11)bp	(15)bp
Average earnings assets	\$871,940	\$796,275	\$739,215	9.5%	7.7%
Prime rate at year end	3.25%	7.25%	8.25%	(400)bp	(100)bp
Average prime rate	5.09%	8.05%	7.98%	(296)bp	7bp

bp = basis point = 1/100th of a percent

Prime rate is included above to provide a general indication of the interest rate environment in which we operate. A large portion of our variable rate loans were indexed to the prime rate and re-price as the prime rate changes, unless they reach a contractual floor or ceiling.

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The following table provides information relating to our average balance sheet and reflects the average yield on assets and average cost of liabilities for the indicated periods. Yields and costs for the periods presented are derived by dividing income or expense by the average monthly balance of assets or liabilities, respectively.

(Dollars in thousands)	Year Ended December 31,								
	2008			2007			2006		
	Average Balance	Average Interest	Average Yield/Cost	Average Balance	Average Interest	Average Yield/Cost	Average Balance	Average Interest	Average Yield/Cost
ASSETS									
Interest earning assets:									
U.S. Treasury and agencies	\$ 6,469	\$ 257	3.97%	\$ 18,147	\$ 651	3.59%	\$ 27,823	\$ 891	3.20%
Mortgage-backed securities	9,006	390	4.33%	11,993	517	4.31%	14,832	631	4.25%
Equity securities	1,543	67	4.34%	2,036	75	3.68%	1,974	73	3.70%
State and political subdivision securities(1)	9,426	600	6.37%	9,935	633	6.37%	7,134	459	6.43%
Corporate bonds	2,533	159	6.28%	4,358	307	7.04%	6,047	413	6.83%
Loans(2)(3)(4)	830,748	55,739	6.71%	741,274	58,019	7.83%	667,793	50,803	7.61%
FHLB stock	8,116	423	5.21%	7,621	503	6.60%	7,351	427	5.81%
Interest bearing deposits	4,099	134	3.27%	911	55	6.04%	6,261	290	4.63%
Total interest earning assets	871,940	57,769	6.63%	796,275	60,760	7.63%	739,215	53,987	7.30%
Less: Allowance for loan losses	(9,114)			(7,966)			(7,456)		
Non-interest earning assets	76,343			61,912			57,227		
Total assets	\$ 939,169			\$ 850,221			\$ 788,986		
LIABILITIES AND STOCKHOLDERS' EQUITY									
Interest bearing liabilities:									
Savings accounts	\$ 106,901	\$ 1,666	1.56%	\$ 96,221	\$ 3,017	3.14%	\$ 91,418	\$ 2,542	2.78%
NOW and money market accounts	136,796	1,307	0.96%	123,408	2,166	1.76%	129,063	2,061	1.60%
Certificates of deposit and other time deposits	444,718	17,539	3.94%	424,603	20,336	4.79%	352,364	14,085	4.00%
Short-term borrowings	44,454	896	2.02%	36,782	1,935	5.26%	35,826	1,904	5.31%
FHLB advances	53,009	2,413	4.55%	34,732	1,580	4.55%	54,503	2,621	4.81%
Subordinated debentures	14,667	978	6.67%	10,000	717	7.17%	10,000	895	8.95%
Total interest bearing liabilities	800,545	24,799	3.10%	725,746	29,751	4.10%	673,174	24,108	3.58%
Non-interest bearing liabilities:									
Non-interest bearing deposits	57,962			46,343			42,289		
Other liabilities	5,349			5,508			4,768		
Total liabilities	863,856			777,597			720,231		
Stockholders' equity	75,313			72,624			68,755		
Total liabilities and stockholders' equity	\$ 939,169			\$ 850,221			\$ 788,986		
Net interest income		\$ 32,970			\$ 31,009			\$ 29,879	
Net interest spread			3.53%			3.53%			3.72%
Net interest margin			3.78%			3.89%			4.04%
Ratio of average interest earning assets to average interest bearing liabilities			108.92%			109.72%			109.81%

(1) Taxable equivalent yields are calculated assuming a 34% federal income tax rate.

(2) Includes loan fees, immaterial in amount, in both interest income and the calculation of yield on loans.

(3) Calculations include non-accruing loans in the average loan amounts outstanding.

(4) Includes loans held for sale.

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The table below provides information regarding changes in interest income and interest expense for the periods indicated. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to (1) changes in rate (changes in rate multiplied by old volume); (2) changes in volume (change in volume multiplied by old rate); and (3) changes in rate-volume (change in rate multiplied by change in volume). Changes in rate-volume are proportionately allocated between rate and volume variance.

(Dollars in thousands)	Year Ended December 31, 2008 vs. 2007			Year Ended December 31, 2007 vs. 2006		
	Increase (decrease) Due to change in			Increase (decrease) Due to change in		
	Rate	Volume	Net Change	Rate	Volume	Net Change
Interest income:						
U.S. Treasury and agencies	\$ 64	\$ (458)	\$ (394)	\$ 98	\$ (338)	\$ (240)
Mortgage-backed securities	2	(129)	(127)	8	(122)	(114)
Equity securities	12	(20)	(8)	—	2	2
State and political subdivision securities	(1)	(32)	(33)	(5)	179	174
Corporate bonds	(148)	—	(148)	(106)	—	(106)
Loans	(8,825)	6,545	(2,280)	1,498	5,718	7,216
FHLB stock	(111)	31	(80)	60	16	76
Interest bearing deposits	(35)	114	79	68	(303)	(235)
Total interest earning assets	<u>(9,042)</u>	<u>6,051</u>	<u>(2,991)</u>	<u>1,621</u>	<u>5,152</u>	<u>6,773</u>
Interest expense:						
Savings accounts	(1,655)	304	(1,351)	336	139	475
NOW and money market accounts	(1,073)	214	(859)	198	(93)	105
Certificates of deposit and other time deposits	(3,724)	927	(2,797)	3,072	3,179	6,251
Short-term borrowings	(1,380)	341	(1,039)	31	—	31
FHLB advances	1	832	833	(135)	(906)	(1,041)
Subordinated debentures	(53)	314	261	(178)	—	(178)
Total interest bearing liabilities	<u>(7,884)</u>	<u>2,932</u>	<u>(4,952)</u>	<u>3,324</u>	<u>2,319</u>	<u>5,643</u>
Net change in net interest income	<u>\$(1,158)</u>	<u>\$3,119</u>	<u>\$ 1,961</u>	<u>\$(1,703)</u>	<u>\$2,833</u>	<u>\$ 1,130</u>

Non-Interest Income and Non-Interest Expense

The following tables provide a comparison of the components of non-interest income and expenses for the years ended December 31, 2008, 2007 and 2006. The tables show the dollar and percentage

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change from 2007 to 2008 and from 2006 to 2007. Below each table is a discussion of significant changes and trends.

(Dollars in thousands)	2008	2007	2006	2008/2007		2007/2006	
				Change	%	Change	%
Non-interest income							
Customer service fees on deposit accounts	\$6,601	\$5,792	\$5,460	\$ 809	14.0%	\$ 332	6.1%
Gain on sale of mortgage loans	697	569	783	128	22.5%	(214)	-27.3%
Gain on sale of securities	55	—	—	55	100.0%	—	0.0%
Gain on sale of real estate held for development	—	227	—	(227)	-100.0%	227	100.0%
Losses on securities impairment	(516)	—	—	(516)	100.0%	—	0.0%
Write down on real estate acquired through foreclosure	(162)	—	—	(162)	100.0%	—	0.0%
Brokerage commissions	469	424	346	45	10.6%	78	22.5%
Other income	1,305	1,191	1,150	114	9.6%	41	3.6%
	<u>\$8,449</u>	<u>\$8,203</u>	<u>\$7,739</u>	<u>\$ 246</u>	<u>3.0%</u>	<u>\$ 464</u>	<u>6.0%</u>

Growth in customer service fees on deposit accounts, our largest component of non-interest income, is primarily due to growth in customer deposits, overdraft fee income on retail checking accounts and the sale of fee-based products for 2008. We continue to increase our customer base through cross-selling opportunities and marketing initiatives and promotions. In addition, we continue to emphasize growing our checking account base to better enhance our profitability and franchise value.

We originate qualified VA, KHC, RHC and conventional secondary market loans and sell them into the secondary market with servicing rights released. Prevailing mortgage interest rates fell substantially in late 2007 and remained at attractive levels during 2008 helping to contribute to the increase in the volume of loans closed for 2008.

We invest in various types of liquid assets, including United States Treasury obligations, securities of various federal agencies, obligations of states and political subdivisions, corporate bonds, mutual funds, stocks and others. During 2008 we recorded a gain on sale of investments of \$55,000. Gains on investment securities are infrequent in nature and are not a consistent recurring source of income.

Through our subsidiary, First Federal Office Park, we hold commercial lots adjacent to our home office on Ring Road in Elizabethtown, that are available for sale. During the March 2007 quarter we recorded \$227,000 in gains from a lot sale. Currently, one of the original nine lots held for sale remains unsold.

We recognized other-than-temporary impairment charges of \$516,000 during the second and fourth quarters of 2008 on equity securities. Management believes this impairment was primarily attributable to current economic conditions. Since recovery does not appear likely in the near future, we recognized the impairment losses. Previously, we recognized the decline in market value of these equity securities in stockholders' equity through accumulated other comprehensive income.

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Further reducing non-interest income for the 2008 period was a 10% or \$162,000 write-down of the carrying value of real estate owned properties that had been held for twelve months.

(Dollars in thousands)	2008	2007	2006	2008/2007		2007/2006	
				Change	%	Change	%
Non-interest expenses							
Employee compensation and benefits	\$14,600	\$12,593	\$11,903	\$2,007	15.9%	\$ 690	5.8%
Office occupancy expense and equipment	2,865	2,373	2,106	492	20.7%	267	12.7%
Marketing and advertising	782	914	859	(132)	-14.4%	55	6.4%
Outside services and data processing	3,324	2,632	2,567	692	26.3%	65	2.5%
Bank franchise tax	1,010	923	871	87	9.4%	52	6.0%
FDIC insurance premiums	716	77	76	639	829.9%	1	1.3%
Write off of issuance cost of Trust Preferred Securities	—	229	—	(229)	-100.0%	229	100.0%
Amortization of core deposit intangible	207	—	—	207	100.0%	—	0.0%
Other expense	4,782	4,049	3,570	733	18.1%	479	13.4%
	<u>\$28,286</u>	<u>\$23,790</u>	<u>\$21,952</u>	<u>\$4,496</u>	<u>18.9%</u>	<u>\$1,838</u>	<u>8.4%</u>

Employee compensation and benefits is the largest component of non-interest expense. Since 2006, we have added three commercial lending associates and twenty-two retail associates with our expansion efforts. These associates were hired for a commercial private banking center which opened in April 2007, a new Louisville retail branch facility that opened in June 2007, a new Bullitt County retail branch facility that opened in August 2008 and other positions to support our growth. We added twenty additional associates in the second quarter of 2008 as a result of the recent acquisition. We look for a continued increase in employee compensation and benefits expense in line with recent years, as we progress with our retail expansion and market protection efforts.

Office occupancy expense and equipment and outside services and data processing increased due to additional operating expenses related to our expansion efforts and a system upgrade. We anticipate the increased level of non-interest expense to continue in 2009 with additional retail expansion.

Included in non-interest expense for the 2007 period is \$229,000 in unamortized subordinated debentures issuance cost incurred when we redeemed all of our underlying \$10.0 million issuance of cumulative trust preferred securities. These securities paid distributions at a quarterly adjustable rate of LIBOR plus 360 basis points (8.97% on March 26, 2007). We issued new subordinated debentures at a 10 year fixed rate of 6.69%.

Other expense increased due to increases in interchange expense, REO expense, losses on NOW accounts, FDIC insurance premiums and other operating expenses. Interchange expense increased due to the switch to real-time debit card processing, which is more expensive per item than the batch processing method we used previously. REO expense relating to repair, maintenance and taxes increased due to increases in real estate we acquired through foreclosure.

The FDIC charges insured financial institutions premiums to maintain the Deposit Insurance Fund at a certain level. See Part I, Item 1, "Business—*Federal Deposit Insurance Assessments*." On October 16, 2008, the FDIC published a restoration plan designed to replenish the Deposit Insurance Fund over a period of five years and to increase the deposit insurance reserve ratio. In order to implement the restoration plan, the FDIC proposes to change both its risk-based assessment system and its base assessment rates. Either an increase in the Risk Category of our bank subsidiary, or adjustments to the base assessment rates, could materially increase our deposit insurance premiums and assessments.

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Our efficiency ratio was 69% for 2008 compared to 61% for the 2007 period. The increase principally reflects our recent expansion efforts.

Income Taxes

The effective tax rate decreased to 31% for the year ended December 31, 2008 compared to 33% for the year ended December 31, 2007. During 2007 we accrued \$99,000 in state income tax, net of the federal benefit, in a contiguous state. Our level of interest income generated from properties financed in this state increased to a level which required us to pay state income tax. This contributed to the increase in the effective tax rate to 33%. For the year ended December 31, 2006, we recorded a \$281,000 reduction of federal income tax as a result of a re-evaluation of our tax contingency reserves. Income tax expense was reduced by this amount, resulting in an effective tax rate of 31% for the year ended 2006.

ANALYSIS OF FINANCIAL CONDITION

Total assets at December 31, 2008 increased to \$1.0 billion compared to \$872.7 million at December 31, 2007, an increase of \$144.4 million. Approximately \$71.2 million of the increase was attributable to the June 2008 acquisition of FSB Bancshares, Inc.

Loans

Net loans increased \$139.3 million to \$899.4 million at December 31, 2008 compared to \$760.1 million at December 31, 2007. The recent acquisition of FSB Bancshares, Inc. contributed approximately \$48.6 million in new loans. Our commercial real estate portfolio increased \$92.4 million to \$563.3 million at December 31, 2008. For the 2008 period, these loans comprised 62% of the total loan portfolio compared to 61% at December 31, 2007. Our residential mortgage loan portfolio increased for the 2008 period due to the recent acquisition by \$33.0 million. The residential mortgage loans we acquired are seasoned performing loans and none are considered to have any sub-prime characteristics. Consumer, home equity, indirect consumer and commercial loans also increased during the 2008 period. Offsetting this growth was a \$4.0 million decrease in the real estate construction loan portfolio to \$17.4 million at December 31, 2008, compared to \$21.4 million at December 31, 2007. For 2009, the growth in commercial real estate loans may not continue to grow at a similar rate experienced over the last few years due to the current economic slow-down. However, we believe we will still be well positioned to benefit from growth in our local markets when the economy rebounds in the future.

Loan Portfolio Composition. The following table presents a summary of the loan portfolio, net of deferred loan fees, by type. There are no foreign loans in our portfolio and other than the categories noted; there is no concentration of loans in any industry exceeding 10% of total loans.

(Dollars in thousands)	December 31,									
	2008		2007		2006		2005		2004	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Type of Loan:										
Real Estate:										
Residential	\$165,318	18.11%	\$132,209	17.21%	\$137,155	19.44%	\$142,358	22.14%	\$158,966	26.23%
Construction	17,387	1.90	21,383	2.78	23,953	3.39	13,579	2.11	10,850	1.79
Commercial	563,314	61.70	470,929	61.32	410,146	58.12	353,637	54.99	302,567	49.94
Consumer and home equity	69,649	7.63	63,090	8.21	62,805	8.90	66,208	10.29	70,141	11.58
Indirect consumer	31,754	3.48	27,721	3.61	30,857	4.37	31,577	4.91	30,798	5.08
Commercial, other	56,012	6.13	51,924	6.76	40,121	5.68	35,161	5.47	31,376	5.18
Loans held for sale	9,567	1.05	780	0.10	673	0.10	597	0.09	1,219	0.20
Total loans	<u>\$913,001</u>	<u>100.00%</u>	<u>\$768,036</u>	<u>100.00%</u>	<u>\$705,710</u>	<u>100.00%</u>	<u>\$643,117</u>	<u>100.00%</u>	<u>\$605,917</u>	<u>100.00%</u>

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Loan Maturity Schedule. The following table provides information at December 31, 2008, regarding the dollar amount of loans, net of deferred loan fees, maturing in the loan portfolio based on their contractual terms to maturity.

	Due during the year ended December 31, 2009	Due after 1 through 5 years after December 31, 2008	Due after 5 years after December 31, 2008	Total Loans
(Dollars in thousands)				
Residential mortgage	\$ 18,038	\$ 26,657	\$ 120,623	\$165,318
Real estate construction	15,371	2,016	—	17,387
Real estate commercial	193,472	320,076	49,766	563,314
Consumer, home equity and indirect consumer	10,457	54,727	36,219	101,403
Commercial, other	21,362	31,808	2,842	56,012
Loans held for sale	9,567	—	—	9,567
Total	<u>\$ 268,267</u>	<u>\$ 435,284</u>	<u>\$ 209,450</u>	<u>\$913,001</u>

The following table breaks down loans maturing after one year, by fixed and adjustable rates.

	Fixed Rates	Floating or Adjustable Rates	Total
(Dollars in thousands)			
Residential mortgage	\$ 99,265	\$ 48,015	\$147,280
Real estate construction	1,632	384	2,016
Real estate commercial	240,108	129,734	369,842
Consumer, home equity and indirect consumer	63,721	27,225	90,946
Commercial, other	22,073	12,577	34,650
Total	<u>\$426,799</u>	<u>\$ 217,935</u>	<u>\$644,734</u>

Allowance and Provision for Loan Losses

Our financial performance depends on the quality of the loans we originate and management's ability to assess the degree of risk in existing loans when it determines the allowance for loan losses. An increase in loan charge-offs or non-performing loans or an inadequate allowance for loan losses could reduce net interest income, net income and capital and limit the range of products and services we can offer.

The Allowance for Loan Loss Review Committee evaluates the allowance for loan losses quarterly to maintain a level sufficient to absorb probable incurred credit losses existing in the loan portfolio. Periodic provisions to the allowance are made as needed. The Committee determines the allowance by applying loss estimates to graded loans by categories, as described below. In addition, the Committee analyzes such factors as changes in lending policies and procedures; underwriting standards; collection; charge-off and recovery history; changes in national and local economic business conditions and developments; changes in the characteristics of the portfolio; ability and depth of lending management and staff; changes in the trend of the volume and severity of past due, non-accrual and classified loans; troubled debt restructuring and other loan modifications; and results of regulatory examinations.

2008 was an extremely tumultuous year for the U.S. economy and the financial service industry. Deteriorating property values provided a catalyst for declining valuations for loan portfolios. The property value declines, which began in the second half of 2007, continued throughout 2008. The markets we serve have generally avoided the severe property value declines experienced in other parts of the country; however, we were still significantly impacted. In response to these adverse economic

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conditions, we took the opportunity to strengthen our allowance for loan losses substantially during the second half of 2008.

The following table analyzes loan loss experience for the periods indicated.

(Dollars in thousands)	Year Ended December 31,				
	2008	2007	2006	2005	2004
Balance at beginning of period	\$ 7,922	\$7,684	\$7,377	\$6,489	\$5,568
Allowance related to acquisition	327	—	—	—	—
Loans charged-off:					
Real estate mortgage	15	18	3	15	41
Consumer	515	385	446	584	702
Commercial	364	807	165	67	206
Total charge-offs	894	1,210	614	666	949
Recoveries:					
Real estate mortgage	4	10	7	4	—
Consumer	239	222	287	290	214
Commercial	20	7	87	2	—
Total recoveries	263	239	381	296	214
Net loans charged-off	631	971	233	370	735
Provision for loan losses	5,947	1,209	540	1,258	1,656
Balance at end of period	\$13,565	\$7,922	\$7,684	\$7,377	\$6,489
Allowance for loan losses to total loans (excluding loans held for sale)	1.50%	1.03%	1.09%	1.15%	1.07%
Net charge-offs to average loans outstanding	0.08%	0.13%	0.03%	0.06%	0.13%
Allowance for loan losses to total non-performing loans	81%	89%	159%	118%	124%

The provision for loan losses increased by \$4.7 million to \$5.9 million in 2008 compared to 2007. The increase was related to a \$1.7 million specific reserve for a classified commercial real estate development loan. This relationship had been previously classified during the first quarter of 2008. We also recorded a \$1.2 million specific reserve on a commercial real estate relationship during the fourth quarter of 2008. The reserve was increased based on an updated appraisal of the underlying collateral. The increase in the provision was also related to strong loan growth in the overall portfolio as well as from specific reserves on several other commercial real estate relationships. The provision for the 2007 period was smaller due to the improved performance of one of our credit relationships, which reduced the allowance allocated to the loan. The allowance for loan losses increased \$5.6 million to \$13.6 million from December 31, 2007 to December 31, 2008. The increase included the addition of \$327,000 as a result of the FSB Bancshares, Inc. acquisition, an increase in net loans for 2008, as well as the provision recorded to reflect a \$26.5 million increase in classified loans for the 2008 period.

The provision for loan losses increased \$669,000 to \$1.2 million for 2007 compared to 2006 due to growth in the loan portfolio as well as specific allocation for loans classified during the third quarter of 2007. In addition, we recorded a smaller provision for 2006 due to the improved performance of certain credit relationships which resulted in a reduction in the allowance allocated to those loans. The allowance for loan losses increased \$238,000 to \$7.9 million from December 31, 2006 to December 31, 2007. The increase in the allowance was related to a \$62.1 million increase in net loans for the year, as well as provision recorded, in conjunction with a \$3.1 million increase in classified loans for the 2007 period. Net charge-offs increased \$738,000 for the 2007 period which was primarily the result of a

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\$751,000 charge off during the fourth quarter on a commercial loan. The loan was fully reserved for in a prior quarter.

The following table depicts management's allocation of the allowance for loan losses by loan type. Allowance and allocation is based on management's current evaluation of risk in each category, economic conditions, past loss experience, loan volume, past due history and other factors. Since these factors and management's assumptions are subject to change, the allocation is not a prediction of future portfolio performance.

	December 31,									
	2008		2007		2006		2005		2004	
	Amount of Allowance	Percent of Total loans	Amount of Allowance	Percent of Total loans	Amount of Allowance	Percent of Total loans	Amount of Allowance	Percent of Total loans	Amount of Allowance	Percent of Total loans
(Dollars in thousands)										
Residential mortgage	\$ 455	18%	\$ 348	17%	\$ 340	20%	\$ 373	22%	\$ 413	26%
Consumer	1,415	11	1,293	12	1,298	13	1,372	15	1,345	17
Commercial	11,695	71	6,281	71	6,046	67	5,632	63	4,731	57
Total	\$ 13,565	100%	\$ 7,922	100%	\$ 7,684	100%	\$ 7,377	100%	\$ 6,489	100%

Federal regulations require banks to classify their own assets on a regular basis. The regulations provide for three categories of classified loans—substandard, doubtful and loss.

The following table provides information with respect to classified loans for the periods indicated:

(Dollars in thousands)	December 31,	
	2008	2007
Classified Loans		
Substandard	\$41,901	\$15,442
Doubtful	—	38
Loss	114	52
Total Classified	\$42,015	\$15,532

As we focused on credit quality during 2008, there was a significant migration of loans into the Special Mention and Substandard loan categories during the second half of the year. If economic conditions continue to put stress on our borrowers going forward, this may result in higher provisions for loan losses. It is our expectation that the economy will remain in a recession at least for the next several quarters. Credit quality will continue to be one of our primary focuses in 2009.

The \$26.5 million increase in substandard assets for 2008 was primarily the result of downgrading loans with twelve borrowers with balances ranging from \$891,000 to \$8.7 million. Offsetting this increase was the transfer of three classified loans having balances of \$1.5 million, \$1.3 million and \$1.1 million to real estate acquired through foreclosure. Approximately \$22.6 million of the total classified loans were related to real estate development or real estate construction loans in our market area. Classified consumer loans totaled \$ 1.4 million, classified mortgage loans totaled \$5.3 million and classified commercial loans totaled \$12.7 million. For more information on collection efforts, evaluation of collateral and how loss amounts are estimated, see "Non-Performing Assets."

Although we may allocate a portion of the allowance to specific loans or loan categories, the entire allowance is available for active charge-offs. We develop our allowance estimates based on actual loss experience adjusted for current economic conditions. Allowance estimates represent a prudent measurement of the risk in the loan portfolio, which we apply to individual loans based on loan type.

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Non-Performing Assets

Non-performing assets consist of certain restructured loans for which interest rate or other terms have been renegotiated, loans on which interest is no longer accrued, real estate acquired through foreclosure and repossessed assets. We do not have any loans longer than 90 days past due still on accrual. Loans, including impaired loans under SFAS 114, are placed on non-accrual status when they become past due 90 days or more as to principal or interest, unless they are adequately secured and in the process of collection. Loans are considered impaired when we no longer anticipate full principal or interest payments in accordance with the contractual loan terms. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate, or at the fair value of collateral if repayment is expected solely from collateral.

We review our loans on a regular basis and implement normal collection procedures when a borrower fails to make a required payment on a loan. If the delinquency on a mortgage loan exceeds 90 days and is not cured through normal collection procedures or an acceptable arrangement is not worked out with the borrower, we institute measures to remedy the default, including commencing a foreclosure action. We generally charge off consumer loans when management deems a loan uncollectible and any available collateral has been liquidated. We handle commercial business and real estate loan delinquencies on an individual basis with the advice of legal counsel.

We recognize interest income on loans on the accrual basis except for those loans in a non-accrual of income status. We discontinue accruing interest on impaired loans when management believes, after consideration of economic and business conditions and collection efforts that the borrowers' financial condition is such that collection of interest is doubtful, typically after the loan becomes 90 days delinquent. When we discontinue interest accrual, we reverse existing accrued interest and subsequently recognize interest income only to the extent we receive cash payments.

We classify real estate acquired as a result of foreclosure or by deed in lieu of foreclosure as real estate owned until such time as it is sold. We classify new and used automobile, motorcycle and all terrain vehicles acquired as a result of foreclosure as repossessed assets until they are sold. When such property is acquired we record it at the lower of the unpaid principal balance of the related loan or its fair market value. We charge any write-down of the property at the time of acquisition to the allowance for loan losses. Subsequent gains and losses are included in non-interest income and non-interest expense. Real estate acquired through foreclosure increased \$4.2 million to \$5.9 million at December 31, 2008. The increase was primarily the result of three commercial credit relationships totaling \$1.4 million, \$1.3 million and \$1.1 million that were transferred during the 2008 period.

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The following table provides information with respect to non-performing assets for the periods indicated.

(Dollar in thousands)	December 31,				
	2008	2007	2006	2005	2004
Restructured	\$ 1,182	\$ 2,335	\$2,470	\$3,104	\$3,218
Past due 90 days still on accrual	—	—	—	—	—
Loans on non-accrual status	15,587	6,554	2,368	3,128	2,022
Total non-performing loans	16,769	8,889	4,838	6,232	5,240
Real estate acquired through foreclosure	5,925	1,749	918	1,022	681
Other repossessed assets	91	52	82	119	40
Total non-performing assets	<u>\$22,785</u>	<u>\$10,690</u>	<u>\$5,838</u>	<u>\$7,373</u>	<u>\$5,961</u>
Interest income that would have been earned on non-performing loans	\$ 825	\$ 696	\$ 368	\$ 432	\$ 336
Interest income recognized on non-performing loans	75	188	227	219	197
Ratios: Non-performing loans to total loans (excluding loans held for sale)	1.86%	1.16%	0.69%	0.97%	0.87%
Non-performing assets to total loans (excluding loans held for sale)	2.52%	1.39%	0.83%	1.15%	0.99%

Non-performing loans increased \$7.9 million to \$16.8 million at December 31, 2008 compared to \$8.9 million at December 31, 2007. The increase in non-accrual loans consist primarily of four credit relationships with balances ranging from \$1.0 million to \$4.1 million. These credit relationships are secured by real estate and we have provided adequate allowance based on current information. All non-performing loans are considered impaired.

Non-performing assets for the 2008 period include \$1.2 million in restructured commercial, mortgage and consumer loans. Restructured loans primarily consist of five credit relationships with balances ranging from \$110,000 to \$349,000. The terms of these loans have been renegotiated to reduce the rate of interest and extend the term, thus reducing the amount of cash flow required from the borrower to service the loans. The borrowers are currently meeting the terms of the restructured loans. The decrease in restructured loans from December 31, 2007 was primarily due to the removal of one credit relationship totaling \$2.0 million from the restructured loan category since the terms of the loan are now substantially equivalent to terms on which loans with comparable risks are being made and the borrower has performed per the terms of the contract.

Investment Securities

Interest on securities provides us our largest source of interest income after interest on loans, constituting 3.2% of the total interest income for the year ended December 31, 2008. The securities portfolio serves as a source of liquidity and earnings and contributes to the management of interest rate risk. We have the authority to invest in various types of liquid assets, including short-term United States Treasury obligations and securities of various federal agencies, obligations of states and political subdivisions, corporate bonds, certificates of deposit at insured savings and loans and banks, bankers' acceptances, and federal funds. We may also invest a portion of our assets in certain commercial paper and corporate debt securities. We are also authorized to invest in mutual funds and stocks whose assets conform to the investments that we are authorized to make directly. The available-for-sale and held-to-maturity investment portfolios decreased by \$16.9 million during the 2008 period as securities were called for redemption in accordance with their terms due to decreasing rates. The FSB Bancshares, Inc. acquisition contributed approximately \$2.5 million in federal agencies and obligations of states and political subdivisions that are held-to-maturity. We also purchased \$524,000 in equity securities during the 2008 period.

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We review all unrealized losses at least on a quarterly basis to determine whether the losses are other than temporary and more frequently when economic or market concerns warrant such evaluation. We consider the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and our intent and ability to retain the investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. In analyzing an issuer's financial condition, we may consider whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, and the results of reviews of the issuer's financial condition.

The unrealized losses on our temporarily impaired debt securities held in state and municipal issuers are a result of changes in interest rates for fixed-rate securities where the interest rate received is less than the current rate available for new offerings of similar securities. Because the decline in market value is attributable to changes in interest rates and market liquidity and not credit quality, and because we have the ability and intent to hold these investments until recovery of fair value, which may be maturity, we do not consider these investments to be other-than-temporarily impaired at December 31, 2008.

We have evaluated the decline in the fair value of our trust preferred securities, which are included in corporate securities and are directly related to the credit and liquidity crisis being experienced in the financial services industry over the past year. The trust preferred securities market is currently inactive making the valuation of trust preferred securities very difficult. The trust preferred securities are valued by management using unobservable inputs (i.e., Level 3 inputs under SFAS No. 157) through a discounted cash flow analysis as permitted under SFAS 157 and using the expected cash flows appropriately discounted using present value techniques. Refer to Note 4—Fair Value for more information.

All of our trust preferred securities remain investment grade with the exception of three securities and have continued to pay interest as scheduled through December 31, 2008, and are expected to continue paying interest as scheduled. We believe the cash flows of our trust preferred securities, as discounted, appropriately reflect the estimated fair value of the securities. Management has analyzed this portfolio to determine whether the decline is other than temporary and has concluded that only temporary impairment exists. See Note 2—Securities for more information. Management will continue to evaluate these securities for impairment quarterly. Under U.S. generally accepted accounting principles, we have reflected the current period temporary fair value decline in stockholders' equity through comprehensive income.

We recognized other-than-temporary impairment charges of \$516,000 during the year on equity securities with a cost basis of \$840,000. Management believes this impairment was primarily attributable to current economic conditions. Since recovery does not appear likely in the near future, we recognized the impairment losses. Previously, we recognized the decline in market value of these equity securities in stockholders' equity through comprehensive income. We continue to monitor these holdings.

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The following table provides the carrying value of our securities portfolio at the dates indicated.

(Dollars in thousands)	December 31,		
	2008	2007	2006
Securities available-for-sale:			
U.S. Treasury and agencies	\$ —	\$ 501	\$ 3,484
Mortgage-backed	6,139	7,576	9,244
Equity	948	1,522	2,146
State and municipal	8,615	9,598	10,029
Corporate	73	2,807	3,320
Total	<u>\$15,775</u>	<u>\$22,004</u>	<u>\$28,223</u>
Securities held-to-maturity:			
U.S. Treasury and agencies	\$ 4,503	\$14,098	\$18,097
Mortgage-backed	1,780	3,142	4,127
State and municipal	481	—	—
Corporate	258	441	2,000
Total	<u>\$ 7,022</u>	<u>\$17,681</u>	<u>\$24,224</u>

The following table provides the scheduled maturities, amortized cost, fair value and weighted average yields for our securities at December 31, 2008.

(Dollars in thousands)	Amortized Cost	Fair Value	Weighted Average Yield*
Securities available-for-sale:			
Due in one year or less	\$ 110	\$ 111	4.30%
Due after one year through five years	2,183	2,200	4.29
Due after five years through ten years	2,159	2,207	4.79
Due after ten years	13,917	10,309	4.08
Equity	933	948	4.34
Total	<u>\$19,302</u>	<u>\$15,775</u>	4.20

(Dollars in thousands)	Amortized Cost	Fair Value	Weighted Average Yield*
Securities held-to-maturity:			
Due in one year or less	\$ 4,738	\$4,792	4.53%
Due after one year through five years	1,886	1,882	4.41
Due after five years through ten years	90	90	4.49
Due after ten years	308	82	5.14
Total	<u>\$ 7,022</u>	<u>\$6,846</u>	4.52

* The weighted average yields are calculated on amortized cost on a non tax-equivalent basis.

Deposits

We rely primarily on providing excellent customer service and long-standing relationships with customers to attract and retain deposits. Market interest rates and rates on deposit products offered by

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competing financial institutions can significantly affect our ability to attract and retain deposits. We attract both short-term and long-term deposits from the general public by offering a wide range of deposit accounts and interest rates. In recent years market conditions have caused us to rely increasingly on short-term certificate accounts and other deposit alternatives that are more responsive to market interest rates. We use forecasts based on interest rate risk simulations to assist management in monitoring our use of certificates of deposit and other deposit products as funding sources and the impact of the use of those products on interest income and net interest margin in various rate environments.

In conjunction with our initiatives to expand and enhance our retail branch network, we emphasize growing our customer checking account base to better enhance profitability and franchise value. Total deposits increased \$86.2 million compared to December 31, 2007. The acquisition of FSB Bancshares, Inc. contributed approximately \$55.8 million in deposits. Retail and commercial deposits increased \$89.0 million which was offset by a \$2.8 million decrease in public funds and brokered certificates for the 2008 period. Brokered deposits were \$15.4 million at December 31, 2008 compared to \$24.3 million at December 31, 2007.

To evaluate our funding needs in light of deposit trends resulting from these changing conditions, management and Board committees evaluate simulated performance reports that forecast changes in margins. We continue to offer attractive certificate rates for various terms to allow us to retain deposit customers and reduce interest rate risk during the current rate environment, while protecting the margin.

We offer a broad selection of deposit instruments, including non-interest bearing checking, statement and passbook savings accounts, health savings accounts, NOW accounts, money market accounts and fixed and variable rate certificates with varying maturities. We also offer tax-deferred individual retirement accounts. The flow of deposits is influenced significantly by general economic conditions, changes in interest rates and competition. As of December 31, 2008, approximately 40% of our deposits consisted of various savings and demand deposit accounts from which customers can withdraw funds at any time without penalty. Management periodically adjusts interest rates paid on our deposit products, maturity terms, service fees and withdrawal penalties.

We also offer certificates of deposit with a variety of terms, interest rates and minimum deposit requirements. The variety of deposit accounts allows us to compete more effectively for funds and to respond with more flexibility to the flow of funds away from depository institutions into direct investment vehicles such as government and corporate securities. However, market conditions continue to significantly affect our ability to attract and maintain deposits and our cost of funds.

The following table breaks down our deposits.

(Dollars in thousands)	December 31,	
	2008	2007
Non-interest bearing	\$ 55,668	\$ 46,978
NOW demand	99,890	79,133
Savings	111,310	91,249
Money market	40,593	49,306
Certificates of deposit	467,938	422,577
Total	<u>\$775,399</u>	<u>\$689,243</u>

As of December 31, 2008, certificates of deposits in amounts of \$100,000 or more total \$211.9 million, with \$196.5 million held by persons residing within our service areas. An additional \$15.4 million of certificates of deposits in amounts of \$100,000 or more were obtained from deposit

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brokers at December 31, 2008. Brokered deposits consist of certificates of deposit placed by deposit brokers for a fee and can be utilized to support our asset growth.

The following table shows at December 31, 2008 the amount of our certificates of deposit of \$100,000 or more by time remaining until maturity.

<u>Maturity Period</u>	<u>Certificates of Deposit</u> (In Thousands)
Three months or less	\$ 24,795
Three through six months	41,608
Six through twelve months	54,662
Over twelve months	90,796
Total	<u>\$ 211,861</u>

Short-term Borrowings

We have the ability to obtain short-term borrowings, consisting of federal funds purchased and securities sold under agreements to repurchase at year end 2008 and 2007. We had short-term borrowings of \$94.9 million for 2008 from the FHLB of Cincinnati, First Tennessee Bank and National City Bank and \$42.8 million for 2007 from the FHLB of Cincinnati. These borrowings averaged a rate of 2.02% for 2008 and 5.26% for 2007.

Advances from Federal Home Loan Bank

Deposits are the primary source of funds for our lending and investment activities and for our general business purposes. We can also use advances (borrowings) from the FHLB of Cincinnati to compensate for reductions in deposits or deposit inflows at less than projected levels. Advances from the FHLB are secured by our stock in the FHLB, certain securities, certain commercial real estate loans and substantially all of our first mortgage, multi-family and open end home equity loans. At December 31, 2008 we had \$52.9 million in advances outstanding from the FHLB and the capacity to increase our borrowings an additional \$4.0 million.

The FHLB of Cincinnati functions as a central reserve bank providing credit for savings banks and other member financial institutions. As a member, we are required to own capital stock in the FHLB and are authorized to apply for advances on the security of such stock and certain of our home mortgages, other real estate loans and other assets (principally, securities which are obligations of, or guaranteed by, the United States) provided that we meet certain creditworthiness standards. For further information, see Note 8 of the Notes to Consolidated Financial Statements in this Annual Report.

The following table provides information about our FHLB advances and short-term borrowings as of and for the periods ended.

	<u>December 31,</u>		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
	(Dollars in thousands)		
Average balance outstanding	\$ 97,463	\$ 71,514	\$ 90,329
Maximum amount outstanding at any month-end during the period	147,816	96,318	121,836
Year end balance	147,816	95,883	96,724
Weighted average interest rate:			
At end of year	1.81%	4.19%	5.00%
During the year	3.40%	4.92%	5.01%

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Subordinated Debentures

On June 24, 2008, First Federal Statutory Trust III, an unconsolidated trust subsidiary of First Financial Service Corporation, issued \$8.0 million in trust preferred securities. The trust loaned the proceeds of the offering to us in exchange for junior subordinated deferrable interest debentures which we used to finance the purchase of FSB Bancshares, Inc. In accordance with FASB Interpretation 46, the trust is not consolidated with our financial statements but rather the subordinated debentures are shown as a liability. The subordinated debentures, which mature on June 24, 2038, can be called at par in whole or in part on or after June 24, 2018. The subordinated debentures pay a fixed rate of 8% for thirty years. We have the option to defer interest payments on the subordinated debt from time to time for a period not to exceed five consecutive years. The subordinated debentures are considered as Tier I capital for the Corporation under current regulatory guidelines.

In 2002, another trust we formed completed a private placement of 10,000 shares of cumulative trust preferred securities with a liquidation preference of \$1,000 per security for a total outstanding of \$10.0 million. These securities pay distributions of interest. On March 26, 2007 we called the \$10.0 million in subordinated debentures adjustable quarterly at LIBOR plus 360 basis points (8.97% on March 26, 2007) and issued new 30 year cumulative trust preferred securities at a 10 year fixed rate of 6.69% adjusting quarterly thereafter at LIBOR plus 160 basis points. The subordinated debentures, which mature March 22, 2037, can be called at par in whole or in part on or after March 15, 2017. We have the option to defer interest payments on the subordinated debt from time to time for a period not to exceed five consecutive years. The subordinated debentures are considered as Tier I capital for the Corporation under current regulatory guidelines.

The trust loaned the proceeds of the offering to us in exchange for junior subordinated deferrable interest debentures. In accordance with FASB Interpretation 46, the trust is not consolidated with our financial statements but rather the subordinated debentures are shown as a liability.

LIQUIDITY

Liquidity risk arises from the possibility we may not be able to satisfy current or future financial commitments, or may become unduly reliant on alternative funding sources. The objective of liquidity risk management is to ensure that we can meet the cash flow requirements of depositors and borrowers, as well as our operating cash needs, at a reasonable cost, taking into account all on- and off-balance sheet funding demands. We maintain an investment and funds management policy, which identifies the primary sources of liquidity, establishes procedures for monitoring and measuring liquidity, and establishes minimum liquidity requirements in compliance with regulatory guidance. The Asset Liability Committee continually monitors our liquidity position.

Our sources of funds include the sale of securities in the available-for-sale portion of the investment portfolio, the payment of principal on loans and mortgage-backed securities, proceeds realized from loans held for sale, brokered deposits and other wholesale funding. We also secured federal funds borrowing lines from three of our correspondent banks. Two of the lines are for \$15 million each and the other one is for \$5 million. Our banking centers also provide access to retail deposit markets. If large certificate depositors shift to our competitors or other markets in response to interest rate changes, we have the ability to replenish those deposits through alternative funding sources. Traditionally, we have also borrowed from the FHLB to supplement our funding requirements. At December 31, 2008, we had sufficient collateral available to borrow, approximately, an additional \$4.0 million in advances from the FHLB. We believe our sources of liquidity are adequate to meet expected cash needs for the foreseeable future.

At the holding company level, the Corporation uses cash to pay dividends to stockholders, repurchase common stock, make selected investments and acquisitions, and service debt. The main

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sources of funding for the Corporation include dividends from the Bank, borrowings and access to the capital markets. Also, the Corporation has lines of credit of \$18 million with a correspondent bank.

The primary source of funding for the Corporation has been dividends and returns of investment from the Bank. Kentucky banking laws limit the amount of dividends that may be paid to the Corporation by the Bank without prior approval of the KOFI. Under these laws, the amount of dividends that may be paid in any calendar year is limited to current year's net income, as defined in the laws, combined with the retained net income of the preceding two years, less any dividends declared during those periods. As a result of a \$6 million dividend in 2008 used to finance the purchase of FSB Bancshares, Inc., the Bank needed and obtained approval for its first quarter 2009 dividend. Because of these limitations, consolidated cash flows as presented in the consolidated statements of cash flows may not represent cash immediately available to the Corporation. During 2008, the Bank declared and paid dividends of \$10.8 million to the Corporation.

CAPITAL

Stockholders' equity decreased \$508,000 during 2008, primarily due to cash dividends declared and the net change in unrealized losses on securities available-for-sale. This decrease was offset by net income earned during the year. Average stockholders' equity to average assets ratio decreased to 8.02% at December 31, 2008 from 8.54% at the end of 2007.

During 2008, we did not purchase any shares of our own common stock. The current repurchase program authorizes the repurchase of 466,803 shares from time-to-time if market conditions are deemed favorable. The repurchase program will remain effective until the number of shares authorized is repurchased or until the program expires November 19, 2010. As of December 31, 2008, 466,803 shares could be repurchased under the current stock repurchase program.

On January 9, 2009, we sold \$20 million of cumulative perpetual preferred shares, with a liquidation preference of \$1,000 per share (the "Senior Preferred Shares") to the U.S. Treasury under the terms of its Capital Purchase Plan. Pursuant to CPP, the U.S. Treasury will purchase up to \$250 billion of senior preferred shares on standardized terms from qualifying financial institutions as part of the Troubled Asset Relief Program authorized by the Emergency Economic Stabilization Act of 2008. The Senior Preferred Shares constitute Tier 1 capital and rank senior to our common shares. The Senior Preferred Shares pay cumulative dividends at a rate of 5% per annum for the first five years and will reset to a rate of 9% per annum after five years. The Senior Preferred Shares may be redeemed at any time, at our option.

Under the terms of the CPP stock purchase agreement, we also issued the U.S. Treasury a warrant to purchase an amount of our common stock equal to 15% of the aggregate amount of the Senior Preferred Shares, or \$3 million. The warrant entitles the U.S. Treasury to purchase 215,983 common shares at a purchase price of \$13.89 per share. The initial exercise price for the warrant and the number of shares subject to the warrant were determined by reference to the market price of our common stock calculated on a 20-day trailing average as of December 8, 2008, the date the U.S. Treasury approved our application. The warrant has a term of 10 years and is potentially dilutive to earnings per share.

Each of the federal bank regulatory agencies has established minimum leverage capital requirements for banks. Banks must maintain a minimum ratio of Tier 1 capital to adjusted average quarterly assets ranging from 3% to 5%, subject to federal bank regulatory evaluation of an organization's overall safety and soundness. We intend to maintain a capital position that meets or exceeds the "well capitalized" requirements established for banks by the FDIC. The following table shows the ratios of Tier 1 capital and total capital to risk-adjusted assets and the leverage ratios for the Corporation and the Bank as of December 31, 2008.

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**Capital Adequacy Ratios as of
December 31, 2008**

<u>Risk-Based Capital Ratios</u>	<u>Regulatory Minimums</u>	<u>Well-Capitalized Minimums</u>	<u>The Bank</u>	<u>The Corporation</u>
Tier 1 capital(1)	4.00%	6.00%	8.72%	8.89%
Total risk-based capital(2)	8.00%	10.00%	9.97%	10.14%
Tier 1 leverage ratio(3)	4.00%	5.00%	8.10%	8.09%

- (1) Shareholders' equity plus corporation-obligated mandatory redeemable capital securities, less unrealized gains (losses) on debt securities available for sale, net of deferred income taxes, less nonqualifying intangible assets; computed as a ratio of risk-weighted assets, as defined in the risk-based capital guidelines.
- (2) Tier 1 capital plus qualifying loan loss allowance and subordinated debt; computed as a ratio of risk-weighted assets, as defined in the risk-based capital guidelines.
- (3) Tier 1 capital computed as a percentage of fourth quarter average assets less nonqualifying intangibles.

OFF BALANCE SHEET ARRANGEMENTS

Our off balance sheet arrangements consist of commitments to make loans, unused borrower lines of credit, and stand by letters of credit, which are disclosed in Note 18 to the consolidated financial statements.

AGGREGATE CONTRACTUAL OBLIGATIONS

<u>December 31, 2008</u>	<u>Total</u>	<u>Less than one year</u>	<u>Greater than one year to 3 years</u>	<u>Greater than 3 years to 5 years</u>	<u>More than 5 years</u>
(Dollars in thousands)					
Aggregate Contractual Obligations:					
Time deposits	\$467,938	\$266,061	\$186,864	\$ 14,652	\$ 361
FHLB borrowings	52,947	131	25,262	265	27,289
Short-term borrowings	94,869	94,869	—	—	—
Subordinated debentures	18,000	—	—	—	18,000
Lease commitments	6,653	624	1,106	724	4,199

FHLB borrowings represent the amounts that are due to the FHLB of Cincinnati. These amounts have fixed maturity dates. Four of these borrowings, although fixed, are subject to conversion provisions at the option of the FHLB. The FHLB has the right to convert these advances to a variable rate or we can prepay the advances at no penalty. There is a substantial penalty if we prepay the advances before the FHLB exercises its right. We do not believe these advances will be converted in the near term.

The subordinated debentures, which mature June 24, 2038 and March 22, 2037, are redeemable before the maturity date at our option on or after June 24, 2018 and March 15, 2017 at their principal amount plus accrued interest. The subordinated debentures are also redeemable in whole or in part from time to time, upon the occurrence of specific events defined within the trust indenture. The interest rate on the subordinated debentures is at a 30 year fixed rate of 8.00% and a 10 year fixed rate of 6.69% adjusting quarterly thereafter at LIBOR plus 1.60%. We have the option to defer distributions on the subordinated debentures from time to time for a period not to exceed 20 consecutive quarters.

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Lease commitments represent the total future minimum lease payments under non-cancelable operating leases.

IMPACT OF INFLATION & CHANGING PRICES

The financial statements and related data presented herein have been prepared in accordance with U.S. generally accepted accounting principles, which require the measurement of financial position and operating results in historical dollars without considering changes in the relative purchasing power of money over time due to inflation.

The primary impact of inflation on our operations is reflected in increasing operating costs. Unlike most industrial companies, virtually all of the assets and liabilities of a financial institution are monetary in nature. As a result, changes in interest rates have a more significant impact on our performance than the effects of general levels of inflation and changes in prices. Periods of high inflation are often accompanied by relatively higher interest rates, and periods of low inflation are accompanied by relatively lower interest rates. As market interest rates rise or fall in relation to the rates earned on our loans and investments, the value of these assets decreases or increases respectively.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Asset /Liability Management and Market Risk

To minimize the volatility of net interest income and exposure to economic loss that may result from fluctuating interest rates, we manage our exposure to adverse changes in interest rates through asset and liability management activities within guidelines established by our Asset Liability Committee ("ALCO"). The ALCO, which includes senior management representatives, has the responsibility for approving and ensuring compliance with asset/liability management policies. Interest rate risk is the exposure to adverse changes in the net interest income as a result of market fluctuations in interest rates. The ALCO, on an ongoing basis, monitors interest rate and liquidity risk in order to implement appropriate funding and balance sheet strategies. Management considers interest rate risk to be our most significant market risk.

We utilize an earnings simulation model to analyze net interest income sensitivity. We then evaluate potential changes in market interest rates and their subsequent effects on net interest income. The model projects the effect of instantaneous movements in interest rates of both 100 and 200 basis points. We also incorporate assumptions based on the historical behavior of our deposit rates and balances in relation to changes in interest rates into the model. These assumptions are inherently uncertain and, as a result, the model cannot precisely measure future net interest income or precisely predict the impact of fluctuations in market interest rates on net interest income. Actual results will differ from the model's simulated results due to timing, magnitude and frequency of interest rate changes as well as changes in market conditions and the application and timing of various management strategies.

Our interest sensitivity profile was asset sensitive at December 31, 2008 and December 31, 2007. Given a sustained 100 basis point decrease in rates, our base net interest income would decrease by an estimated 2.67% at December 31, 2008 compared to a decrease of 1.10% at December 31, 2007. Given a 100 basis point increase in interest rates our base net interest income would increase by an estimated 1.49% at December 31, 2008 compared to an increase of 1.09% at December 31, 2007.

Our interest sensitivity at any point in time will be affected by a number of factors. These factors include the mix of interest sensitive assets and liabilities, their relative pricing schedules, market interest rates, deposit growth, loan growth, decay rates and prepayment speed assumptions.

We use various asset/liability strategies to manage the re-pricing characteristics of our assets and liabilities designed to ensure that exposure to interest rate fluctuations is limited within our guidelines

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of acceptable levels of risk-taking. As demonstrated by the December 31, 2008 and December 31, 2007 sensitivity tables, our balance sheet has an asset sensitive position. This means that our earning assets, which consist of loans and investment securities, will change in price at a faster rate than our deposits and borrowings. Therefore, if short term interest rates increase, our net interest income will increase. Likewise, if short term interest rates decrease, our net interest income will decrease.

Our sensitivity to interest rate changes is presented based on data as of December 31, 2008 and 2007.

	December 31, 2008				
	Decrease in Rates			Increase in Rates	
	200 Basis Points	100 Basis Points	Base	100 Basis Points	200 Basis Points
(Dollars in thousands)					
Projected interest income					
Loans	\$ 50,663	\$ 52,195	\$53,664	\$ 55,105	\$ 56,577
Investments	966	985	1,002	1,033	1,063
Total interest income	<u>51,629</u>	<u>53,180</u>	<u>54,666</u>	<u>56,138</u>	<u>57,640</u>
Projected interest expense					
Deposits	15,815	16,026	16,419	16,984	17,523
Borrowed funds	3,559	3,570	3,743	4,135	4,525
Total interest expense	<u>19,374</u>	<u>19,596</u>	<u>20,162</u>	<u>21,119</u>	<u>22,048</u>
Net interest income	<u>\$ 32,255</u>	<u>\$ 33,584</u>	<u>\$34,504</u>	<u>\$ 35,019</u>	<u>\$ 35,592</u>
Change from base	\$ (2,249)	\$ (920)		\$ 515	\$ 1,088
% Change from base	(6.52)%	(2.67)%		1.49%	3.15%

	December 31, 2007				
	Decrease in Rates			Increase in Rates	
	200 Basis Points	100 Basis Points	Base	100 Basis Points	200 Basis Points
(Dollars in thousands)					
Projected interest income					
Loans	\$ 54,208	\$ 55,624	\$57,011	\$ 58,344	\$ 59,644
Investments	2,319	2,351	2,376	2,407	2,439
Total interest income	<u>56,527</u>	<u>57,975</u>	<u>59,387</u>	<u>60,751</u>	<u>62,083</u>
Projected interest expense					
Deposits	20,995	21,856	22,733	23,572	24,485
Borrowed funds	3,481	3,656	3,829	3,997	4,166
Total interest expense	<u>24,476</u>	<u>25,512</u>	<u>26,562</u>	<u>27,569</u>	<u>28,651</u>
Net interest income	<u>\$ 32,051</u>	<u>\$ 32,463</u>	<u>\$32,825</u>	<u>\$ 33,182</u>	<u>\$ 33,432</u>
Change from base	\$ (774)	\$ (362)		\$ 357	\$ 607
% Change from base	(2.36)%	(1.10)%		1.09%	1.85%

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ITEM 8. Financial Statements and Supplementary Data

FIRST FINANCIAL SERVICE CORPORATION

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Audited Consolidated Financial Statements:

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Report on Management's Assessment of Internal Control Over Financial Reporting

First Financial Service Corporation is responsible for the preparation, integrity, and fair presentation of the consolidated financial statements included in this annual report. We, as management of First Financial Service Corporation, are responsible for establishing and maintaining effective internal control over financial reporting that is designed to produce reliable financial statements in conformity with U. S. generally accepted accounting principles. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the system of internal control over financial reporting as of December 31, 2008, in relation to criteria for effective internal control over financial reporting as described in "Internal Control—Integrated Framework," issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management concludes that, as of December 31, 2008, its system of internal control over financial reporting was not effective as it relates to certain internal controls over the lending function. See "Item 9A. Controls and Procedures" for further information. Crowe Horwath LLP, independent registered public accounting firm, has issued an attestation report on the Corporation's internal control over financial reporting dated March 16, 2009.

Date: March 16, 2009

By: /s/ B. KEITH JOHNSON

B. Keith Johnson
Chief Executive Officer

Date: March 16, 2009

By: /s/ STEVEN M. ZAGAR

Steven M. Zagar
Chief Financial Officer
Principal Accounting Officer

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders
First Financial Service Corporation
Elizabethtown, Kentucky

We have audited the accompanying consolidated balance sheets of First Financial Service Corporation as of December 31, 2008 and 2007 and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2008. We also have audited First Financial Service Corporation's internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). First Financial Service Corporation's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Report on Management's Assessment of Internal Control over Financial Reporting. Our responsibility is to express an opinion on these financial statements and an opinion on the company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weakness has been identified and included in management's assessment: The process of adequately monitoring and quantifying the magnitude of impaired loan relationships was not operating effectively as of December 31, 2008.

In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, First Financial Service Corporation has not maintained effective internal control over financial reporting as of December 31, 2008, based on the criteria established in *Internal Control—Integrated Framework* issued by the COSO.

The material weakness identified above was considered in determining the nature, timing and extent of audit procedures applied in our audit of the 2008 financial statements. In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of First Financial Service Corporation as of December 31, 2008 and 2007, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2008, in conformity with accounting principles generally accepted in the United States of America.



Crowe Horwath LLP

Louisville, Kentucky
March 16, 2009

FIRST FINANCIAL SERVICE CORPORATION**Consolidated Balance Sheets**

		<u>December 31,</u>	
		<u>2008</u>	<u>2007</u>
(Dollars in thousands, except share data)			
ASSETS:			
Cash and due from banks		\$ 17,310	\$ 14,242
Interest bearing deposits		3,595	706
Total cash and cash equivalents		<u>20,905</u>	<u>14,948</u>
Securities available-for-sale		15,775	22,004
Securities held-to-maturity, fair value of \$6,846 (2008) and \$17,624 (2007)		7,022	17,681
Total securities		<u>22,797</u>	<u>39,685</u>
Loans held for sale		9,567	780
Loans, net of unearned fees		903,434	767,256
Allowance for loan losses		(13,565)	(7,922)
Net loans		<u>899,436</u>	<u>760,114</u>
Federal Home Loan Bank stock		8,515	7,621
Cash surrender value of life insurance		8,654	8,290
Premises and equipment, net		30,068	26,335
Real estate owned:			
Acquired through foreclosure		5,925	1,749
Held for development		45	45
Other repossessed assets		91	52
Goodwill		11,931	8,384
Core deposit intangible		1,703	—
Accrued interest receivable		4,379	4,324
Deferred income taxes		1,147	—
Other assets		1,451	1,144
TOTAL ASSETS		<u><u>\$1,017,047</u></u>	<u><u>\$872,691</u></u>
LIABILITIES AND STOCKHOLDERS' EQUITY			
LIABILITIES:			
Deposits:			
Non-interest bearing		\$ 55,668	\$ 46,978
Interest bearing		719,731	642,265
Total deposits		<u>775,399</u>	<u>689,243</u>
Short-term borrowings		94,869	42,800
Advances from Federal Home Loan Bank		52,947	53,083
Subordinated debentures		18,000	10,000
Accrued interest payable		288	1,093
Accounts payable and other liabilities		2,592	1,789
Deferred income taxes		—	1,223
TOTAL LIABILITIES		<u>944,095</u>	<u>799,231</u>
Commitments and contingent liabilities (See Note 18)		—	—
STOCKHOLDERS' EQUITY:			
Serial preferred stock, 5,000,000 shares authorized and unissued		—	—
Common stock, \$1 par value per share; authorized 10,000,000 shares; issued and outstanding, 4,668,030 shares (2008), and 4,661,083 shares (2007)		4,668	4,661
Additional paid-in capital		34,145	33,886
Retained earnings		36,476	35,225
Accumulated other comprehensive loss		(2,337)	(312)

TOTAL STOCKHOLDERS' EQUITY	<u>72,952</u>	<u>73,460</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$1,017,047</u>	<u>\$872,691</u>

See notes to the consolidated financial statements.

FIRST FINANCIAL SERVICE CORPORATION**Consolidated Statements of Income**

	Year Ended December 31,		
	2008	2007	2006
(Dollars in thousands, except per share data)			
Interest and Dividend Income:			
Loans, including fees	\$55,739	\$58,019	\$50,803
Taxable securities	1,429	2,108	2,726
Tax exempt securities	396	418	303
Total interest income	<u>57,564</u>	<u>60,545</u>	<u>53,832</u>
Interest Expense:			
Deposits	20,512	25,519	18,688
Short-term borrowings	896	1,935	1,904
Federal Home Loan Bank advances	2,413	1,580	2,621
Subordinated debentures	978	717	895
Total interest expense	<u>24,799</u>	<u>29,751</u>	<u>24,108</u>
Net interest income	<u>32,765</u>	<u>30,794</u>	<u>29,724</u>
Provision for loan losses	5,947	1,209	540
Net interest income after provision for loan losses	<u>26,818</u>	<u>29,585</u>	<u>29,184</u>
Non-interest Income:			
Customer service fees on deposit accounts	6,601	5,792	5,460
Gain on sale of mortgage loans	697	569	783
Gain on sale of securities	55	—	—
Gain on sale of real estate held for development	—	227	—
Losses on securities impairment	(516)	—	—
Write down on real estate acquired through foreclosure	(162)	—	—
Brokerage commissions	469	424	346
Other income	1,305	1,191	1,150
Total non-interest income	<u>8,449</u>	<u>8,203</u>	<u>7,739</u>
Non-interest Expense:			
Employee compensation and benefits	14,600	12,593	11,903
Office occupancy expense and equipment	2,865	2,373	2,106
Marketing and advertising	782	914	859
Outside services and data processing	3,324	2,632	2,567
Bank franchise tax	1,010	923	871
FDIC insurance premiums	716	77	76
Write off of issuance cost of Trust Preferred Securities	—	229	—
Amortization of core deposit intangible	207	—	—
Other expense	4,782	4,049	3,570
Total non-interest expense	<u>28,286</u>	<u>23,790</u>	<u>21,952</u>
Income before income taxes	<u>6,981</u>	<u>13,998</u>	<u>14,971</u>
Income taxes	2,184	4,646	4,634
Net Income	<u>\$ 4,797</u>	<u>\$ 9,352</u>	<u>\$10,337</u>
Shares applicable to basic income per share	<u>4,666</u>	<u>4,722</u>	<u>4,821</u>
Basic income per share	<u>\$ 1.03</u>	<u>\$ 1.98</u>	<u>\$ 2.14</u>
Shares applicable to diluted income per share	4,686	4,774	4,870
Diluted income per share	<u>\$ 1.02</u>	<u>\$ 1.96</u>	<u>\$ 2.12</u>
Cash dividends declared per share	<u>\$ 0.760</u>	<u>\$ 0.726</u>	<u>\$ 0.660</u>

See notes to the consolidated financial statements.

FIRST FINANCIAL SERVICE CORPORATION**Consolidated Statements of Comprehensive Income**

(Dollars in thousands)	Year Ended December 31,		
	2008	2007	2006
Net Income	\$ 4,797	\$9,352	\$10,337
Other comprehensive income (loss):			
Change in unrealized gain (loss) on securities available-for-sale	(3,529)	(601)	41
Reclassification of realized amount	461	—	—
Net unrealized gain (loss) recognized in comprehensive income	(3,068)	(601)	41
Tax effect	1,043	204	(13)
Total other comprehensive income (loss)	(2,025)	(397)	28
Comprehensive Income	<u>\$ 2,772</u>	<u>\$8,955</u>	<u>\$10,365</u>

See notes to the consolidated financial statements.

FIRST FINANCIAL SERVICE CORPORATION**Consolidated Statements of Changes in Stockholders' Equity****Years Ending December 31, 2008, 2007 and 2006****(Dollars In Thousands, Except Per Share Amounts)**

	Common Shares	Stock Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), Net of Tax	Total
Balance, January 1, 2006	3,984	\$3,984	\$16,409	\$ 44,291	\$ 57	\$64,741
Net income				10,337		10,337
Stock dividend-10%	398	398	10,835	(11,233)		—
Stock issued for stock options exercised and employee benefit plans	3	3	61			64
Stock-based compensation expense			129			129
Net change in unrealized gains (losses) on securities available- for-sale, net of tax					28	28
Cash dividends declared (\$.66 per share)				(3,185)		(3,185)
Stock repurchased	(1)	(1)	(15)	—	—	(16)
Balance, December 31, 2006	4,384	4,384	27,419	40,210	85	72,098
Net income				9,352		9,352
Stock dividend-10%	424	424	10,493	(10,917)		—
Stock issued for stock options exercised and employee benefit plans	9	9	165			174
Stock-based compensation expense			110			110
Net change in unrealized gains (losses) on securities available- for-sale, net of tax					(397)	(397)
Cash dividends declared and cash dividends for fractional shares for stock dividend (\$.73 per share)				(3,420)		(3,420)
Stock repurchased	(156)	(156)	(4,301)	—	—	(4,457)
Balance, December 31, 2007	4,661	4,661	33,886	35,225	(312)	73,460
Net income				4,797		4,797
Stock issued for employee benefit plans	7	7	137			144
Stock-based compensation expense			122			122
Net change in unrealized gains (losses) on securities available- for-sale, net of tax					(2,025)	(2,025)
Cash dividends declared (\$.76 per share)	—	—	—	(3,546)	—	(3,546)
Balance, December 31, 2008	4,668	\$4,668	\$34,145	\$ 36,476	\$ (2,337)	\$72,952

See notes to the consolidated financial statements.

FIRST FINANCIAL SERVICE CORPORATION**Consolidated Statements of Cash Flows**

(Dollars in thousands)	Year Ended December 31,		
	2008	2007	2006
Operating Activities:			
Net income	\$ 4,797	\$ 9,352	\$ 10,337
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	5,947	1,209	540
Depreciation on premises and equipment	1,592	1,425	1,378
Federal Home Loan Bank stock dividends	(309)	—	(427)
Core deposit intangible amortization	207	—	—
Net amortization (accretion) available-for-sale	(3)	(2)	17
Net amortization (accretion) held-to-maturity	10	20	31
Impairment loss on securities	516	—	—
Gain on sale of investments available-for-sale	(55)	—	—
Gain on sale of real estate held for development	—	(227)	—
Gain on sale of mortgage loans	(697)	(569)	(783)
Origination of loans held for sale	(58,332)	(34,206)	(38,708)
Proceeds on sale of loans held for sale	50,242	34,668	39,415
Deferred taxes	(1,785)	54	(20)
Stock-based compensation expense	122	110	129
Changes in:			
Cash surrender value of life insurance	(364)	(343)	(310)
Interest receivable	(55)	(230)	(1,043)
Other assets	131	244	499
Interest payable	(933)	820	(116)
Accounts payable and other liabilities	(46)	468	298
Net cash from operating activities	<u>985</u>	<u>12,793</u>	<u>11,237</u>
Investing Activities:			
Cash paid for acquisition of Farmers State Bank, net of cash acquired	(1,466)	—	—
Sales of securities available-for-sale	669	—	—
Purchases of securities available-for-sale	(524)	(395)	(6,641)
Maturities of securities available-for-sale	2,557	6,015	6,767
Maturities of securities held-to-maturity	13,161	6,523	8,976
Net change in loans	(92,055)	(63,991)	(62,607)
Net purchases of premises and equipment	(4,306)	(5,260)	(4,744)
Sales of real estate held for development	—	519	—
Net cash from investing activities	<u>(81,964)</u>	<u>(56,589)</u>	<u>(58,249)</u>
Financing Activities			
Net change in deposits	30,405	48,206	49,931
Change in short-term borrowings	52,069	(25,700)	49,000
Advances from Federal Home Loan Bank	—	25,000	—
Repayments to Federal Home Loan Bank	(136)	(141)	(50,151)
Proceeds from issuance of subordinated debentures	8,000	10,000	—
Payoff of subordinated debentures	—	(10,000)	—
Issuance of common stock for options and employee benefit plans	144	174	64
Dividends paid	(3,546)	(3,420)	(3,185)
Common stock repurchased	—	(4,457)	(16)
Net cash from financing activities	<u>86,936</u>	<u>39,662</u>	<u>45,643</u>
Increase (Decrease) in cash and cash equivalents	5,957	(4,134)	(1,369)
Cash and cash equivalents, beginning of year	14,948	19,082	20,451
Cash and cash equivalents, end of year	<u>\$ 20,905</u>	<u>\$ 14,948</u>	<u>\$ 19,082</u>

See notes to the consolidated financial statements.

See Note 16 regarding non-cash transactions included in the acquisition.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The following is a description of the significant accounting policies First Financial Service Corporation follows in preparing and presenting its consolidated financial statements:

Principles of Consolidation and Business—The consolidated financial statements include the accounts of First Financial Service Corporation and its wholly owned subsidiary, First Federal Savings Bank. First Federal Savings Bank has three wholly owned subsidiaries, First Service Corporation of Elizabethtown, Heritage Properties, LLC and First Federal Office Park, LLC. Unless the text clearly suggests otherwise, references to "us," "we," or "our" include First Financial Service Corporation and its wholly-owned subsidiary. All significant intercompany transactions and balances have been eliminated in consolidation.

Our business consists primarily of attracting deposits from the general public and origination of mortgage loans on commercial property, single-family residences and multi-family housing. We also make home improvement loans, consumer loans and commercial business loans. Our primary lending area is a region within North Central Kentucky. The economy within this region is diversified with a variety of medical service, manufacturing, and agricultural industries, and Fort Knox, a military installation.

The principal sources of funds for our lending and investment activities are deposits, repayment of loans, Federal Home Loan Bank advances and other borrowings. Our principal source of income is interest on loans. In addition, other income is derived from loan origination fees, service charges, returns on investment securities, gain on sale of mortgage loans, and brokerage and insurance commissions.

Our subsidiary First Service Corporation is a licensed broker providing investment services and offering tax-deferred annuities, government securities and stocks and bonds to our customers. Heritage Properties, LLC holds real estate acquired through foreclosure which is available for sale. First Federal Office Park, LLC, another subsidiary, holds a commercial lot adjacent to our home office on Ring Road in Elizabethtown, which is available for sale.

Estimates and Assumptions—The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of the amount of revenues and expenses during the reporting period. Actual results could differ from those estimates. The allowance for loan losses and the fair value of financial instruments are particularly subject to change.

Cash Flows—For purposes of the statement of cash flows, we consider all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. Cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold and certain interest bearing deposits. Net cash flows are reported for interest-bearing deposits, loans, short-term borrowings and deposits.

Securities—We classify investments into held-to-maturity and available-for-sale. Debt securities in which management has a positive intent and ability to hold are classified as held-to-maturity and are carried at cost adjusted for the amortization of premiums and discounts using the interest method over the terms of the securities. Debt and equity securities, which do not fall into this category, are classified as available-for-sale. Unrealized holding gains and losses, net of tax, on available-for-sale securities are reported as a component of accumulated other comprehensive income.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

Declines in the fair value of securities below their cost that are other than temporary are reflected as realized losses. In estimating other-than-temporary losses, management considers: (1) the length of time and extent that fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, and (3) our ability and intent to hold the security for a period sufficient to allow for any anticipated recovery in fair value. For certain securities, we evaluated for impairment based on an evaluation as to whether there has been an adverse change in expected cash flows.

Loans—Loans are stated at unpaid principal balances, less undistributed construction loans, and net deferred loan origination fees. We defer loan origination fees and discounts net of certain direct origination costs. These net deferred fees are amortized using the level yield method on a loan-by-loan basis over the lives of the underlying loans.

Interest income on loans is accrued on the unpaid principal balance except for those loans in nonaccrual status. The accrual of interest is discontinued when a loan becomes 90 or more days delinquent. When interest accrual is discontinued, all accrued interest not received is reversed against interest income. Interest income is subsequently recognized only to the extent cash payments are received. Interest accruals resume when the loan becomes less than 90 days delinquent.

Allowance for Loan Losses—The allowance for loan losses is a valuation allowance for probable incurred credit losses. Loan losses are charged against the allowance when we believe the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Our periodic evaluation of the allowance is based on our past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and current economic conditions. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off.

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

Loans are considered impaired when, based on current information and events, it is probable that full principal or interest payments are not anticipated in accordance with the contractual loan terms. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate, or at the fair value of collateral if repayment is expected solely from collateral. Commercial and commercial real estate loans are individually evaluated for impairment. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans, are collectively evaluated for impairment and are not separately identified for impairment disclosures. A portion of the allowance for loan losses is allocated to impaired loans if the value of such loans is less than the unpaid balance. If these allocations cause

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

the allowance for loan losses to require an increase, such increase is reported in the provision for loan losses.

Mortgage Banking Activities—Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or market value. To deliver closed loans to the secondary market and to control its interest rate risk prior to sale, we enter into "best efforts" agreements to sell loans. The aggregate market value of mortgage loans held for sale considers the price of the sales contracts. The loans are sold with servicing released.

Loan commitments related to the origination of mortgage loans held for sale are accounted for as derivative instruments. Our commitments are for fixed rate mortgage loans, generally lasting 60 to 90 days and are at market rates when initiated. Considered derivatives, we had commitments to originate \$12.7 million and \$6.0 million in loans at December 31, 2008 and 2007, which we intend to sell after the loans are closed.

The fair value was not material. Substantially all of the gain on sale generated from mortgage banking activities continues to be recorded when closed loans are delivered into the sales contracts.

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

Cash Surrender Value of Life Insurance—We have purchased life insurance policies on certain key executives. In accordance with EITF 06-5, owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

Premises and Equipment—Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Buildings and related components are depreciated using the straight-line method with useful lives ranging from 5 to 40 years. Furniture, fixtures and equipment are depreciated using the straight-line method with useful lives ranging from 3 to 15 years.

Real Estate Owned—Real estate properties acquired through foreclosure and in settlement of loans are stated at lower of cost or fair value less estimated selling costs at the date of foreclosure. The excess of cost over fair value less the estimated costs to sell at the time of foreclosure is charged to the allowance for loan losses. Costs relating to development and improvement of property are capitalized, whereas costs relating to holding property are not capitalized and are charged against operations in the current period.

Real Estate Held for Development—Real estate properties held for development and sale are carried at the lower of cost, including cost of development and improvement subsequent to acquisition, or fair value less estimated selling costs. The portion of interest costs relating to the development of real estate is capitalized.

Other Repossessed Assets—Consumer assets acquired through repossession and in settlement of loans, typically automobiles, are carried at lower of cost or fair value at the date of repossession. The excess cost over fair value at time of repossession is charged to the allowance for loan losses.

Goodwill and Other Intangible Assets—Goodwill results from business acquisitions and represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

identifiable intangible assets. Goodwill is assessed at least annually for impairment and any such impairment will be recognized in the period identified.

Other intangible assets consist of core deposit and acquired customer relationship intangible assets arising from whole bank and branch acquisitions. They are initially measured at fair value and then are amortized on an accelerated method over their estimated useful lives, which range from 7 to 10 years.

Long-Term Assets—Premises and equipment, core deposit and other intangible assets, and other long-term assets are reviewed for impairment when events indicate their carrying amount may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value.

Stock Dividend—We declared a 10% stock dividend on August 16, 2007 to our shareholders of record as of August 29, 2007, payable on September 14, 2007. The payment of this dividend was in addition to the regular quarterly cash dividend. Per share amounts have been restated for the impact of the stock dividend.

Stock dividends for 20% or less are reported by transferring the fair value, as of the dividend date, of the stock issued from retained earnings to common stock and additional paid-in-capital. Fractional share amounts are paid in cash with a reduction to retained earnings.

Brokerage and Insurance Commissions—Brokerage commissions are recognized as income on settlement date. Insurance commissions on loan products (credit life, mortgage life, accidental death, and guaranteed auto protection) are recognized as income over the life of the loan.

Stock Based Compensation—Compensation cost is recognized for stock options issued to employees, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options. Compensation cost is recognized over the required service period, generally defined as the vesting period.

Income Taxes—Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized. We adopted FASB Interpretation 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"), as of January 1, 2007. A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. We recognize interest and penalties related to income tax matters in income tax expense.

Employee Stock Ownership Plan—Compensation expense is based on the market price of shares as they are committed to be released to participant accounts. Dividends on allocated ESOP shares reduce retained earnings. Since the ESOP has not acquired shares in advance of allocation to participant accounts, the plan has no unallocated shares.

Earnings Per Common Share—Basic earnings per common share is net income divided by the weighted average number of common shares outstanding during the period. Diluted earnings per common share include the dilutive effect of additional potential common shares issuable under stock

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

options. Earnings and dividends per share are restated for all stock dividends through the date of issuance of the financial statements.

Loss Contingencies—In the normal course of business, there are various outstanding legal proceedings and claims. In the opinion of management the disposition of such legal proceedings and claims will not materially affect our consolidated financial position, results of operations or liquidity.

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, which are also recognized as a separate component of equity, net of tax.

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

Dividend Restriction—Banking regulations require maintaining certain capital levels and may limit the dividends paid by the bank to the holding company or by the holding company to shareholders.

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

Operating Segments—Segments are parts of a company evaluated by management with separate financial information. Our internal financial information is primarily reported and evaluated in three lines of business, banking, mortgage banking, and brokerage. These segments are dominated by banking at a magnitude for which separate individual segment disclosures are not required.

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

Adoption of New Accounting Standards—In January 2009, the FASB issued FASB Staff Position No. EITF 99-20-1, *Amendments to the Impairment Guidance of EITF Issue No. 99-20*. This FASB staff position revises the impairment guidance for beneficial interests in EITF 99-20 to make it consistent with the requirements of FASB Statement No. 115 for determining whether an impairment of debt or equity securities has occurred. This FASB staff position became effective for interim and annual reporting periods ending after December 15, 2008, and shall be applied prospectively. We incorporated this guidance in our review of impairment as of December 31, 2008.

We adopted the provisions of SFAS No. 157, *Fair Value Measurements* ("SFAS No. 157") on January 1, 2008. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in U.S. generally accepted accounting principles (U.S. GAAP), and expands disclosures about fair value measurements. More specifically, this statement clarifies the definition of fair value, establishes a fair valuation hierarchy based upon observable (e.g. quoted prices, interest rates, yield curves) and unobservable market inputs, and expands disclosure requirements to include the inputs used to develop estimates of fair value and the effects of the estimates on income for the period. This statement does not require any new fair value measurements. For further information, see Note 4.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In February 2008, the FASB issued Staff Position (FSP) 157-2, *Effective Date of FASB Statement No. 157*. This FSP delays the effective date of FAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. We applied this guidance in recording our business combination.

In October 2008, the FASB issued FSP No. 157-3, *Determining the Fair Value of a Financial Asset When the Market for that Asset Is Not Active*. The FSP clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key consideration in determining the fair value of a financial asset when the market for that financial asset is not active. We applied this guidance in valuing our trust preferred securities. See Note 2 for further details.

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*. This statement allows companies to record certain financial assets and financial liabilities at full fair value if they so choose. The statement was issued to mitigate volatility in reported earnings caused by an accounting model utilizing multiple measurement attributes. The adoption of the fair value option is recorded as a cumulative-effect adjustment to the opening balance of retained earnings, which would be January 1, 2008. Upon adoption, the difference between the carrying amount and the fair value of the items chosen is removed from the balance sheet and included in the cumulative-effect adjustment. Subsequent changes in fair value are recorded through the income statement. We did not elect the fair value option for any financial assets or financial liabilities as of January 1, 2008 or subsequently.

In November 2007, the SEC issued Staff Accounting Bulletin No. 109, "Written Loan Commitments Recorded at Fair Value through Earnings" ("SAB 109"). Previously, Staff Accounting Bulletin No. 105, "Application of Accounting Principles to Loan Commitments" ("SAB 105"), stated that in measuring the fair value of a derivative loan commitment, a company should not incorporate the expected net future cash flows related to the associated servicing of the loan. SAB 109 supersedes SAB 105 and indicates that the expected net future cash flows related to the associated servicing of the loan should be included in measuring fair value for all written loan commitments that are accounted for at fair value through earnings. SAB 105 also indicated that internally-developed intangible assets should not be recorded as part of the fair value of a derivative loan commitment, and SAB 109 retains that view. SAB 109 has not had a material impact on our financial statements.

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*. This issue requires that a liability be recorded during the service period when a split-dollar life insurance agreement continues after participants' employment or retirement. The required accrued liability will be based on either the post-employment benefit cost for the continuing life insurance or based on the future death benefit depending on the contractual terms of the underlying agreement. This issue is effective for fiscal years beginning after December 15, 2007. The impact of adoption was not material.

Effect of Newly Issued But Not Yet Effective Accounting Standards—In December 2007, the FASB issued SFAS 141 (revised 2007), *Business Combinations (SFAS 141R)*. SFAS 141R establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree. SFAS 141R also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

evaluate the nature and financial effects of the business combination. SFAS 141R is effective for business combinations where the acquisition date is on or after fiscal years beginning after December 15, 2008. SFAS 141R is expected to have an impact on our accounting for any business combinations closing on or after January 1, 2009.

In December 2007, the FASB issued SFAS 160, *Non-controlling Interests in Consolidated Financial Statements—an amendment of ARB No. 51 (SFAS 160)*. SFAS 160 establishes accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 clarifies that a non-controlling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements and requires retroactive adoption of the presentation and disclosure requirements for existing minority interests. All other requirements of SFAS 160 shall be applied prospectively. SFAS 160 is effective for fiscal years beginning after December 15, 2008. Adoption of this standard is not expected to have a material impact.

In March 2008, the FASB issued Statement No. 161—*Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. SFAS No. 161 requires enhanced disclosures about how and why an entity uses derivative instruments, how derivative instruments and related items are accounted for under Statement 133 and how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows. The new standard is effective for us on January 1, 2009. Adoption of this standard is not expected to have a material impact.

In September 2008, the FASB issued FASB Staff Position No. FAS 133-1 and FIN 45-4, *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161*. This staff position amends FASB Statement 133 to require sellers of credit derivatives to disclose information about their credit derivatives and hybrid instruments that have embedded credit derivatives. This staff position also amends FASB Interpretation No. 45 to require additional disclosure about the current status of the payment/performance risk of the guarantee. It also clarifies the intent of FASB about the effective date of SFAS No. 161. These provisions of this FASB staff position are effective for the reporting periods ending after November 15, 2008. Adoption of this standard is not expected to have a material impact.

In December 2008, the FASB issued FASB Staff Position No. FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*. This FASB staff position amends FASB Statement No. 140 to require public entities to provide additional disclosures about transferors' continuing involvement with transferred financial assets. It also amends Interpretation 46(R) to require public enterprises, including sponsors that have a variable interest in a variable interest entity, to provide additional disclosures about their involvement with variable interest entities. This FASB staff position becomes effective on December 31, 2008. Adoption of this standard is not expected to have a material impact.

In December 2008, the FASB issued FASB Staff Position No. 132(R)-1, *Employers' Disclosures about Postretirement Benefit Plan Assets*. This FASB staff position amends FASB Statement No. 132 to provide guidance on an employer's disclosures about plan assets of a defined benefit pension or other postretirement plan. FSP FAS 132(R)-1 requires disclosure of the fair value of each major category of plan assets for pension plans and other postretirement benefit plans. This FASB staff position becomes

[Table of Contents](#)**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

effective for us on January 1, 2010. Adoption of this standard is not expected to have a material impact.

2. SECURITIES

The amortized cost basis and fair values of securities are as follows:

(Dollars in thousands)	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
Securities available-for-sale:				
December 31, 2008:				
Mortgage-backed	\$ 6,079	\$ 70	\$ (10)	\$ 6,139
Equity	933	17	(2)	948
State and municipal	9,558	3	(946)	8,615
Corporate	2,732	—	(2,659)	73
Total	<u>\$ 19,302</u>	<u>\$ 90</u>	<u>\$ (3,617)</u>	<u>\$ 15,775</u>
December 31, 2007:				
U.S. Treasury and agencies	\$ 498	\$ 3	\$ —	\$ 501
Mortgage-backed	7,624	5	(53)	7,576
Equity	1,553	324	(355)	1,522
State and municipal	9,994	4	(400)	9,598
Corporate	2,807	—	—	2,807
Total	<u>\$ 22,476</u>	<u>\$ 336</u>	<u>\$ (808)</u>	<u>\$ 22,004</u>
Securities held-to-maturity:				
December 31, 2008:				
U.S. Treasury and agencies	\$ 4,503	\$ 54	\$ —	\$ 4,557
Mortgage-backed	1,780	—	(7)	1,773
State and municipal	481	2	—	483
Corporate	258	—	(225)	33
Total	<u>\$ 7,022</u>	<u>\$ 56</u>	<u>\$ (232)</u>	<u>\$ 6,846</u>
December 31, 2007:				
U.S. Treasury and agencies	\$ 14,098	\$ 33	\$ (38)	\$ 14,093
Mortgage-backed	3,142	1	(51)	3,092
Corporate	441	—	(2)	439
Total	<u>\$ 17,681</u>	<u>\$ 34</u>	<u>\$ (91)</u>	<u>\$ 17,624</u>

[Table of Contents](#)**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****2. SECURITIES (Continued)**

The amortized cost and fair value of securities at December 31, 2008, by contractual maturity, are shown below. Securities not due at a single maturity date, primarily mortgage-backed and equity securities, are shown separately.

(Dollars in thousands)	<u>Available for Sale</u>		<u>Held-to-Maturity</u>	
	<u>Amortized</u>	<u>Fair</u>	<u>Amortized</u>	<u>Fair</u>
	<u>Cost</u>	<u>Value</u>	<u>Cost</u>	<u>Value</u>
Due in one year or less	\$ 110	\$ 111	\$ 4,738	\$4,792
Due after one year through five years	115	117	246	248
Due after five years through ten years	—	—	—	—
Due after ten years	12,065	8,460	258	33
Mortgage-backed	6,079	6,139	1,780	1,773
Equity	933	948	—	—
	<u>\$19,302</u>	<u>\$15,775</u>	<u>\$ 7,022</u>	<u>\$6,846</u>

The following schedule shows the proceeds from sales of available-for-sale securities and the gross realized gains on those sales:

	<u>Year Ended December 31,</u>		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
	(Dollars in thousands)		
Proceeds from sales	\$ 669	\$ —	\$ —
Gross realized gains	\$ 55	\$ —	\$ —

Tax expense related to the realized gain for the year ended December 31, 2008 was \$19,000.

Investment securities pledged to secure public deposits and FHLB advances had an amortized cost of \$19.6 million and fair value of \$18.8 million at December 31, 2008 and a \$22.0 million amortized cost and a \$21.7 fair value at December 31, 2007.

Securities with unrealized losses at year-end 2008 and 2007 aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position are as follows. Trust preferred securities are included in the corporate category:

December 31, 2008	<u>Less than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair</u>	<u>Unrealized</u>	<u>Fair</u>	<u>Unrealized</u>	<u>Fair</u>	<u>Unrealized</u>
<u>Description of Securities</u>	<u>Value</u>	<u>Loss</u>	<u>Value</u>	<u>Loss</u>	<u>Value</u>	<u>Loss</u>
Mortgage-backed	\$3,944	\$ (15)	\$ 526	\$ (2)	\$ 4,470	\$ (17)
Equity	6	(2)	—	—	6	(2)
State and municipal	938	(99)	7,450	(847)	8,388	(946)
Corporate	106	(2,884)	—	—	106	(2,884)
Total temporarily impaired	<u>\$4,994</u>	<u>\$ (3,000)</u>	<u>\$7,976</u>	<u>\$ (849)</u>	<u>\$12,970</u>	<u>\$ (3,849)</u>

[Table of Contents](#)**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****2. SECURITIES (Continued)**

December 31, 2007	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<u>Description of Securities</u>						
U. S. Treasury and agencies	\$ —	\$ —	\$10,062	\$ (38)	\$10,062	\$ (38)
Mortgage-backed	—	—	8,939	(104)	8,939	(104)
Equity	127	(73)	345	(282)	472	(355)
State and municipal	1,128	(19)	7,882	(381)	9,010	(400)
Corporate	439	(2)	—	—	439	(2)
Total temporarily impaired	<u>\$1,694</u>	<u>\$ (94)</u>	<u>\$27,228</u>	<u>\$ (805)</u>	<u>\$28,922</u>	<u>\$ (899)</u>

Each quarter we reviewed all investments with an unrealized loss position for other than temporary impairment ("OTTI") under SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS No. 115") and EITF 99-20-1, "Amendments to the Impairment Guidance of EITF 99-20. EITF 99-20-1 revises the impairment guidance for beneficial interests in EITF 99-20 to better align with the requirements of SFAS No. 115 for determining whether an impairment of debt securities has occurred. According to SFAS No. 115, for individual securities classified as either available-for-sale ("AFS") or held-to-maturity ("HTM"), a company shall determine whether a decline in fair value below amortized cost basis is other-than-temporarily impaired ("OTTI"). If the decline in fair value is judged to be OTTI, the cost basis of the individual security shall be written down to fair value and the write-down shall be included in earnings.

The unrealized losses on the state and municipal securities were caused primarily by interest rate decreases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because we have the ability and intent to hold those investments until a recovery of fair value, which may be maturity, we do not consider those investments to be other than temporarily impaired at December 31, 2008.

We recognized other-than-temporary impairment charges of \$516,000 during the year on equity securities with a cost basis of \$840,000. Management believes this impairment was primarily attributable to current economic conditions. Since recovery does not appear likely in the near future, we recognized the impairment losses. Previously, we recognized the decline in market value of these equity securities in stockholders' equity through comprehensive income. We continue to monitor these holdings.

As discussed in Note 4—Fair Value, the fair value of our portfolio of trust preferred securities, which are included in the corporate category, has decreased significantly as a result of the current credit crisis and lack of liquidity in the financial markets. There are limited trades in trust preferred securities and the majority of holders of such instruments have elected not to participate in the market unless they are required to sell as a result of liquidation, bankruptcy, or other forced or distressed conditions.

To determine if the five trust preferred securities were other than temporarily impaired as of December 31, 2008, we used a discounted cash flow analysis. The cash flow models used were used to determine if the current present value of the cash flows expected on each security were still equivalent to the original cash flows projected on the security when purchased. The cash flows on each security were equivalent to the original cash flows projected when the security was purchased as there have been no principal or interest shortfalls. The cash flow analysis takes into consideration assumptions for prepayments, defaults and deferrals for the underlying pool of banks, insurance companies and REITs. The cash flow analysis supports our assertion that there is no change in the present value of cash flows, and that we have determined the decline in fair value below amortized cost is temporary, based on

[Table of Contents](#)**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****2. SECURITIES (Continued)**

management's assessment of the full recoverability of the securities and that we have the intent and ability to hold these securities until full recovery or maturity.

In making our determination, we considered all available market information that could be obtained without undue cost and effort, and considered the unique characteristics of each trust preferred security individually by assessing the available market information and the various risks associated with that security including:

- Valuation estimates provided by our investment broker;
- The amount of fair value decline;
- How long the decline in fair value has existed;
- Significant rating agency changes on the issuer;
- Level of interest rates and any movement in pricing for credit and other risks;
- Information about the performance of the underlying institutions that issued the debt instruments, such as net income, return on equity, capital adequacy, non-performing assets, Texas ratios, etc;
- Our intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in fair value; and
- Other relevant observable inputs.

We will continue to evaluate the portfolio of trust preferred securities for OTTI on a quarterly basis.

3. LOANS

Loans are summarized as follows:

(Dollars in thousands)	December 31,	
	2008	2007
Commercial	\$ 56,863	\$ 52,595
Real estate commercial	563,314	470,929
Real estate construction	17,387	21,383
Residential mortgage	165,337	132,329
Consumer and home equity	69,649	63,090
Indirect consumer	31,754	27,721
Loans held for sale	9,567	780
	<u>913,871</u>	<u>768,827</u>
Less:		
Net deferred loan origination fees	(870)	(791)
Allowance for loan losses	(13,565)	(7,922)
	<u>(14,435)</u>	<u>(8,713)</u>
Net Loans	<u>\$899,436</u>	<u>\$760,114</u>

We utilize eligible real estate loans to collateralize advances and letters of credit from the Federal Home Loan Bank. We had \$515 million and \$430 million in residential mortgage, commercial real

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estate, multi-family and open end home equity loans pledged under this arrangement at December 31, 2008 and 2007.

The allowance for loan loss is summarized as follows:

(Dollars in thousands)	As of and For the Years Ended December 31,		
	2008	2007	2006
Balance, beginning of year	\$ 7,922	\$ 7,684	\$7,377
Allowance related to acquisition	327	—	—
Provision for loan losses	5,947	1,209	540
Charge-offs	(894)	(1,210)	(614)
Recoveries	263	239	381
Balance, end of year	<u>\$13,565</u>	<u>\$ 7,922</u>	<u>\$7,684</u>

Impaired loans are summarized below. There were no impaired loans for the periods presented without an allowance allocation.

(Dollars in thousands)	As of and For the Years Ended December 31,		
	2008	2007	2006
Year-end impaired loans	\$16,769	\$8,889	\$4,838
Amount of allowance for loan loss allocated	3,090	117	128
Average impaired loans outstanding	11,746	6,970	5,808
Interest income recognized	75	188	227
Interest income received	75	188	227

We report non-performing loans as impaired. Our non-performing loans at year-end were as follows:

(Dollars in thousands)	December 31,	
	2008	2007
Restructured	\$ 1,182	\$2,335
Loans past due over 90 days still on accrual	—	—
Non accrual loans	15,587	6,554
Total	<u>\$16,769</u>	<u>\$8,889</u>

4. FAIR VALUE

SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS No. 157 establishes a fair value hierarchy that prioritizes the use of inputs used in valuation methodologies into the following three levels:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.

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

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

[Table of Contents](#)**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****4. FAIR VALUE (Continued)***Assets and Liabilities Measured at Fair Value on a Recurring Basis*

Assets measured at fair value on a recurring basis as of December 31, 2008 are summarized below:

(Dollars in thousands)	<u>December 31, 2008</u>	<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
Assets:				
Available-for-sale securities	\$ 15,775	\$ 657	\$ 14,754	\$ 364

The fair values of equity securities are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs). The fair values of debt securities are determined by a 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). In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within (Level 3) of the valuation hierarchy.

Between June 2002 and July 2006, we invested in four AFS and one HTM investment grade tranches of trust preferred collateralized debt obligation ("CDO") securities. The securities were issued and are referred to as Preferred Term Securities Limited ("PreTSL"). The underlying collateral for the PreTSL is unguaranteed pooled trust preferred securities issued by banks, insurance companies and REITs geographically dispersed across the United States. We hold five PreTSL securities, two of which are investment grade. Prior to September 30, 2008, we determined the fair value of the trust preferred securities using a valuation technique based on Level 2 inputs. The Level 2 inputs included estimates of the market value for each security provided through our investment broker.

Since late 2007, the markets for collateralized debt obligations and trust preferred securities have become increasingly inactive. The inactivity was first evidenced in late 2007 when new issues of similar securities were discounted in order to complete the offering. Beginning in the second quarter of 2008, the purchase and sale activity of these securities substantially decreased as investors elected to hold the securities instead of selling them at substantially depressed prices. Our brokers have indicated that little if any activity is occurring in this sector and that the PreTSL securities trades that are taking place are primarily distressed sales where the seller must liquidate as a result of insolvency, redemptions or closure of a fund holding the security, or other distressed conditions. As a result, the bid-ask spreads have widened significantly and the volume of trades decreased significantly compared to historical volumes.

As of December 31, 2008, we determined that the market for the trust preferred securities that we hold and for similar CDO securities (such as higher-rated tranches within the same CDO security) are also not active. That determination was made considering that there are few observable transactions for the trust preferred securities or similar CDO securities and the observable prices for those transactions have varied substantially over time. Consequently, we have considered those observable inputs and determined that our trust preferred securities are classified within Level 3 of the fair value hierarchy.

We have determined that an income approach valuation technique (using cash flows and present value techniques) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs is equally or more representative of fair value than relying on the estimation of

[Table of Contents](#)**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****4. FAIR VALUE (Continued)**

market value technique used at prior measurement dates, which now has few observable inputs and relies on an inactive market with distressed sales conditions that would require significant adjustments.

We received valuation estimates on our trust preferred securities for December 31, 2008. Those valuation estimates were based on proprietary pricing models utilizing significant unobservable inputs in an inactive market with distressed sales, Level 3 inputs, rather than actual transactions in an active market.

In accordance with the requirements of SFAS 157, we determined that a risk-adjusted discount rate appropriately reflects the reporting entity's estimate of the assumptions that market participants would use in an active market to estimate the selling price of the asset at the measurement date.

We conduct a thorough review of fair value hierarchy classifications on a quarterly basis. Reclassification of certain financial instruments may occur when input observability changes.

The table below presents a reconciliation and income statement classification of gains and losses for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the period ended December 31, 2008:

(Dollars in thousands)	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) Asset/Liability
Beginning balance, January 1, 2008	\$ —
Total gains or losses realized:	
Included in earnings	
Impairment charge on security	(349)
Transfers in and/or out of Level 3	713
Ending balance, December 31, 2008	<u>\$ 364</u>

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

Assets measured at fair value on a nonrecurring basis as of December 31, 2008 are summarized below:

(Dollars in thousands)	December 31, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Impaired Loans	\$ 13,679	\$ —	\$ —	\$ 13,679

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of \$16.8 million, with a valuation allowance of \$3.1 million, resulting in an additional provision for loan losses of \$3.0 million for the 2008 period. Values for collateral dependent loans are generally based on appraisals obtained from licensed real estate appraisals and in certain circumstances consideration of offers obtained to purchase properties prior to foreclosure. Appraisals for commercial real estate generally use three methods to derive value: cost, sales or market comparison and income approach. The cost method bases value on the estimated

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cost to replace the current property after considering adjustments for depreciation. Values of the market comparison approach evaluate the sales price of similar properties in the same market area. The income approach considers net operating income generated by the property and an investors required return. The final value is a reconciliation of these three approaches and takes into consideration any other factors management deems relevant to arrive at a representative fair value.

Fair Value of Financial Instruments

The estimated fair value of financial instruments not previously presented is as follows:

(Dollars in thousands)	December 31, 2008		December 31, 2007	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Financial assets:				
Cash and due from banks	\$ 20,905	\$ 20,905	\$ 14,948	\$ 14,948
Securities held-to-maturity	7,022	6,846	17,681	17,624
Loans held for sale	9,567	9,702	780	793
Loans, net	889,869	925,817	759,334	771,971
Accrued interest receivable	4,379	4,379	4,324	4,324
FHLB stock	8,515	N/A	7,621	N/A
Financial liabilities:				
Deposits	775,399	777,743	689,243	683,091
Short-term borrowings	94,869	94,869	42,800	42,800
Advances from Federal Home Loan Bank	52,947	57,757	53,083	53,386
Subordinated debentures	18,000	12,804	10,000	8,830
Accrued interest payable	288	288	1,093	1,093

The methods and assumptions used in estimating fair value disclosures for financial instruments are presented below:

Carrying amount is the estimated fair value for cash and cash equivalents, interest bearing deposits, accrued interest receivable and payable, demand deposits, short-term debt and variable rate loans or deposits that reprice frequently and fully. Held-to-maturity securities fair values are based on market prices or dealer quotes and if no such information is available, on the rate and term of the security and information about the issuer. The value of loans held for sale is based on the underlying sale commitments. For fixed rate loans or deposits and for variable rate loans or deposits with infrequent reprising or reprising limits, fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk. Fair values of advances from Federal Home Loan Bank and subordinated debentures are based on current rates for similar financing. The fair value of off-balance-sheet items is based on the current fees or cost that would be charged to enter into or terminate such arrangements and is not material. It is not practicable to determine the fair value of FHLB stock due to restrictions placed on its transferability.

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Premises and equipment consist of the following:

(Dollars in thousands)	<u>December 31,</u>	
	<u>2008</u>	<u>2007</u>
Land	\$ 7,623	\$ 6,666
Buildings	23,879	20,429
Furniture, fixtures and equipment	11,560	9,269
	<u>43,062</u>	<u>36,364</u>
Less accumulated depreciation	(12,994)	(10,029)
	<u>\$ 30,068</u>	<u>\$ 26,335</u>

Certain premises are leased under various operating leases. Rental expense was \$432,000, \$370,000 and \$281,000, for the years ended December 31, 2008, 2007 and 2006, respectively. Future minimum commitments under these leases are:

(Dollars in thousands)	<u>Year Ended</u>
	<u>December 31,</u>
2009	\$ 624
2010	578
2011	528
2012	428
2013	296
Thereafter	4,199
	<u>\$ 6,653</u>

6. DEPOSITS

Time Deposits of \$100,000 or more were \$211.9 million and \$174.9 million at December 31, 2008 and 2007, respectively. At December 31, 2008, scheduled maturities of time deposits are as follows:

(Dollars in thousands)	<u>Amount</u>
2009	\$266,061
2010	160,848
2011	26,016
2012	7,085
2013	7,567
Thereafter	361
	<u>\$467,938</u>

7. SHORT-TERM BORROWINGS

Short-term borrowings consist of federal funds purchased. We had short-term borrowings of \$94.9 million and \$42.8 million from the FHLB of Cincinnati, First Tennessee Bank and National City Bank at December 31, 2008 and from the FHLB of Cincinnati at 2007. These borrowings averaged a rate of 2.02% and 5.26% for 2008 and 2007.

[Table of Contents](#)**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****8. ADVANCES FROM FEDERAL HOME LOAN BANK**

Under the collateral requirements of the Federal Home Loan Bank (FHLB) of Cincinnati, we have the capacity to borrow an additional \$4.0 million from the FHLB at December 31, 2008. During 2007, we entered into \$25.0 million in convertible fixed rate advances with fixed rates ranging from 3.99% to 4.22% and maturities of seven to ten years. These advances are fixed for periods ranging from one to three years. At the end of the fixed rate term and quarterly thereafter, the FHLB has the right to convert these advances to variable rate advances tied to the three-month LIBOR index. Upon conversion, we can prepay the advances at no penalty.

Advances from the FHLB at year-end are as follows:

(Dollars in Thousands)	December 31,			
	2008		2007	
	Weighted-Average Rate	Amount	Weighted-Average Rate	Amount
Fixed rate advances:				
Mortgage matched advances with interest rates from 5.75% to 7.45% due through 2009	6.28%	\$ 1	5.90%	\$ 7
Convertible fixed rate advances with interest rates from 3.99% to 5.05% due through 2017	4.55%	50,000	4.55%	50,000
Other fixed rate advances with interest rates from 4.19% to 5.72% due through 2020	4.94%	2,946	4.94%	3,076
Total borrowings		<u>\$52,947</u>		<u>\$53,083</u>

The aggregate minimum annual repayments of borrowings as of December 31, 2008 are as follows:

(Dollars in Thousands)	
2009	\$ 131
2010	131
2011	25,131
2012	132
2013	133
Thereafter	27,289
	<u>\$ 52,947</u>

9. LINES OF CREDIT

The Corporation has \$18.0 million in lines of credit with a correspondent bank. As of December 31, 2008, the outstanding balance of these lines was \$0. The lines mature on January 19, 2010 and December 19, 2013. Interest is due quarterly at a rate of prime minus 50 basis points with a floor of 4.50%.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**10. SUBORDINATED DEBENTURES**

On June 24, 2008, First Federal Statutory Trust III, an unconsolidated trust subsidiary of First Financial Service Corporation, issued \$8.0 million in trust preferred securities. The trust loaned the proceeds of the offering to us in exchange for junior subordinated deferrable interest debentures which we used to finance the purchase of FSB Bancshares, Inc. In accordance with FASB Interpretation 46, the trust is not consolidated with our financial statements but rather the subordinated debentures are shown as a liability. The subordinated debentures, which mature on June 24, 2038, can be called at par in whole or in part on or after June 24, 2018. The subordinated debentures pay a fixed rate of 8% for thirty years. We have the option to defer interest payments on the subordinated debt from time to time for a period not to exceed five consecutive years. The subordinated debentures are considered as Tier I capital for the Corporation under current regulatory guidelines.

In 2002, another trust we formed completed a private placement of 10,000 shares of cumulative trust preferred securities with a liquidation preference of \$1,000 per security for a total outstanding of \$10.0 million. These securities pay distributions of interest. On March 26, 2007 we called the \$10.0 million in subordinated debentures adjustable quarterly at LIBOR plus 360 basis points (8.97% on March 26, 2007) and issued new 30 year cumulative trust preferred securities at a 10 year fixed rate of 6.69% adjusting quarterly thereafter at LIBOR plus 160 basis points. The subordinated debentures, which mature March 22, 2037, can be called at par in whole or in part on or after March 15, 2017. We have the option to defer interest payments on the subordinated debt from time to time for a period not to exceed five consecutive years. The subordinated debentures are considered as Tier I capital for the Corporation under current regulatory guidelines. The trust loaned the proceeds of the offering to us in exchange for junior subordinated deferrable interest debentures. In accordance with FASB Interpretation 46, the trust is not consolidated with our financial statements but rather the subordinated debentures are shown as a liability.

11. INCOME TAXES

We file a consolidated federal income tax return and income tax is apportioned among all companies based on their taxable income or loss. Provision for income taxes is as follows:

(Dollars in thousands)	Year Ended December 31,		
	2008	2007	2006
Current	\$ 3,615	\$4,591	\$4,654
Deferred	(1,431)	55	(20)
Total income tax expense	<u>\$ 2,184</u>	<u>\$4,646</u>	<u>\$4,634</u>

[Table of Contents](#)**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****11. INCOME TAXES (Continued)**

The provision for income taxes differs from the amount computed at the statutory rates as follows:

(Dollars in thousands)	Year Ended December 31,		
	2008	2007	2006
Federal statutory rate	34.0%	34.0%	34.0%
Tax-exempt interest income	(1.9)	(1.0)	(0.7)
Increase in cash surrender value of life insurance	(1.8)	(0.8)	(0.7)
Dividends to ESOP	(0.6)	(0.3)	(0.3)
Stock option expense	0.6	0.3	0.3
Tax contingency reserve	—	—	(1.9)
Effect of state tax expense recorded	0.7	0.7	—
Other	0.3	0.3	0.2
Effective rate	<u>31.3%</u>	<u>33.2%</u>	<u>30.9%</u>

During the fourth quarter of 2006 we re-evaluated our tax contingency reserves and determined that approximately \$281,000 was no longer required. As a result, tax expense was reduced by this amount, resulting in an effective tax rate of 31% for the year ended 2006.

Temporary differences between the financial statement carrying amounts and tax bases of assets and liabilities that give rise to significant portions of deferred income taxes relate to the following:

(Dollars in thousands)	December 31,	
	2008	2007
Deferred tax assets:		
Allowance for loan losses	\$4,612	\$ 2,693
Net unrealized loss on securities available-for-sale	1,204	161
Other than temporary impairment	176	—
Prepaid retirement benefits	98	53
Nonaccrual loan interest	287	122
Accrued liabilities and other	289	79
	<u>6,666</u>	<u>3,108</u>
Deferred tax liabilities:		
Depreciation	\$1,871	\$ 1,539
Federal Home Loan Bank stock	1,554	1,449
Intangibles and fair value adjustments	1,796	1,106
Deferred gain on like-kind exchange	8	8
Other	290	229
	<u>5,519</u>	<u>4,331</u>
Net deferred tax assets/(liabilities)	<u>\$1,147</u>	<u>\$(1,223)</u>

Federal income tax laws provided savings banks with additional bad debt deductions through 1987, totaling \$9.3 million for us. Accounting standards do not require a deferred tax liability to be recorded on this amount, which would otherwise total \$3.2 million at December 31, 2008 and 2007. If we were liquidated or otherwise ceased to be a bank or if tax laws were to change, the \$3.2 million would be recorded as a liability with an offset to expense.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. INCOME TAXES (Continued)

We adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ("FIN 48"), on January 1, 2007 and recorded \$99,000 which included \$138,000 of state income tax expense, \$12,000 of interest, and federal benefit of \$51,000. During 2007, we identified that we were subject to state income tax in a contiguous state under FIN 48. We have \$150,000 of gross unrecognized tax benefits. In 2009, we filed a voluntary disclosure agreement with the state in which lending activities have occurred but tax returns have not been filed. This will reverse the entire FIN 48 reserve recorded. No other accruals for uncertain tax positions were recorded in 2008. Should the accrual of any interest or penalties relative to unrecognized tax benefits be necessary, it is our policy to record such accruals in our income tax accounts; \$12,000 of interest was accrued at December 31, 2008 and 2007. We file a consolidated U.S. federal income tax return and the Company and its non-bank subsidiaries file an income tax return in the state of Kentucky. These returns are subject to examination by taxing authorities for all years after 2004.

12. STOCKHOLDERS' EQUITY

- (a) **Regulatory Capital Requirements**—The Corporation and the Bank are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action. Management believes as of December 31, 2008, the Company and Bank meet all capital adequacy requirements to which it is subject.

Prompt corrective action regulations provide five classifications; well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as to asset growth and expansion, and capital restoration plans are required.

Quantitative measures established by regulation to ensure capital adequacy require the Corporation and the Bank to maintain minimum amounts and ratios (set forth in the following table) of Total and Tier I capital (as defined in the regulations) to risk weighted assets (as defined) and of Tier I capital (as defined) to average assets (as defined).

The most recent notification from the FDIC categorized the Bank as adequately capitalized under the regulatory framework for prompt corrective action. Subsequent to year end, the Corporation received proceeds under the Capital Purchase Program. Amounts were contributed to the Bank such that the Bank is now well capitalized.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

12. STOCKHOLDERS' EQUITY (Continued)

The actual and required capital amounts and ratios are presented below.

(Dollars in thousands)	Actual		For Capital Adequacy Purposes		To Be Considered Well Capitalized Under Prompt Correction Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2008:						
Total risk-based capital (to risk-weighted assets)						
Consolidated	\$90,890	10.14%	\$71,717	8.00%	N/A	N/A
Bank	89,224	9.97	71,625	8.00	89,531	10.00
Tier I capital (to risk-weighted assets)						
Consolidated	79,655	8.89	35,859	4.00	N/A	N/A
Bank	78,029	8.72	35,812	4.00	53,719	6.00
Tier I capital (to average assets)						
Consolidated	79,655	8.09	39,367	4.00	N/A	N/A
Bank	78,029	8.10	38,546	4.00	48,182	5.00

(Dollars in thousands)	Actual		For Capital Adequacy Purposes		To Be Considered Well Capitalized Under Prompt Correction Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2007:						
Total risk-based capital (to risk-weighted assets)						
Consolidated	\$83,310	10.85%	\$61,405	8.00%	N/A	N/A
Bank	80,176	10.48	61,220	8.00	76,526	10.00
Tier I capital (to risk-weighted assets)						
Consolidated	75,388	9.82	30,703	4.00	N/A	N/A
Bank	72,126	9.43	30,610	4.00	45,915	6.00
Tier I capital (to average assets)						
Consolidated	75,388	8.70	34,661	4.00	N/A	N/A
Bank	72,126	8.32	34,661	4.00	43,326	5.00

- (b) **Dividend Restrictions**—Our principal source of funds for dividend payments is dividends received from the Bank. Banking regulations limit the amount of dividends that may be paid without prior approval of regulatory agencies. Under these regulations, the amount of dividends that may be paid in any calendar year is limited to the current year's net profits, combined with the retained net profits of the preceding two years, subject to the capital requirements described above. As a result of a \$6 million dividend in 2008 used to finance the purchase of FSB Bancshares, Inc., the Bank needed and obtained approval for its first quarter 2009 dividend.
- (c) **Liquidation Account**—In connection with our conversion from mutual to stock form of ownership during 1987, we established a "liquidation account", currently in the amount of \$521,000 for the purpose of granting to eligible deposit account holders a priority in the event of future liquidation. Only in such an event, an eligible account holder who continues to maintain a deposit account will

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**12. STOCKHOLDERS' EQUITY (Continued)**

be entitled to receive a distribution from the liquidation account. The total amount of the liquidation account decreases in an amount proportionately corresponding to decreases in the deposit account balances of the eligible account holders.

- (d) **Capital Purchase Program**—On January 9, 2009, we sold \$20 million of cumulative perpetual preferred shares, with a liquidation preference of \$1,000 per share (the "Senior Preferred Shares") to the U.S. Treasury under the terms of its Capital Purchase Plan. The Senior Preferred Shares constitute Tier 1 capital and rank senior to our common shares. The Senior Preferred Shares pay cumulative dividends at a rate of 5% per annum for the first five years and will reset to a rate of 9% per annum after five years. The Senior Preferred Shares may be redeemed at any time, at our option. See Note 21 for additional information.

13. EARNINGS PER SHARE

The reconciliation of the numerators and denominators of the basic and diluted EPS is as follows:

(In thousands, except per share data)	Year Ended December 31,		
	2008	2007	2006
Net income available to common shareholders	\$4,797	\$9,352	\$10,337
Basic EPS:			
Weighted average common shares	4,666	4,722	4,821
Diluted EPS:			
Weighted average common shares	4,666	4,722	4,821
Dilutive effect of stock options	20	52	49
Weighted average common and incremental shares	4,686	4,774	4,870
Earnings Per Share:			
Basic	\$ 1.03	\$ 1.98	\$ 2.14
Diluted	\$ 1.02	\$ 1.96	\$ 2.12

Stock options for 124,928, 28,600 and 28,600 shares of common stock were not included in the December 31, 2008, 2007 and 2006 computation of diluted earnings per share because their impact was anti-dilutive.

14. EMPLOYEE BENEFIT PLANS

- (a) **Pension Plan**—We are a participant in the Pentegra Defined Benefit Plan for Financial Institutions (formerly known as Financial Institutions Retirement Fund) which is a non-contributory, multiple-employer defined benefit pension plan, covering employees hired before June 1, 2002. Because the plan was curtailed, employees hired on or after that date are not eligible for membership in the fund. Eligible employees are 100% vested at the completion of five years of participation in the plan. Our policy is to contribute annually the minimum funding amounts. Employer contributions and administrative expenses charged to operations for the years ended December 31, 2008, 2007 and 2006 totaled \$1,000, \$158,000, and \$340,000, respectively. Accrued liabilities associated with the plan as of December 31, 2008 and 2007 were \$458,000 and \$156,000, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**14. EMPLOYEE BENEFIT PLANS (Continued)**

- (b) **KSOP**—We have a combined 401(k)/Employee Stock Ownership Plan. The plan is available to all employees meeting certain eligibility requirements. The plan allows employee contributions up to 50% of their compensation up to the annual dollar limit set by the IRS. The employer matches 100% of the employee contributions up to 6% of the employee's compensation. If the employee does not contribute at least 2% of the employee's compensation, then the employer makes a minimum contribution for the employee of 2% of the employee's compensation. Employees are 100% vested in matching contributions upon meeting the eligibility requirements of the plan. Shares of our common stock are acquired in non-leveraged transactions. At the time of purchase, the shares are released and allocated to eligible employees determined by a formula specified in the plan agreement. Accordingly, the plan has no unallocated shares. The number of shares to be purchased and allocated is at the Board of Directors discretion. Employer matching contributions and administrative expenses charged to operations for the plan for the years ended December 31, 2008, 2007 and 2006 were \$494,000, \$483,000, and \$446,000, respectively.

Shares in the plan and the fair value of shares released during the year charged to compensation expense were as follows:

	<u>Year Ended December 31,</u>		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
KSOP shares (ending)	224,956	214,195	208,496
Shares released	7,877	4,223	3,058
Compensation expense	\$110,500	\$102,000	\$ 96,000

- (c) **Stock Option Plan**—Our 2006 Stock Incentive Plan, which is shareholder approved, succeeded our 1998 Stock Option and Incentive Plan. Under the 2006 Plan, we may grant either incentive or non-qualified stock options to key employees and directors for a total of 647,350 shares of our common stock at not less than fair value at the date such options are granted. Options available for future grant under the 1998 Plan totaled 38,500 shares and were rolled into the 2006 Plan. We believe that the ability to award stock options and other forms of stock-based incentive compensation can assist us in attracting and retaining key employees. Stock-based incentive compensation is also a means to align the interests of key employees with those of our shareholders by providing awards intended to reward recipients for our long-term growth. The option to purchase shares vest over periods of one to five years and expire ten years after the date of grant. We issue new shares of common stock upon the exercise of stock options. At December 31, 2008 options available for future grant under the 2006 Plan totaled 590,750. Compensation cost related to options granted under the 1998 and 2006 Plans that was charged against earnings for the years ended December 31, 2008, 2007 and 2006 was \$122,000, \$102,000 and \$129,000, respectively.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option valuation model that uses various weighted-average assumptions. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. The expected volatility is based on the fluctuation in the price of a share of stock over the period for which the option is being valued and the expected life of the options granted represents the period of time the options are expected to be outstanding.

[Table of Contents](#)**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****14. EMPLOYEE BENEFIT PLANS (Continued)**

The weighted-average assumptions for options granted during the years ended December 31, 2008, 2007 and 2006 and the resulting estimated weighted average fair value per share is presented below.

	<u>December 31,</u>		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Assumptions:			
Risk-free interest rate	3.48%	4.11%	4.71%
Expected dividend yield	3.49%	3.17%	2.47%
Expected life (years)	10	10	10
Expected common stock market price volatility	24%	24%	25%
Estimated fair value per share	\$4.84	\$5.78	\$9.30

A summary of option activity under the 1998 and 2006 Plans for the year ended December 31, 2008 is presented below:

(Dollars In Thousands)	<u>Number of Options</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Term</u>	<u>Aggregate Intrinsic Value</u>
Outstanding, beginning of period	193,067	\$ 18.95		
Granted during period	16,000	22.44		
Forfeited during period	(550)	28.00		
Exercised during period	—	—		
Outstanding, end of period	<u>208,517</u>	\$ 19.19	4.7	\$ —
Eligible for exercise at period end	<u>136,376</u>	\$ 17.63	<u>3.4</u>	<u>\$ —</u>

The total intrinsic value of options exercised during the periods ended December 31, 2007, and 2006 was \$65,000 and \$13,000 respectively. There were no options exercised, modified or settled in cash during the 2008 period. There was no tax benefit recognized from the option exercises as they are considered incentive stock options. Management expects all outstanding unvested options will vest.

As of December 31, 2008 there was \$257,000 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the 1998 and 2006 Plans. That cost is expected to be recognized over a weighted-average period of 3.3 years. Cash received from option exercises under all share-based payment arrangements for the periods ended December 31, 2008, 2007 and 2006 was \$0, \$72,000 and \$12,000 respectively.

- (d) **Employee Stock Purchase Plan**—We maintain an Employee Stock Purchase Plan whereby eligible employees have the option to purchase common stock of the Corporation through payroll deduction at a 10% discount. The purchase price of the shares under the plan will be 90% of the closing price of the common stock at the date of purchase. The plan provides for the purchase of up to 100,000 shares of common stock, which may be obtained by purchases issued from a reserve. Funding for the purchase of common stock is from employee contributions. Total compensation cost charged against earnings for the Plan for the periods ended December 31, 2008 and 2007 totaled \$9,000 and \$18,000, respectively. There was not any expense recorded for this plan in 2006.

[Table of Contents](#)**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****15. CASH FLOW ACTIVITIES**

The following information is presented as supplemental disclosures to the statement of cash flows.

(a) Cash Paid for:

(Dollars in thousands)	Year Ended December 31,		
	2008	2007	2006
Interest expense	\$25,604	\$28,931	\$24,224
Income taxes	\$ 3,649	\$ 4,526	\$ 4,410

(b) Supplemental disclosure of non-cash activities:

(Dollars in thousands)	Year Ended December 31,		
	2008	2007	2006
Loans to facilitate sales of real estate owned and repossessed assets	\$ 978	\$1,169	\$1,352
Transfers from loans to real estate acquired through foreclosure and repossessed assets	\$5,196	\$1,970	\$1,209

16. BUSINESS COMBINATION

On June 25, 2008, we acquired 100% of the outstanding shares of FSB Bancshares, Inc. and its wholly owned subsidiary, The Farmers State Bank, located in Southern Indiana. The Farmers State Bank has offices in Harrison and Floyd County, Indiana. These counties are adjacent to our counties of Meade, Hardin, Bullitt and Jefferson. The branches of The Farmers State Bank are branches of First Financial Service Corporation's wholly owned subsidiary First Federal Savings Bank. Operating results of FSB Bancshares, Inc. have been included in the consolidated financial statements since the date of the acquisition. The purpose of the acquisition was to establish market share in the state of Indiana, expand our customer base, enhance deposit fee income and reduce operating costs through economies of scale.

The aggregate purchase price was \$14.0 million, paid in cash. The purchase price resulted in approximately \$3.5 million in goodwill and \$1.9 million in core deposit intangible. The core deposit intangible asset is being amortized over 8.5 years, using an accelerated method. Goodwill will not be amortized but instead evaluated periodically for impairment. Goodwill and intangible assets are not deducted for tax purposes.

[Table of Contents](#)**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****16. BUSINESS COMBINATION (Continued)**

The following table summarizes the estimated fair value of assets acquired and liabilities assumed at the date of acquisition:

(Dollars in thousands)	<u>Amount</u>
Cash	\$12,534
Securities held to maturity	2,512
Loans, net	48,645
FHLB Stock	585
Premises and equipment	1,019
Real estate acquired through foreclosure	185
Goodwill	3,547
Core deposit intangibles	1,910
Other assets	250
Total assets acquired	<u>71,187</u>
Deposits	55,751
Other liabilities	1,436
Total liabilities assumed	<u>57,187</u>
Net assets acquired	<u>\$14,000</u>

Pro Forma Results of Operations

The following table presents unaudited pro forma results of operations for the years ended December 31, 2008 and 2007, as if the Farmers State Bank acquisition had occurred effective January 1, 2007. The pro forma financial information is not necessarily indicative of the results of operations as they actually would have been if the acquisition had occurred at January 1, 2007, and is not intended to be a projection of future results.

(Dollars in thousands, except per share data)	<u>2008</u>	<u>2007</u>
Net interest income	\$33,981	\$33,578
Net income	4,434	9,978
Basic income per share	\$ 0.95	\$ 2.11
Diluted income per share	0.95	2.09

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**17. CONDENSED FINANCIAL INFORMATION (PARENT COMPANY ONLY)**

The following condensed statements summarize the balance sheets, operating results and cash flows of First Financial Service Corporation (Parent Company only).

Condensed Balance Sheets

(Dollars in thousands)	December 31,	
	2008	2007
Assets		
Cash and interest bearing deposits	\$ 813	\$ 953
Investment in Bank	89,323	80,405
Securities available-for sale	942	1,230
Land and building	—	776
Other assets	172	217
	<u>\$91,250</u>	<u>\$83,581</u>
Liabilities and Stockholders' Equity		
Subordinated debentures	\$18,000	\$10,000
Other liabilities	298	121
Stockholders' equity	72,952	73,460
	<u>\$91,250</u>	<u>\$83,581</u>

Condensed Statements of Income

(Dollars in thousands)	Year Ended December 31,		
	2008	2007	2006
Dividend from Bank	\$10,823	\$8,900	\$ 4,212
Interest income	70	59	57
Interest expense	(978)	(717)	(895)
Gain on sale of securities	55	—	—
Losses on securities impairment	(516)	—	—
Other income	5	—	—
Write off of issuance cost of Trust Preferred			
Securities	—	(229)	—
Other expenses	(520)	(512)	(408)
Income before income tax benefit	<u>8,939</u>	<u>7,501</u>	<u>2,966</u>
Income tax benefit	703	536	483
Income before equity in undistributed net			
income of Bank	9,642	8,037	3,449
Equity in undistributed net income of Bank	(4,845)	1,315	6,888
Net income	<u>\$ 4,797</u>	<u>\$9,352</u>	<u>\$10,337</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**17. CONDENSED FINANCIAL INFORMATION (PARENT COMPANY ONLY) (Continued)****Condensed Statements of Cash Flows**

(Dollars in thousands)	Year Ended December 31,		
	2008	2007	2006
Operating Activities:			
Net income	\$ 4,797	\$ 9,352	\$10,337
Adjustments to reconcile net income to cash provided by operating activities:			
Equity in undistributed net income of Bank	4,845	(1,315)	(6,888)
Losses on securities impairment	516	—	—
Gain on sale of securities available-for-sale	(55)	—	—
Stock-based compensation expense	122	110	129
Changes in:			
Other assets	(185)	112	(94)
Accounts payable and other liabilities	177	20	75
Net cash from operating activities	<u>10,217</u>	<u>8,279</u>	<u>3,559</u>
Investing Activities:			
Cash paid for acquisition of Farmers State Bank	(14,000)	—	—
Capital contributed to Bank	(1,100)	—	—
Purchases of securities available-for-sale	(524)	—	(200)
Sales of securities available-for-sale	669	—	—
Net purchases of premises and equipment	—	(24)	—
Net cash from investing activities	<u>(14,955)</u>	<u>(24)</u>	<u>(200)</u>
Financing Activities:			
Proceeds from issuance of subordinated debentures	8,000	10,000	—
Payoff of subordinated debentures	—	(10,000)	—
Issuance of common stock for options and employee benefit plans	144	174	64
Dividends paid	(3,546)	(3,420)	(3,185)
Common stock repurchases	—	(4,457)	(16)
Net cash from financing activities	<u>4,598</u>	<u>(7,703)</u>	<u>(3,137)</u>
Net change in cash and interest bearing deposits	(140)	552	222
Cash and interest bearing deposits, beginning of year	<u>953</u>	<u>401</u>	<u>179</u>
Cash and interest bearing deposits, end of year	<u>\$ 813</u>	<u>\$ 953</u>	<u>\$ 401</u>

18. FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK

We are a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments primarily include commitments to extend credit, and lines and letters of credit, and

involve, to varying degrees, elements

[Table of Contents](#)**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****18. FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK (Continued)**

of credit and interest-rate risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of these instruments reflect the extent of our involvement in particular classes of financial instruments.

Our exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual notional amount of those instruments. Creditworthiness for all instruments is evaluated on a case-by-case basis in accordance with our credit policies. We use the same credit policies in making commitments and conditional obligations as we do for on-balance-sheet instruments. Collateral from the customer may be required based on management's credit evaluation of the customer and may include business assets of commercial customers as well as personal property and real estate of individual customers or guarantors.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

The contractual amounts of financial instruments with off-balance-sheet risk at year end were as follows:

	<u>December 31, 2008</u>		<u>December 31, 2007</u>	
	<u>Fixed Rate</u>	<u>Variable Rate</u>	<u>Fixed Rate</u>	<u>Variable Rate</u>
(Dollars in thousands)				
Commitments to make loans	\$490	\$ 434	\$ —	\$ 343
Unused lines of credit	—	105,398	—	88,756
Standby letters of credit	—	10,135	—	10,293
	<u>\$490</u>	<u>\$115,967</u>	<u>\$ —</u>	<u>\$99,392</u>

At December 31, 2008 and 2007, we had \$119.7 million, and \$94.3 million in letters of credit from the Federal Home Loan Bank issued to collateralize public deposits. These letters of credit are secured by a blanket pledge of eligible one-to-four family residential mortgage loans. (For additional information see Note 3 on Loans and Note 8 on Advances from the Federal Home Loan Bank.)

[Table of Contents](#)**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****19. RELATED PARTY TRANSACTIONS**

Certain directors, executive officers and principal shareholders of the Company, including associates of such persons, are our loan and deposit customers. Related party deposits at December 31, 2008 and 2007 were \$3.0 million and \$3.4 million. A summary of the related party loan activity, for loans aggregating \$60,000 or more to any one related party, is as follows:

(Dollars in thousands)	Year Ended December 31,	
	2008	2007
Beginning of year	\$ 312	\$ 288
New loans	1,011	167
Repayments	(17)	(143)
End of year	<u>\$1,306</u>	<u>\$ 312</u>

20. SUMMARY OF QUARTERLY FINANCIAL DATA—(Unaudited)

(Dollars in thousands except per share data)	<u>March 31,</u>	<u>June 30,</u>	<u>September 30,</u>	<u>December 31,</u>
Year Ended December 31, 2008:				
Total interest income	\$ 14,516	\$ 13,762	\$ 14,830	\$ 14,456
Total interest expense	6,771	5,759	6,406	5,863
Net interest income	7,745	8,003	8,424	8,593
Provision for loan losses	584	514	1,720	3,129
Non-interest income	1,954	2,140	2,367	1,988
Non-interest expense	6,335	6,517	7,637	7,797
Net income	1,883	2,099	991	(176)
Earnings per share:				
Basic	0.40	0.45	0.21	(0.04)
Diluted	0.40	0.45	0.21	(0.04)
Year Ended December 31, 2007:				
Total interest income	\$ 14,661	\$ 15,007	\$ 15,352	\$ 15,525
Total interest expense	7,085	7,348	7,672	7,646
Net interest income	7,576	7,659	7,680	7,879
Provision for loan losses	81	127	740	261
Non-interest income	1,945	2,039	2,205	2,014
Non-interest expense	6,015	5,801	6,006	5,967
Net income	2,317	2,544	2,131	2,361
Earnings per share:				
Basic	0.48	0.54	0.46	0.51
Diluted	0.48	0.54	0.45	0.50

Net income decreased during the third and fourth quarters of 2008 compared to 2007 due to a decrease in our net interest margin, an increase in provision for loan loss expense, a higher level of non-interest expense related to our expansion efforts, a write down taken on investment securities that were other-than-temporarily impaired and a write down on real estate acquired through foreclosure.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

21. SUBSEQUENT EVENT

On October 3, 2008, Congress passed the Emergency Economic Stabilization Act of 2008 (EESA), which creates the Troubled Asset Relief Program ("TARP") and provides the U.S. Secretary of the Treasury with broad authority to implement certain actions to help restore stability and liquidity to U.S. markets. The Capital Purchase Program (the "CPP") was announced by the U.S. Treasury on October 14, 2008 as part of TARP. Pursuant to the CPP, the U.S. Treasury will purchase up to \$250 billion of senior preferred shares on standardized terms from qualifying financial institutions. The purpose of the CPP is to encourage U.S. financial institutions to build capital to increase the flow of financing to U.S. businesses and consumers and to support the U.S. economy.

The CPP is voluntary and requires a participating institution to comply with a number of restrictions and provisions, including standards for executive compensation and corporate governance and limitations on share repurchases and the declaration and payment of dividends on common shares. The standard terms of the CPP require that a participating financial institution limit the payment of dividends to the most recent quarterly amount prior to October 14, 2008, which is \$0.19 per share in our case. This dividend limitation will remain in effect until the earlier of three years or such time that the preferred shares are redeemed.

Eligible financial institutions could generally apply to issue senior preferred shares to the U.S. Treasury in aggregate amounts ranging from 1% to 3% of the institution's risk-weighted assets. We applied for an investment by the U.S. Treasury of \$20 million, which was approved by the U.S. Treasury on December 8, 2008. On January 9, 2009, we issued \$20 million of cumulative perpetual preferred shares, with a liquidation preference of \$1,000 per share (the "Senior Preferred Shares"). The Senior Preferred Shares constitute Tier 1 capital and rank senior to our common shares. The Senior Preferred Shares pay cumulative dividends quarterly at a rate of 5% per annum for the first five years and will reset to a rate of 9% per annum after five years. The Senior Preferred Shares may be redeemed at any time, at our option.

We also issued a warrant to the U.S. Treasury to purchase 215,983 common shares at a purchase price of \$13.89 per share, which is equal to 15% of the aggregate amount of the Senior Preferred Shares purchased by the U.S. Treasury or \$3 million. The initial exercise price for the warrant and the number of common shares subject to the warrant were determined by reference to the market price of the common shares on December 8, 2008, the date the U.S. Treasury (calculated on a 20-day trailing average). The warrant has a term of 10 years and is potentially dilutive to earnings per share.

ITEM 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None

ITEM 9A. Controls and Procedures

Management is responsible for establishing and maintaining effective disclosure controls and procedures, as defined under Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934. As of December 31, 2008, an evaluation was performed under the supervision and with the participation of management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, management concluded that, except as discussed below, disclosure controls and procedures as of December 31, 2008 were effective in ensuring material information required to be disclosed in this Annual Report on Form 10-K was recorded, processed, summarized, and reported on a timely basis. Additionally, there were no changes in our internal control over financial reporting that occurred during the quarter ended December 31, 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Management's responsibilities related to establishing and maintaining effective disclosure controls and procedures include maintaining effective internal controls over financial reporting that are designed to produce reliable financial statements in accordance with accounting principles generally accepted in the United States. As disclosed in the Report on Management's Assessment of Internal Control Over Financial Reporting of this Annual Report, we assessed our system of internal control over financial reporting as of December 31, 2008, in relation to criteria for effective internal control over financial reporting as described in "Internal Control—Integrated Framework," issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, we believe that, as of December 31, 2008, our system of internal control over financial reporting was not operating effectively as it relates to certain internal controls related to the lending function.

We have a matter that has been classified as a material weakness in internal control over financial reporting as of December 31, 2008.

The Public Company Accounting Oversight Board's Auditing Standard No. 5 has defined a material weakness as "a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected."

During the third quarter 2008 and as disclosed in our September 2008 10-Q, Crowe Horwath LLP ("Crowe"), our registered independent public accounting firm, identified a matter as they conducted audit work. This matter related to the adequacy of the allowance for loan losses and the application of SFAS No. 114 "Accounting by Creditors for Impairment of a Loan" ("SFAS No. 114"). Based on the evaluation by our Chief Executive Officer and our Chief Financial Officer they concluded that our disclosure controls and procedures related to the application of SFAS No. 114 were not effective as of September 30, 2008 related to one loan transaction. Specifically, this transaction related to the use of a wrong value obtained from an appraisal on one commercial real estate loan in determining the amount of impairment change needed to be taken by the Company. This transaction was identified after discussions with Crowe and resulted in an additional impairment change of approximately \$1.4 million. At that time, management made modifications to the internal control procedures for determining write-downs on impaired loans to remediate this deficiency and anticipated that such controls would operate effectively for the remainder of 2008.

However, during follow-up audit procedures being performed by Crowe as of December 31, 2008, related to the control deficiency noted above, further internal control issues were identified. Crowe reviewed a sample of criticized and classified loans from the Company's internally generated loan watch

list to ensure the loans were properly classified and adequately reserved. During Crowe's review, two loan relationships were identified that had potential impairment issues. One loan had a significant collateral shortfall of approximately \$600,000. This shortfall arose due to the lack of site visitations on behalf of the loan officer assigned to this credit. The collateral shortfall was remediated in the first quarter of 2009. The second loan contained weak underwriting characteristics along with the inability of the credit to cash flow considered on a stand alone basis. Although this loan was less than thirty days delinquent, management ordered an updated appraisal, which resulted in a specific reserve being placed on the loan of approximately \$1.2 million. Although, each of these situations was unique in nature, it gave rise to the question of the ability of management to adequately identify and quantify the magnitude of potentially impaired loan relationships.

Based on the evaluation by our Chief Executive Officer and our Chief Financial Officer they concluded that our disclosure controls and procedures related to the application of SFAS No. 114 were still not operating effectively as of December 31, 2008.

To remediate the material weakness described above and enhance our internal controls over financial reporting, management has initiated the following significant changes:

- Revised our procedures related to internal control over financial reporting with respect to classified commercial loans. This includes more frequent reviews of criticized and classified loans and more detailed documentation;
- Created a new internal loan classification of "Watch" to be placed between the lowest classification of "Pass" and the classification of "Special Mention". This additional loan category will be useful for identifying and classifying loans as they begin to show signs of weakness, but are not to the full extent of being criticized;
- Strengthened the review process for determining the amount of specific reserve and/or level of impairment required on loan relationships warranting such charges; and
- Brought the function of loan review in-house. Previously, the function of loan review was outsourced to an independent third party. The third party would conduct quarterly reviews and report any issues identified to management. As the Company's loan portfolio has grown significantly over the past few years, it has become necessary to increase the volume of loans subjected to an independent loan review function and have the evaluation process be on-going. Accordingly, the loan review function has been elevated to a full time position reporting directly to the Risk Management Committee of the Board of Directors.

Notwithstanding the evaluation and initiation of these remediation actions, the identified significant material weakness in our internal controls over financial reporting will not be considered remediated until the new controls are fully implemented, in operation for a sufficient period of time, tested, and concluded by management to be operating effectively.

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PART III

ITEM 10. Directors and Executive Officers of the Registrant

The information contained under the sections captioned "Proposal I—Election of Directors" and "Section 16(a) Beneficial Ownership Reporting Compliance" in the Company's definitive proxy statement for the 2009 Annual Meeting of Shareholders (the "Proxy Statement") is incorporated herein by reference.

(a) Code of Ethics

You may obtain copies of First Financial Service Corporation's code of ethics free of charge by contacting Janelle Poppe, Corporate Secretary-Treasurer, First Federal Savings Bank, 2323 Ring Road, Elizabethtown, Kentucky 42701 (telephone) 270-765-2131.

ITEM 11. Executive Compensation

The information contained under the sections captioned "Executive Compensation" in the Proxy Statement is incorporated herein by reference.

ITEM 12. Security Ownership of Certain Beneficial Owners and Management

(a) Security Ownership of Certain Beneficial Owners

Information required by this item is incorporated herein by reference to the section captioned "Voting Securities and Principal Holders Thereof" in the Proxy Statement

(b) Security Ownership of Management

Information required by this item is incorporated herein by reference to the sections captioned "Proposal I—Election of Directors" and "Voting Securities and Principal Holders Thereof" in the Proxy Statement.

(c) Changes in Control

We know of no arrangements, including any pledge by any person of securities of the Company, the operation of which may at a subsequent date result in a change of control of the Company.

ITEM 13. Certain Relationships and Related Transactions

The information required by this item is incorporated herein by reference to the section captioned "Transactions with the Corporation and the Bank" in the Proxy Statement.

ITEM 14. Principal Accountant Fees and Services

The information required by this item is incorporated by reference to the section captioned "Independent Public Accountants" in the Proxy Statement.

PART IV

ITEM 15. Exhibits and Financial Statement Schedules

1. Financial Statements Filed

- (a)(1) Report of Independent Registered Public Accounting Firm—Crowe Horwath LLP
- (b) Consolidated Balance Sheets at December 31, 2008 and 2007.
- (c) Consolidated Statements of Income for the years ended December 31, 2008, 2007 and 2006.
- (d) Consolidated Statements of Comprehensive Income for the years ended December 31, 2008, 2007 and 2006.
- (e) Consolidated Statements of Changes in Stockholders' Equity for the years ended December 31, 2008, 2007 and 2006.
- (f) Consolidated Statements of Cash Flows for the years ended December 31, 2008, 2007 and 2006.
- (g) Notes to Consolidated Financial Statements

2. Financial Statements Schedules

All financial statement schedules have been omitted, as the required information is either inapplicable or included in the financial statements or related notes.

3. Exhibits

- 3.1, 4.1 Amended and Restated Articles of Incorporation*
- 3.2, 4.2 Articles of Amendment to the Amended and Restated Articles of Incorporation filed January 7, 2009†
- 3.3, 4.3 Amended and Restated Bylaws**
- 4.4 Shareholder Rights Agreement dated April 15, 2003***
- 10.1 2006 Stock Option and Incentive Compensation Plan****
- 10.2 Form of Stock Option Agreement**
- 10.3 Letter Agreement, dated January 9, 2009, including the Securities Purchase Agreement-Standard Terms incorporated by reference therein, between First Financial Service Corporation and the U.S. Department of Treasury†
- 10.4 Warrant to purchase common stock issued to the U. S. Department of Treasury†
- 10.5 Form of Waiver of Senior Executive Officers†
- 21 Subsidiaries of the Registrant
- 23 Consent of Crowe Horwath LLP, Independent Registered Public Accounting Firm

- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of Sarbanes-Oxley Act
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of Sarbanes-Oxley Act

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32 Certification of Chief Executive Officer and Chief Financial Officer
Pursuant to 18 U.S.C. Section 1350 (As Adopted Pursuant to
Section 906 of the Sarbanes-Oxley Act of 2002)

* Incorporated by reference to Form 10-Q filed August 9, 2004.

** Incorporated by reference to Form 10-K dated March 15, 2005.

*** Incorporated by reference to Form 8-K dated April 15, 2003.

**** Incorporated by reference to Exhibit 10 to Form S-8 Registration Statement
(No. 333-142415) filed April 27, 2007.

† Incorporated by reference to Form 8-K dated January 12, 2009

[Table of Contents](#)**SIGNATURES**

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

**FIRST FINANCIAL SERVICE
CORPORATION**

Date: 3/16/09

By: /s/ B. KEITH JOHNSON

B. Keith Johnson
Chief Executive Officer
Duly Authorized Representative

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

	<u>Name</u>	<u>Title</u>	<u>Date</u>
By:	<u> /s/ B. KEITH JOHNSON </u> B. Keith Johnson	Principal Executive Officer & Director	3/16/09
By:	<u> /s/ BOB BROWN </u> Bob Brown	Director	3/16/09
By:	<u> /s/ GAIL SCHOMP </u> Gail Schomp	Director	3/16/09
By:	<u> /s/ DIANE E. LOGSDON </u> Diane E. Logsdon	Director	3/16/09
By:	<u> /s/ J. ALTON RIDER </u> J. Alton Rider	Director	3/16/09
By:	<u> /s/ JOHN L. NEWCOMB, JR. </u> John L. Newcomb, Jr.	Director	3/16/09
By:	<u> /s/ WALTER D. HUDDLESTON </u> Walter D. Huddleston	Director	3/16/09

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	<u>Name</u>	<u>Title</u>	<u>Date</u>
By:	<u>/s/ MICHAEL THOMAS, DVM</u> Michael Thomas, DVM	Director	3/16/09
By:	<u>/s/ STEPHEN MOUSER</u> Stephen Mouser	Director	3/16/09
By:	<u>/s/ DONALD SCHEER</u> Donald Scheer	Director	3/16/09
By:	<u>/s/ STEVEN M. ZAGAR</u> Steven M. Zagar	Chief Financial Officer Principal Accounting Officer	3/16/09

[Table of Contents](#)**INDEX TO EXHIBITS**

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