

FIRST FARMERS & MERCHANTS CORP
Form 10-Q
August 07, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended June 30, 2009

or

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

For the transition period from _____ to _____

Commission File Numbers: 000-10972

First Farmers and Merchants Corporation

(Exact name of registrant as specified in its charter)

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Tennessee

(State or other jurisdiction of incorporation or organization)

62-1148660

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

816 South Garden Street

Columbia, Tennessee

(Address of principal executive offices)

38402-1148

(Zip Code)

931-388-3145

(Registrant's telephone number, including area code)

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

As of August 7, 2009, the registrant had outstanding 5,530,000 shares of common stock.

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements.

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

Consolidated balance sheets June 30, 2009 and December 31, 2008.

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

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

Selected notes to consolidated financial statements.

FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

| (Dollars in Thousands, Except Per Share Data) | June 30, 2009 (Unaudited) | December 31, 2008 (1) |
|---|---------------------------------|-----------------------------|
| ASSETS | | |
| Cash and due from banks | \$ 43,384 | \$ 22,656 |
| Interest-bearing due from banks | 2,928 | 4,680 |
| Federal funds sold | 300 | 4,200 |
| Total cash and cash equivalents | 46,612 | 31,536 |
| Securities | | |
| Available-for-sale (amortized cost \$190,200 and \$171,891, respectively) | 187,980 | 174,493 |
| Held-to-maturity (fair market value \$51,818 and \$59,558, respectively) | 51,593 | 59,427 |
| Total Securities | 239,573 | 233,920 |
| Loans, net of deferred fees | 598,527 | 595,519 |
| Allowance for loan losses | (8,210) | (8,625) |
| Net loans | 590,317 | 586,894 |
| Bank premises and equipment, at cost less allowance for depreciation | 20,597 | 17,669 |
| Core deposit and other intangibles | 9,149 | 9,186 |
| Other assets | 37,053 | 31,932 |
| TOTAL ASSETS | \$ 943,301 | \$ 911,137 |
| LIABILITIES | | |
| Deposits | | |
| Noninterest-bearing | \$ 145,692 | \$ 118,111 |
| Interest-bearing (including certificates of deposits over \$100: 2009 - \$149,490; 2008 - \$107,607) | 640,678 | 626,740 |
| Total deposits | 786,370 | 744,851 |
| Federal funds purchased and securities sold under agreements to repurchase | 2,431 | 2,645 |
| Dividends payable | 2,018 | 2,009 |
| Short-term borrowings | 600 | 294 |
| Accounts payable and accrued liabilities | 13,699 | 12,890 |
| Federal Home Loan Bank Advances | 34,177 | 41,177 |
| TOTAL LIABILITIES | 839,295 | 803,866 |
| SHAREHOLDERS EQUITY | | |
| Common stock \$10 par value per share, 8,000,000 shares authorized; 5,530,000 and 5,580,000 shares issued and outstanding as of June 30, 2009 and December 31, 2008, respectively | 55,300 | 55,800 |
| Retained earnings | 49,976 | 49,776 |
| Accumulated other comprehensive income (loss) | (1,365) | 1,600 |
| TOTAL FIRST FARMERS CORPORATION SHAREHOLDERS EQUITY | 103,911 | 107,176 |
| Non-controlling interest | 95 | 95 |
| TOTAL SHAREHOLDERS EQUITY | 104,006 | 107,271 |
| TOTAL LIABILITIES AND SHAREHOLDERS EQUITY | \$ 943,301 | \$ 911,137 |

(1) Derived from audited financial statements.

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

FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

| (Dollars in Thousands, Except Per Share Data) (Unaudited) | Three Months Ended June 30, | | Six Month Ended June 30, | |
|--|--------------------------------|-----------------|-----------------------------|-----------------|
| | 2009 | 2008 | 2009 | 2008 |
| INTEREST AND DIVIDEND INCOME | | | | |
| Interest and fees on loans | \$ 7,910 | \$ 8,141 | \$ 15,777 | \$ 16,477 |
| Income on investment securities | | | | |
| Taxable interest | 1,119 | 1,775 | 2,445 | 3,301 |
| Exempt from federal income tax | 946 | 939 | 1,920 | 1,958 |
| Dividends | 46 | 53 | 106 | 106 |
| | 2,111 | 2,767 | 4,471 | 5,365 |
| Other interest income | 27 | 77 | 44 | 128 |
| TOTAL INTEREST INCOME | 10,048 | 10,985 | 20,292 | 21,970 |
| INTEREST EXPENSE | | | | |
| Interest on deposits | 2,083 | 2,929 | 4,327 | 6,265 |
| Interest on other borrowings | 291 | 193 | 603 | 244 |
| TOTAL INTEREST EXPENSE | 2,374 | 3,122 | 4,930 | 6,509 |
| NET INTEREST INCOME | 7,674 | 7,863 | 15,362 | 15,461 |
| PROVISION FOR POSSIBLE LOAN AND LEASE LOSSES | 770 | | 1,425 | |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN AND LEASE LOSSES | 6,904 | 7,863 | 13,937 | 15,461 |
| NONINTEREST INCOME | | | | |
| Trust department income | 436 | 609 | 994 | 1,256 |
| Service fees on deposit accounts | 1,833 | 1,964 | 3,555 | 3,836 |
| Other fees and commissions | 156 | 135 | 240 | 237 |
| Other operating income | 268 | 290 | 367 | 413 |
| Securities gains | 527 | 120 | 2,482 | 1,128 |
| TOTAL NONINTEREST INCOME | 3,220 | 3,118 | 7,638 | 6,870 |
| NONINTEREST EXPENSE | | | | |
| Salaries and employee benefits | 4,143 | 4,296 | 8,313 | 8,579 |
| Net occupancy expense | 628 | 638 | 1,269 | 1,240 |
| Furniture and equipment expense | 220 | 275 | 548 | 502 |
| Other operating expenses | 3,179 | 2,798 | 6,086 | 5,500 |
| TOTAL NONINTEREST EXPENSES | 8,170 | 8,007 | 16,216 | 15,821 |
| INCOME BEFORE PROVISION FOR INCOME TAXES | 1,954 | 2,974 | 5,359 | 6,510 |
| PROVISION FOR INCOME TAXES | 229 | 458 | 926 | 1,246 |
| NET INCOME | \$ 1,725 | \$ 2,516 | \$ 4,433 | \$ 5,264 |
| BASIC EARNINGS PER SHARE | | | | |
| Weighted Average Shares Outstanding | 5,547,088 | 5,648,732 | 5,560,856 | 5,662,428 |
| Basic Earnings Per Share | \$ 0.31 | \$ 0.45 | \$ 0.80 | \$ 0.93 |

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

FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

| (Dollars in Thousands) (Unaudited) | Six Months Ended June 30, | |
|--|---------------------------|-----------|
| | 2009 | 2008 |
| OPERATING ACTIVITIES | | |
| Net income | \$ 4,433 | \$ 5,264 |
| Adjustments to reconcile net income to net cash provided by operating activities | | |
| (Deficiency) excess of provision for possible loan losses over net charge-offs | (415) | 311 |
| Provision for depreciation and amortization of premises and equipment | 571 | 526 |
| Securities gains | (2,482) | (1,128) |
| Gain from disposition of fixed assets | 129 | |
| (Gain) loss from disposition of other real estate | (6) | 283 |
| Amortization of deposit base intangibles | 37 | 95 |
| Amortization of investment security premiums, net of accretion of discounts | 511 | 180 |
| Increase in cash surrender value of life insurance contracts | (15) | (776) |
| Decrease (increase) in | | |
| Deferred income taxes | 457 | (266) |
| Interest receivable | (108) | 444 |
| Other assets | (3,623) | (382) |
| (Decrease) increase in | | |
| Interest payable | (397) | (362) |
| Other liabilities | 1,207 | 2,308 |
| Total adjustments | (4,134) | 1,233 |
| Net cash provided by operating activities | 299 | 6,497 |
| INVESTING ACTIVITIES | | |
| Proceeds from maturities, calls, and sales of available-for-sale securities | 148,217 | 85,880 |
| Proceeds from maturities and calls of held-to-maturity securities | 7,834 | 7,372 |
| Purchases of investment securities | | |
| Available-for-sale | (164,554) | (90,889) |
| Held-to-maturity | | |
| Net increase in loans | (3,008) | (34,382) |
| Proceeds from sale of other real estate | 41 | 385 |
| Proceeds from sale of fixed assets | | |
| Purchase of life insurance premium | (235) | (696) |
| Purchases of premises and equipment | (3,628) | (989) |
| Net cash used in investing activities | (15,333) | (33,319) |
| FINANCING ACTIVITIES | | |
| Net increase in noninterest-bearing and interest-bearing deposits | 41,520 | 22,185 |
| Net increase in short term borrowings | 90 | 131 |
| (Payments) proceeds from FHLB borrowings | (7,000) | 35,000 |
| Repurchase of common stock | (2,500) | (2,768) |
| Cash dividends | (2,000) | (1,991) |
| Net cash used in financing activities | 30,110 | 52,557 |
| Increase in cash and cash equivalents | 15,076 | 25,735 |
| Cash and cash equivalents at beginning of period | 31,536 | 35,873 |
| Cash and cash equivalents at end of period | \$ 46,612 | \$ 61,608 |

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 OTHER INFORMATION

The interim unaudited consolidated financial statements of First Farmers and Merchants Corporation (the Corporation) presented in this report have been prepared on a consistent basis and in accordance with the instructions to Form 10-Q and do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. These adjustments were of a normal, recurring nature and consistent with generally accepted accounting principles. For further information, refer to the consolidated financial statements and notes included in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2008. Certain reclassifications have been made to prior year amounts to maintain consistency with the current year in accordance with Financial Accounting Standards Board (FASB) Statement No. 160, Noncontrolling Interest in Consolidated Financial Statements, an amendment to ARB Statement No. 51 (SFAS 160). This has resulted in no impact on net income and an increase of \$95,000 total shareholders' equity.

NOTE 2 STOCK REPURCHASE

During the second quarter of 2009, the Corporation repurchased, through negotiated transactions with third-party sellers, 25,000 shares of the Corporation's common stock at a price of \$50 per share for an aggregate purchase price of \$1.25 million.

NOTE 3 FAIR VALUE MEASUREMENT

Effective January 1, 2008, the Corporation adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (SFAS 157), for financial assets and financial liabilities. FASB Staff Position (FSP) No. SFAS 157-2, Effective Date of FASB Statement No. 157, allowed the Corporation to delay application of SFAS 157 for non-financial assets and non-financial liabilities until January 1, 2009; however, the Corporation elected to apply SFAS 157 to non-financial assets and non-financial liabilities effective January 1, 2008. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The application of SFAS 157 in situations where the market for a financial asset is not active was clarified by the issuance of FSP No. SFAS 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active (SFAS 157-3), in October 2008. SFAS 157-3 became effective immediately and did not significantly affect the methods by which the Corporation determines the fair values of its financial assets.

SFAS 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. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability is not adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

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SFAS 157 requires the use of valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (i.e., replacement cost). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the

assumptions market participants would use in pricing the asset or liability, developed based on market data obtained from independent sources. Inputs may also be unobservable, meaning those that reflect the reporting entity's own assumptions about the assumptions market participants could use in pricing the asset or liability, developed based on the best information available in the circumstances. In that regard, SFAS 157 establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

- *Level 1 Inputs* - Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.
- *Level 2 Inputs* - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.
- *Level 3 Inputs* - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

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

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

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

Other assets Included in other assets are certain assets carried at fair value, including the cash value of Bank-owned life insurance policies. The carrying amount of these assets is based on information received from the insurance carriers indicating the financial performance of the policies

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and the amount the Bank would receive should the policies be surrendered. The Bank reflects these investments within Level 2 of the valuation hierarchy.

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

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

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

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

| | Level 1 | Level 2 | Level 3 | Total |
|---|---------------|-------------------|-----------|-------------------|
| Federal funds sold | \$ 300 | | | \$ 300 |
| Available-for-sale securities | | 187,980 | | 187,980 |
| Other assets | | 20,397 | | 20,397 |
| Total assets at fair value | \$ 300 | \$ 208,377 | \$ | \$ 208,677 |
| Securities sold under repurchase agreements | | 2,431 | | 2,431 |
| Other liabilities | | 5,079 | | 5,079 |
| Total liabilities at fair value | \$ | \$ 7,510 | \$ | \$ 7,510 |

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

Impaired loans Certain impaired loans are reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 2 inputs based on observable market data or Level 3 inputs based on customized discounting criteria. During the second quarter of 2009, certain impaired loans were re-measured and reported at fair value through a specific valuation allowance allocation of the allowance for possible loan losses based on the fair value of the underlying collateral. Impaired loans with a carrying value of \$15.7 million were reduced by specific valuation allowance allocations totaling \$1.1 million to a total reported fair value of \$14.6 million based on collateral valuations utilizing Level 3 valuation inputs.

Effective January 1, 2008, the Corporation adopted the provisions of SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115 (SFAS 159)*. SFAS 159 permits the Corporation to choose to measure eligible items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value measurement option has been elected are reported as earnings at each subsequent reporting date. The fair value option: (i) may be applied instrument by instrument, with certain exceptions; therefore, the Corporation may record identical financial assets and liabilities at fair value or by another measurement basis permitted under generally accepted accounting principles; (ii) is irrevocable (unless a new election date occurs); and (iii) is applied only to entire instruments and not to portions of instruments. Adoption of SFAS 159 on January 1, 2008 did not have a significant impact on the Corporation's consolidated financial statements.

SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended *SFAS 107*, requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis. A detailed description of the valuation methodologies used in estimating the fair value of financial instruments is set forth in Note 12 to the consolidated financial statements incorporated by reference into the Corporation's Annual Report on Form 10-K for the year ended December 31, 2008.

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The estimated fair values of financial instruments were as follows:

| | June 30, 2009 | | December 31, 2008 | |
|--|-----------------|------------|-------------------|------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial assets | | | | |
| Cash and due from banks | \$ 43,384 | \$ 43,384 | \$ 22,656 | \$ 22,656 |
| Interest-bearing deposits in banks | 2,928 | 2,928 | 4,680 | 4,680 |
| Federal funds sold | 300 | 300 | 4,200 | 4,200 |
| Securities available-for-sale | 187,980 | 187,980 | 174,493 | 174,493 |
| Securities held-to-maturity | 51,593 | 51,818 | 59,427 | 59,558 |
| Loans, net | 590,317 | 590,220 | 586,894 | 591,471 |
| Accrued interest receivable | 4,439 | 4,439 | 4,331 | 4,331 |
| Financial liabilities | | | | |
| Deposits | 786,370 | 787,827 | 744,851 | 746,308 |
| Federal funds purchased and securities sold under agreements to repurchase | 2,431 | 2,431 | 2,645 | 2,645 |
| Other short term liabilities | 600 | 600 | 294 | 294 |
| Accrued interest payable | 1,297 | 1,297 | 1,693 | 1,693 |
| Off-balance sheet credit related instruments: | | | | |
| Commitments to extend credit | | 108 | | 108 |

NOTE 4 FEDERAL HOME LOAN BANK CREDIT LINE

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

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

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

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

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

NOTE 5 RECENT ACCOUNTING PRONOUNCEMENTS

In December 2007, the FASB replaced SFAS No. 141, Business Combinations (SFAS 141), with SFAS No. 141R (SFAS 141R). SFAS 141R applies to all transactions and other events in which one entity obtains control over one or more other businesses. SFAS 141R requires an acquirer, upon obtaining control of another entity, to recognize the assets, liabilities and any non-controlling interest in the acquiree at fair value as of the acquisition date. Contingent consideration is required to be recognized and measured at fair value on the date of acquisition rather than at a later date when the amount of that consideration may be determinable beyond a reasonable doubt. This fair value approach replaces the cost-allocation process required under SFAS 141 whereby the cost of an acquisition was allocated to the individual assets acquired and liabilities assumed based on their estimated fair value. SFAS 141R requires acquirers to expense acquisition-related costs as incurred rather than allocating such costs to the assets acquired and liabilities assumed, as was previously the case under SFAS 141. Under SFAS 141R, the requirements of SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, would have to be met in order to accrue for a restructuring plan in purchase accounting. Pre-acquisition contingencies are to be recognized at fair value except when a non-contractual contingency is not likely to materialize, in which case nothing should be recognized in purchase accounting. Instead, that contingency would be subject to the probable and estimable recognition criteria of SFAS No. 5, Accounting for Contingencies. SFAS 141R is applicable to the Corporation's accounting for business combinations closing on or after January 1, 2009.

In December 2008, the FASB issued SFAS No. 132(R)-1, Employers' Disclosures about Postretirement Benefit Plan Assets (SFAS 132(R)-1). SFAS 132(R)-1 provides guidance related to an employer's disclosures about plan assets of defined benefit pension or other post-retirement benefit plans. Under SFAS 132(R)-1, disclosures should provide users of financial statements with an understanding of how investment allocation decisions are made, the factors that are pertinent to an understanding of investment policies and strategies, the major categories of plan assets, the inputs and valuation techniques used to measure the fair value of plan assets, the effect of fair value measurements using significant unobservable inputs on changes in plan assets for the period and significant concentrations of risk within plan assets. The disclosures required by SFAS 132(R)-1 will be included in the Corporation's financial statements beginning with the financial statements for the year ended December 31, 2009.

In April 2009, the FASB issued SFAS No. 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (SFAS 157-4). SFAS 157-4 affirms that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction, and clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active. SFAS 157-4 requires an entity to base its conclusion about whether a transaction was not orderly on the weight of the evidence. SFAS 157-4 also amended SFAS 157 to expand certain disclosure requirements. The Corporation adopted the provisions of SFAS 157-4 during the second quarter of 2009. Adoption of SFAS 157-4 did not have a significant impact on the Corporation's financial statements.

In February 2008, the FASB issued SFAS No. 160. SFAS 160 amends Accounting Research Bulletin No. 51, Consolidated Financial Statements, to establish 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, which is sometimes referred to as minority interest, is an ownership interest in the consolidated entity that should be reported as a component of equity in the consolidated financial statements. Among other requirements, SFAS 160 requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the non-controlling interest. It also requires disclosure, on the face of the consolidated income statement, of the amounts of consolidated net income attributable to the parent and to the non-controlling interest. Adoption of SFAS 160 did not have a significant impact on the Corporation's financial statements.

In May 2009, the FASB issued SFAS No. 165, Subsequent Events (SFAS 165). SFAS 165 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. SFAS 165 defines (i) the period after the balance sheet date during which a reporting entity's management should evaluate events or transactions that may occur for

potential recognition or disclosure in the financial statements, (ii) the circumstances under which an entity should recognize events or transactions occurring after

the balance sheet date in its financial statements, and (iii) the disclosures an entity should make about events or transactions that occurred after the balance sheet date. SFAS 165 became effective for the Corporation's financial statements for periods ending after June 15, 2009 and did not have a significant impact on the Corporation's financial statements.

In July 2009, FASB issued SFAS No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, a Replacement of FASB Statement No. 162 (SFAS 168). SFAS 168 replaces SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles and establishes the FASB Accounting Standards Codification (the Codification) as the source of authoritative accounting principles recognized by the FASB to be applied by non-governmental entities in the preparation of financial statements in conformity with generally accepted accounting principles. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative guidance for SEC registrants. All guidance contained in the Codification carries an equal level of authority. All non-grandfathered, non-SEC accounting literature not included in the Codification is superseded and deemed non-authoritative. SFAS 168 will be effective for the Corporation's financial statements for periods ending after September 15, 2009 and is not expected to have a significant impact on the Corporation's financial statements.

In April 2009, the FASB issued SFAS No. 115-2 and SFAS No. 124-2, Recognition and Presentation of Other-Than-Temporary Impairments (SFAS 115-2 and SFAS 124-2). SFAS 115-2 and SFAS 124-2 (i) change existing guidance for determining whether an impairment is other than temporary to debt securities and (ii) replace the existing requirement that the entity's management assert that it has both the intent and ability to hold an impaired security until recovery. They also require that management assert that (a) it does not have the intent to sell the security and (b) it is more likely than not it will not have to sell the security before recovery of its cost basis. Under SFAS 115-2 and SFAS 124-2, declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of the impairment related to other factors is recognized in other comprehensive income. The Corporation adopted the provisions of SFAS 115-2 and SFAS 124-2 during the first quarter of 2009. Adoption of SFAS 115-2 and SFAS 124-2 did not have a significant impact on the Corporation's financial statements.

In April 2009, the FASB issued SFAS No. 107-1 and Accounting Principles Board Opinion (APB) No. 28-1, Interim Disclosures about Fair Value of Financial Instruments (SFAS 107-1 and APB 28-1). SFAS 107-1 and APB 28-1 amend SFAS 107 to require an entity to provide disclosures about fair value of financial instruments in interim financial information. They also amend APB No. 28, Interim Financial Reporting to require disclosures of summarized financial information at interim reporting periods. Under SFAS 107-1 and APB 28-1, a publicly traded company must include disclosures about the fair value of its financial instruments whenever it issues summarized financial information for interim reporting periods. In addition, entities must disclose, in the body or in the accompanying notes of its summarized financial information for interim reporting periods and in its financial statements for annual reporting periods, the fair value of all financial instruments for which it is practicable to estimate that value, whether recognized or not recognized in the statement of financial position, as required by SFAS 107. The new interim disclosures required by SFAS 107-1 and APB 28-1 have been included in the Corporation's interim financial statements beginning with the second quarter of 2009.

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

FORWARD-LOOKING STATEMENTS

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

EXECUTIVE OVERVIEW

At June 30, 2009, the consolidated total assets of the First Farmers and Merchants Corporation (the Corporation) were \$943.3 million, its consolidated net loans were \$590.3 million, its total deposits were \$786.4 million and its total shareholders' equity was \$104.0 million. The Corporation's loan portfolio at June 30, 2009 reflected an increase of \$3.4 million, or 0.6%, compared to December 31, 2008. Total deposits increased \$41.5 million and shareholders' equity decreased 3.0% during the first six months of 2009. Total shareholders' equity includes an unrealized loss on available-for-sale securities of approximately \$1.4 million.

FINANCIAL CONDITION

Average earning assets at June 30, 2009 were up 6.6%, or \$51.7 million, from average earning assets at December 31, 2008. Average overnight investments at June 30, 2009 were up \$9.1 million compared to December 31, 2008. Average investment securities at June 30, 2009 were down 5.9% compared to December 31, 2008, although total investment securities at June 30, 2009 were up \$5.7 million compared to December 31, 2008. Average total assets of \$913.4 million at June 30, 2009 increased 6.8% or \$58.1 million, compared to \$855.3 million at December 31, 2008.

Securities

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Available-for-sale securities are an integral part of the asset/liability management process for First Farmers and Merchants Bank, the Corporation's sole direct subsidiary (the Bank). Accordingly, they represent an important source of liquidity available to fund loans and accommodate asset reallocation strategies dictated by changes in the Bank's operating and tax plans, shifting yield spread relationships and changes in configuration of the yield curve. At June 30, 2009, the Bank's investment securities portfolio had \$188.0 million available-for-sale securities, which are valued at fair market value, and \$51.6 million held-to-maturity securities, which are valued at cost on the balance sheet. These compare to \$174.5 million of available-for-sale securities and \$59.4 million of held-to-maturity securities as of December 31, 2008.

Loans

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

The portfolio experienced positive loan growth for the fifth time in six quarters. Despite this positive trend, overall loan growth has been sluggish in 2009 and remains short of forecasted growth estimates for the year. The home equity line of credit portfolio has grown in each of the first two quarters of 2009, as it continues to provide the low-cost funding mechanism in this interest rate environment. Although there is not an industry concentration as measured by regulatory guidelines within the Bank's loan portfolio, the Bank currently has heavy exposure in five broad industry categories: real estate renting and leasing; religious organizations; trucking; physicians; and public administration. These industries are monitored closely to ensure that underwriting practices, policies and loss allowance levels match the level of risk posed. Real estate loans represented 77.0% of total loans at June 30, 2009 compared to 79.0% at June 30, 2008 and 76.6% at December 31, 2008. Management of the Bank believes the risk of this concentration is acceptable given the quality of underwriting and the low level of historical loss experience. The Bank's construction and development portfolio has shrunk dramatically in 2009, falling by \$16.0 million in the last six months, as existing construction projects have been completed and few new projects have been brought online to replace them. Construction and development loans represented only 4.8% of total loans as of June 30, 2009, compared to 9.3% at June 30, 2008.

The analysis and review of asset quality by the Bank's credit administration includes a formal review that evaluates the adequacy of the allowance for possible loan and lease losses. This review is updated monthly and evaluated more completely quarterly in conjunction with loan review reports and evaluations that are discussed in meetings with loan officers, credit administration and the Bank's Board of Directors. The allowance for possible loan and lease losses was \$8.2 million, or 1.4% of gross loans and leases, at June 30, 2009, compared to \$8.6 million, or 1.4%, at December 31, 2008. Net charge-offs through June 30, 2009 were \$1.8 million, which results in an annualized net charge-off ratio of 0.6%.

A formal process is in place to enhance control over the underwriting of loans and to monitor loan collectability. This process includes education and training of personnel about the Bank's loan policies and procedures, credit analysts to support lenders, timely identification of loans with adverse characteristics, control of corrective actions and objective monitoring of loan reviews. The Special Assets Department of the Bank identifies and monitors assets that need attention. At June 30, 2009, this process identified loans totaling \$8.2 million, or 1.4% of the portfolio, that were classified as other assets especially mentioned, compared to loans totaling \$9.9 million, or 1.7% of the portfolio, so classified at December 31, 2008. Loans totaling \$28.2 million, or 4.7% of the portfolio, were classified as substandard at June 30, 2009, compared to loans totaling \$26.1 million, or 4.4% of the portfolio, so classified at December 31, 2008. No loans were classified as doubtful at June 30, 2009 and December 31, 2008.

Deposits

The Bank does not have any foreign offices and all deposits are serviced in its 19 domestic offices. The Bank's average deposits increased 7.0% during the first six months of 2009 compared to an increase of 1.1% in the first six months of 2008. The increase results from the Bank offering more competitive rates on money market accounts. Average total noninterest-bearing deposits were 15.4% of total deposits at June 30, 2009,

contributing to the Bank's low cost of deposits, compared to 17.1% at December 31, 2008.

Regulatory Requirements for Capital

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

Quantitative measures established by the Board of Governors of the Federal Reserve System to ensure capital adequacy require the Corporation and the Bank to maintain minimum amounts and ratios of Tier 1 Capital and Total Capital (Tier 1 plus Tier 2 Capital) to risk-weighted assets and of Tier 1 Capital to average total assets (leverage capital ratio). Equity capital (net of certain adjustments for intangible assets and investments in non-consolidated subsidiaries and certain classes of preferred stock) is considered Tier 1 Capital. Tier 2 Capital consists of core capital plus subordinated debt, some types of preferred stock, and a defined percentage of the allowance for possible loan and lease losses. To be well-capitalized under federal bank regulations, a bank holding company must have a Tier 1 Capital ratio of at least 6%, a Total Capital ratio of at least 10%, and a leverage capital ratio of at least 5%. At June 30, 2009, the Corporation's Tier 1, Total Capital and leverage capital ratios were 14.9%, 16.1% and 10.7 %, respectively. The ratios were 15.3%, 16.5% and 10.9%, respectively, at December 31, 2008. As of June 30, 2009, the Bank's Tier 1 Capital, Total Capital and leverage capital were 14.6%, 15.8%, and 10.4%, respectively, compared to 15.0%, 16.2%, and 10.6% at December 31, 2008. Management believes, as of June 30, 2009, that the Corporation and the Bank each met all capital adequacy requirements to which they are subject.

LIQUIDITY AND CAPITAL RESOURCES

Most of the capital needs of the Bank historically have been financed with retained earnings and deposits received, and the Corporation's primary source of liquidity has been dividends declared by the Bank. In March 2008, the Bank obtained five advances at \$7 million each from the FHLB. The first scheduled repayment of the advances was made in March 2009. The remaining payments will continue through 2013. In September 2008, the Bank obtained two additional advances of \$3.1 million each for a total borrowing for 2008 of \$41.2 million. The borrowings from the FHLB helped fund investment strategies to enhance the Bank's portfolio. Please refer to Note 4 in the notes to consolidated financial statements for additional information about borrowings from the FHLB and the repayment schedule of such borrowings.

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

The Bank's formal asset and liability management process is used to control interest rate risk and assist management in maintaining reasonable stability in the gross interest margin as a result of changes in the level of interest rates and/or the spread relationships among interest rates. The Bank uses an earnings simulation model to evaluate the impact of different interest rate scenarios on the gross margin. Each quarter, the Bank's Asset/Liability Committee monitors the relationship of rate sensitive earning assets to rate sensitive interest-bearing liabilities (interest rate

sensitivity), which is the principal factor in determining the effect that fluctuating interest rates will have on future net interest income. Rate sensitive earning assets and interest bearing liabilities are financial instruments that can be repriced to current market rates within a defined time period.

CRITICAL ACCOUNTING POLICIES

The accounting principles the Bank follows and the methods of applying these principles conform with accounting principles generally accepted in the United States and with general practices within the banking industry. In connection with the application of those principles, the Bank's management has made judgments and estimates that, in the case of the determination of the allowance for loan and lease losses (ALLL) and the recognition of deferred income tax assets, have been critical to the determination of the Corporation's financial position, results of operations and cash flows. As of June 30, 2009, the deferred income tax asset was \$6.3 million, compared to \$4.9 million at December 31, 2008, and was included with other assets on the balance sheet.

Allowance for Loan and Lease Losses

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

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

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

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

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

Deferred Income Tax Assets

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

OFF-BALANCE SHEET ARRANGEMENTS

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

The total outstanding loan commitments and stand-by letters of credit in the normal course of business at June 30, 2009 were \$108.3 million and \$9.5 million, respectively, compared to \$100.1 million and \$17.1 million, respectively, at June 30, 2008.

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

RESULTS OF OPERATIONS

Total interest income for the first six months of 2009 was \$20.3 million compared to \$22.0 million for the first six months of 2008 and \$10.0 million for the three months ended June 30, 2009 compared to \$11.0 million for the three months ended June 30, 2008. Interest and fees earned on loans and investments are the components of total interest income. Interest and fees earned on loans were \$15.8 million, a decrease of approximately \$700,000, or 4.2%, during the first six months of 2009 compared to the first six months of 2008, and \$7.9 million for the three months ended June 30, 2009, a decrease of \$231,000, or 2.8%, compared to the three months ended June 30, 2008. Nominal interest earned on investment securities and other investments was \$4.5 million, a decrease of approximately \$894,000, or 16.7%, during the first six months of 2009 compared to the first six months of 2008, and \$2.1 million for the three months ended June 30, 2009, a decrease of \$656,000, or 23.7%, compared to the three months ended June 30, 2008.

Total interest expense in the first six months of 2009 was \$4.9 million, a decrease of \$1.6 million, or 24.3%, compared to the first six months of 2008, and \$2.4 million for the three months ended June 30, 2009, a decrease of approximately \$748,000 compared to the three months ended June 30, 2008. The lower interest rates for certificates of deposits and public funds during the second quarter of 2009 were the primary reason for the lower expense. As a policy, budgeted financial goals are monitored on a monthly basis by the Bank's Asset/Liability Committee, which reviews the actual dollar change in net interest income for different interest rate movements. A negative dollar change in net interest income for a 12-month and 24-month period of less than 10.0% of net interest income given a 100 to 200 basis point shift in interest rates is considered an acceptable rate risk position. The rate risk analysis for the 12-month period beginning July 1, 2009 and ending June 30, 2010 showed a worst-case potential change to net interest income of 1.9%, or an increase in net interest income of approximately \$640,000 by the end of the period.

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

- (1) the volume and mix of earning assets and sources of funding;

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- (2) market rates of interest; and
- (3) income tax rates.

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

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

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The net interest margin, on a tax equivalent basis, at June 30, 2009, June 30, 2008 and December, 31, 2008 was 4.01%, 4.40% and 4.40%, respectively.

Additions of \$770,000 were made to the provision for possible loan and lease losses in the second quarter of 2009 as a result of an increase in the level of credit losses on both secured and unsecured consumer loans as well as a downgrade of the credit level on a few commercial loans.

Noninterest income was \$7.6 million, an increase of approximately \$768,000, or 11.2%, during the first six months of 2009 compared to the first six months of 2008, and \$3.2 million for the three months ended June 30, 2009, an increase of approximately \$102,000 compared to the three months ended June 30, 2008. The gains on sales of available-for-sale securities, representing \$2.5 million in income, was the primary reason for the increase.

Noninterest expenses, excluding the provision for possible loan and lease losses, were approximately \$395,000, or 2.5%, higher in the first six months of 2009 as compared to the first six months of 2008. The Bank expensed approximately \$750,000 for the Federal Deposit Insurance Company (FDIC) special assessment and also the increase in the FDIC 's regular assessment for the first six months of 2009.

The Corporation does not have any long-term debt or other long-term obligations; however, in 2008, the Bank received a \$41.2 million advance from FHLB. The scheduled \$7.0 million annual principal maturities of borrowings under this credit line began in March 2009 and will end in 2013. Please refer to Note 4 in the notes to consolidated financial statements for additional information about borrowings from the FHLB.

The Bank also leases certain of its properties. There was not a change during the six-month period ended June 30, 2009 in the terms of these leases.

Net income for the six months ended June 30, 2009 was \$4.4 million, compared to \$5.3 million for the six months ended June 30, 2008. A decrease in interest income on loans and securities contributed to the period-over-period decrease. The Corporation earned \$0.80 per share in the second quarter of 2009 and \$0.93 per share in the second quarter of 2008.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

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

Item 4. Controls and Procedures.

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

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

PART II - OTHER INFORMATION**Item 1A. Risk Factors.**

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

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

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

CORPORATION'S PURCHASES OF EQUITY SECURITIES

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs |
|--------------------------------|----------------------------------|------------------------------|--|--|
| April 1, 2009 - April 30, 2009 | | | | |
| May 1, 2009 - May 31, 2009 | | | | |
| June 1, 2009 - June 30, 2009 | 25,000* | \$ 50.00 | | |
| Total | 25,000 | \$ 50.00 | | |

*Purchased through negotiated transactions with several third-party sellers.

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

The annual meeting for shareholders of the Corporation was held on April 21, 2009. At the meeting, the Corporation's shareholders voted to elect directors. At the meeting, votes were cast as follows:

| | Votes For | Votes Withheld | Abstentions/Broker Non-Votes |
|------------------------|-----------|----------------|------------------------------|
| Kenneth A. Abercrombie | 3,726,860 | 10,832 | 1,842,308 |
| James L. Bailey, Jr. | 3,732,407 | 5,285 | 1,842,308 |
| M. Darlene Baxter | 3,736,704 | 988 | 1,842,308 |

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| | | | |
|--------------------------|-----------|--------|-----------|
| H. Terry Cook, Jr. | 3,735,892 | 1,800 | 1,842,308 |
| Thomas Napier Gordon | 3,689,310 | 48,382 | 1,842,308 |
| Dr. O. Rebecca Hawkins | 3,733,716 | 3,976 | 1,842,308 |
| Timothy E. Pettus | 3,714,137 | 23,555 | 1,842,308 |
| Dr. Joseph W. Remke, III | 3,734,608 | 3,084 | 1,842,308 |
| Matthew M. Scoggins, Jr. | 3,737,384 | 308 | 1,842,308 |
| T. Randy Stevens | 3,736,704 | 988 | 1,842,308 |
| W. Lacy Upchurch | 3,737,384 | 308 | 1,842,308 |
| William R. Walter | 3,736,492 | 1,200 | 1,842,308 |
| Dan C. Wheeler | 3,736,492 | 1,200 | 1,842,308 |
| Dr. David S. Williams | 3,735,288 | 2,404 | 1,842,308 |
| W. Donald Wright | 3,736,492 | 1,200 | 1,842,308 |

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As indicated in the above table, Kenneth A. Abercrombie, James L. Bailey, Jr., M. Darlene Baxter, H. Terry Cook, Jr., Thomas Napier Gordon, Dr. O. Rebecca Hawkins, Timothy E. Pettus, Dr. Joseph W. Remke, III, Matthew M. Scoggins, Jr., T. Randy Stevens, W. Lacy Upchurch, William R. Walter, Dan C. Wheeler, Dr. David S. Williams and W. Donald Wright were elected as directors of the Corporation. The terms of the directors will continue until the annual meeting of shareholders in 2010, or until their respective successors are elected and qualified.

Item 6. Exhibits.

| EXHIBIT NUMBER | DESCRIPTION |
|----------------|---|
| 3.1 | Charter. (1) |
| 3.2 | Articles of Amendment to Charter. (1) |
| 3.3 | Amended and Restated By-laws. (2) |
| 31.1 | Certification of the Chief Executive Officer of First Farmers and Merchants Corporation Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of the Assistant Treasurer (principal financial officer) of First Farmers and Merchants Corporation Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of the Chief Executive Officer and Assistant Treasurer (principal financial officer) of First Farmers and Merchants Corporation Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

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

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

SIGNATURES

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

FIRST FARMERS AND MERCHANTS CORPORATION
(Registrant)

Date August 7, 2009

/s/ T. Randy Stevens
T. Randy Stevens, Chief Executive Officer

Date August 7, 2009

/s/ Patricia P. Bearden
Patricia P. Bearden, Assistant Treasurer (principal
financial officer and principal accounting officer)

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