

FIRST FARMERS & MERCHANTS CORP  
Form 10-K  
March 16, 2007

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

**Washington, D. C. 20549**

(Mark one)

**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, 2006**

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 number 0-10972

First Farmers and Merchants Corporation  
(Exact name of registrant as specified in its charter)

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

Registrant's telephone number, including area code - (931) 388-3145

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

|                     |   |
|---------------------|---|
| Title of each class | Name of each exchange on which registered |
| <u>None</u>         | <u>None</u>                               |

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

Common Stock, par value \$10.00 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 [ X ] 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 [ X ] 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 90 days. [X] Yes [ ] No

Edgar Filing: FIRST FARMERS & MERCHANTS CORP - Form 10-K

Indicate by check mark if the disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the 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 large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer     Accelerated filer     Non-accelerated filer

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 registrant's common stock held by non-affiliates as of June 30, 2006 was approximately \$225,350,300 based on the reported price at which the common stock was last sold (\$50).

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date. 5,760,000 shares as of March 1, 2007

DOCUMENTS INCORPORATED BY REFERENCE

- (1) Annual Report to Shareholders for Fiscal Year Ended December 31, 2006 -- Part II of this Report.
- (2) Proxy Statement for 2007 Annual Shareholders' Meeting to be held on April 17, 2007 -- Part III of this Report.

**PART I**

**Item 1. Business.**

First Farmers and Merchants Corporation (the "Corporation") was incorporated on March 31, 1982 as a Tennessee corporation. As of December 31, 2006, the only direct subsidiary of the Corporation was First Farmers and Merchants Bank, a Tennessee state-chartered bank (the "Bank"). Management evaluates the financial condition of the Corporation in terms of the Bank's operations within its service area. Its principal office is located at 816 South Garden Street, Columbia, Maury County, Tennessee. The Bank has offices in seven counties in Middle Tennessee that are listed below:

|                       |                          |                        |
|-----------------------|--------------------------|------------------------|
| <b>Maury County</b>   | <b>Giles County</b>      | <b>Marshall County</b> |
| Columbia              | Pulaski                  | Lewisburg              |
| Main Office           | Martin House             | Ellington              |
| High Street           | <b>Williamson County</b> | Chapel Hill            |
| Hatcher Lane          | Spring Hill              | <b>Hickman County</b>  |
| Campbell Plaza        | <b>Lawrence County</b>   | Centerville            |
| Northside             | Lawrenceburg             | East Hickman           |
| Mt. Pleasant          | Locust Avenue            |                        |
| Spring Hill           | Crockett                 |                        |
| <b>Dickson County</b> | Loretto                  |                        |
| White Bluff           |                          |                        |
| Dickson               |                          |                        |

The Bank provides only automatic teller machine services in the Saturn General Assembly Building, 100 Saturn Parkway, Spring Hill; in Lawrenceburg at the Quik Mart on East Gaines street; in Columbia at the Tennessee Farm Bureau, Columbia State Community College, Columbia Quik Mart on Hampshire Pike, and Maury Regional Hospital; and in Marshall County at Marshall Plaza, and On-the-Run Market at 1550 Franklin Pike, Lewisburg.

The operations of the Bank are significantly affected by prevailing economic conditions, competition and the monetary, fiscal and regulatory policies of governmental agencies. Lending activities are influenced by the general credit needs of small businesses in the Bank's service area, competition among lenders, the level of interest rates and the availability of funds. The loan portfolio of the Bank is comprised of commercial, commercial and residential real estate, and retail installment loans. Such loans are primarily originated within the Bank's service area in Middle Tennessee. Deposits are the primary source of funds for the Bank. Such deposits consist of checking accounts, regular savings deposits, NOW accounts, money market accounts and market rate certificates of deposit. Deposits are solicited from individuals and businesses in the Bank's service area. In addition, the Bank obtains deposits from state and local entities and, to a lesser extent, U. S. government entities and other depository institutions. Deposit flows and costs of funds are influenced by prevailing market rates of interest, primarily on competing investments, account maturities and the levels of personal income and savings in the Bank's service area. All of the Corporation's assets are located in the United States and all of its revenues generated from external customers originate within the United States.

The Bank's net income is dependent primarily on its net interest income, which is the difference between the interest income earned on its loans, investment assets and other interest-earning assets and the interest paid on deposits and other interest-bearing liabilities. To a lesser extent, the Bank's net income also is affected by its noninterest income derived principally from service fees as well as the level of noninterest expenses such as salaries and employee benefits.

For more information regarding the business of the Corporation and the Bank, please refer to the Management's Discussion and Analysis of Financial Condition and Results of Operations, which is a part of the Annual Report to Shareholders, incorporated by reference herein (the "Annual Report").

The Internet website of the Corporation and the Bank is "www.fandmbank.com." Our most recent currently available Annual Report to Shareholders may be obtained free of charge on our Internet website. A copy may also be obtained free of charge through the mail by request at the "Contact Us" link on our website.

## **Regulation and Supervision**

In addition to the generally applicable state and federal laws governing businesses and employers, the Corporation is subject to extensive regulation by federal and state laws and regulations applicable to financial institutions and their parent companies. Nearly all aspects of the business of the Corporation are subject to specific requirements and restrictions and general regulatory oversight. The principal objectives of state and federal laws regulating financial institutions are the maintenance of the safety and soundness of the financial institutions and the federal deposit insurance system and the protection of consumers or classes of consumers, rather than the specific protection of shareholders of a bank or the parent company of a bank, such as the Corporation. In addition, the supervision, regulation and examination of the Corporation by the bank regulatory agencies is not intended for the protection of the Corporation's shareholders. To the extent the following summary describes statutory or regulatory provisions, it is qualified in its entirety by reference to the particular statute or regulation.

The Corporation, as a bank holding company organized under the Bank Holding Company Act of 1956 (the "BHCA") with the Board of Governors of the Federal Reserve System (the "FRB"), is subject to the regulation and supervision by the FRB. The Corporation is required to file various reports with, and is subject to examination by, the FRB. The FRB has the authority to issue orders to bank holding companies to cease and desist from unsound banking practices and violations of conditions imposed by, or violations of agreements with, the FRB. The FRB is also empowered to assess civil money penalties against companies or individuals who violate the BHCA or orders or regulations thereunder.

The FRB has authority to prohibit bank holding companies from paying dividends if such payment is deemed to be an unsafe or unsound practice. The FRB has indicated generally that it may be an unsafe or unsound practice for bank holding companies to pay dividends unless a bank holding company's net income is sufficient to fund the dividends and the expected rate of earnings retention is consistent with the organization's capital needs, asset quality and overall financial condition. The Corporation depends in part upon dividends received from the Bank to fund its activities, including the payment of dividends. The Bank is subject to regulatory limitations on the amount of dividends it may declare and pay.

Under FRB policy, a bank holding company is expected to act as a source of financial and managerial strength to each of its subsidiary banks and to commit resources to their support. This support may be required at times when the bank holding company may not have the resources to provide it. Similarly, under the cross-guarantee provisions of the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporation (the "FDIC") can hold any FDIC-insured depository institution liable for any loss suffered or anticipated by the FDIC in connection with (i) the "default" of a commonly controlled FDIC-insured depository institution, or (ii) any assistance provided by the FDIC to a commonly controlled FDIC-insured depository institution "in danger of default."

The Corporation is required to comply with risk-based capital guidelines by the FRB and with other tests related to capital adequacy that the FRB adopts from time to time.

The Corporation owns the Bank, which is chartered under the laws of Tennessee and is a member of the Federal Reserve System. The Bank is subject to extensive state regulation and examination by the Tennessee Department of Financial Institutions, the FRB and the FDIC, which insures the deposits of each of the state banks to

the maximum extent permitted by law. The federal and state laws and regulations that are applicable to banks regulate, among other matters, the scope of their business, their investments, their reserves against deposits, the timing of the availability of deposited funds, the amount of loans and the amount of interest that may be charged on loans. Various state consumer laws and regulations also affect the operations of state banks.

The Federal Community Reinvestment Act (the "CRA") generally requires insured depository institutions to identify the communities they serve and to make loans and investments and provide services that meet the credit needs of these communities. Furthermore, the CRA requires the FRB to evaluate the performance of each of the subsidiary banks in helping to meet the credit needs of their communities. As a part of the CRA program, the Bank is subject to periodic examinations by the FRB and must maintain comprehensive records of its CRA activities for this purpose. During these examinations, the FRB rates such institutions' compliance with CRA as "Outstanding," "Satisfactory," "Needs to Improve" or "Substantial Noncompliance." As of the last examination, the Bank received an "Outstanding" rating from the FRB.

The FRB, the FDIC and other bank regulatory agencies have adopted final guidelines (the "Guidelines") for safekeeping confidential, personal customer information. The Guidelines require each financial institution, under the supervision and ongoing oversight of its Board of Directors or an appropriate committee thereof, to create, implement and maintain a comprehensive written information security program designed to ensure the security and confidentiality of customer information, protect against any anticipated threats or hazards to the security or integrity of such information and protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer. The Corporation has adopted a customer information security program that has been approved by the Corporation's Board of Directors.

The activities of the Corporation and the Bank are also subject to regulation under other various federal laws, including the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, the Gramm-Leach-Bliley Act of 1999, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the US Patriot Act), the Truth-in-Lending Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Fair Debt Collection Practice Act, the Electronic Funds Transfer Act and the Currency and Foreign Transactions Reporting Act (Bank Secrecy Act), among others, as well as various state laws.

## **Employees**

The Corporation has no employees. Its subsidiary, the Bank, had approximately 284 full-time employees and 33 part-time employees at December 31, 2006. Five of the Bank's officers are also officers of the Corporation. Employee benefit programs provided by the Bank include a deferred profit-sharing plan, an annual profit-sharing plan, a salary continuation plan, a deferred compensation plan, an executive split-dollar life insurance plan, a post-retirement medical benefits program, training programs, group life and health insurance and paid vacations.

## **Item 1A. Risk Factors.**

An investment in our common stock involves significant risks inherent to our business. The risks and uncertainties that management believes affect or could affect us are described below. This listing should not be considered as all-inclusive. You should carefully read and consider these risks and uncertainties described below together with all of the other information included or incorporated by reference in this report, before you decide to invest in our common stock. References to "we," "us," and "our" in this section refer to the Corporation and the Bank, unless otherwise specified or unless the context otherwise requires.

*We are subject to interest rate risk.*

Our earnings and cash flows are largely dependent upon our net interest income. Interest rates are highly sensitive to many factors that are beyond our control, including general economic conditions and policies of various governmental and regulatory agencies and, in particular, the Federal Reserve. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and securities and the amount of interest we pay on deposits and borrowings, but such changes could also affect (i) our ability to originate loans and obtain deposits, (ii) the fair value of our financial assets and liabilities, and (iii) the average duration of our securities portfolio and other interest-earning rates received on loans and other investments, our net interest income, and therefore, earnings could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings.

Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on our results of operations, any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on our financial condition and results of operations. For further discussion related to our management of interest rate risk, please refer to "LIQUIDITY AND CAPITAL RESOURCES-Interest Rate Risk" in the Management's Discussion and Analysis of Financial Condition and Results of Operations, which is a part of the Annual Report that is included as an exhibit to this filing.

***Our allowance for loan losses may be insufficient.***

We maintain an allowance for loan losses, which is a reserve established through a provision for loan losses charged to expense, that represents management's best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The level of the allowance reflects management's continuing evaluation of 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; 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. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks using existing qualitative and quantitative information, all of which may undergo material changes. An increase in the allowance for loan losses results in a decrease in net income, and possibly capital, and may have a material adverse effect on our financial condition and results of operations. For further discussion related to our allowance for loan losses, please refer to "LOANS AND LOAN QUALITY" and "CRITICAL ACCOUNTING POLICIES-Allowance for Loan Losses" in the Management's Discussion and Analysis of Financial Condition and Results of Operations, which is a part of the Annual Report that is included as an exhibit to this filing.

***We are subject to extensive government regulation and supervision.***

We are subject to extensive regulation and supervision under federal and state laws and regulations. The restrictions imposed by such laws and regulations limit the manner in which we conduct business, undertake new investments and activities and obtain financing. These regulations are designed primarily for the protection of the deposit insurance funds and consumers and not to benefit our shareholders. Financial institution regulation has been the subject of significant legislation in recent years and may be the subject of further significant legislation in the future, none of which is in our control. Significant new laws or changes in, or repeals of, existing laws could have a material adverse effect our financial condition, results of operations or liquidity. Further, federal monetary policy, particularly as implemented through the Federal Reserve System, significantly affects short-term interest rates and credit conditions, and any unfavorable change in these conditions could have a material adverse effect on our financial condition, results of operations or liquidity.

***Competition from other financial services providers could adversely impact our results of operation.***

The banking and financial services business is highly competitive. We face competition in making loans, attracting deposits and providing trust services. Increased competition in the banking and financial services business may reduce our market share, impair its growth or cause the prices we charge for our services to decline. For further discussion related to our competition in our market area, please refer to "FINANCIAL CONDITION - Assets and Liabilities" in the Management's Discussion and Analysis of Financial Condition and Results of Operations, which is a part of the Annual Report that is included as an exhibit to this filing.

***We rely heavily on our management team and on our ability to attract and retain key personnel.***

We are a customer-focused and relationship-driven organization. Future growth is expected to be driven in a large part by the relationships maintained with customers. Additionally, it is important for us to continue to attract, hire, motivate and retain skilled personnel to develop new customer relationships as well as new financial products and services. The market for such people is competitive, and there is no assurance that we will be successful in attracting, hiring, motivating or retaining them.

***Liquidity needs could adversely affect our results of operations and financial condition.***

We rely on dividends from the Bank as our primary source of funds. The primary source of funds of the Bank are customer deposits and loan repayments. While scheduled loan repayments are a relatively stable source of funds, they are subject to the ability of borrowers to repay the loans. The ability of borrowers to repay loans can be adversely affected by a number of factors, including changes in economic conditions, adverse trends or events affecting business industry groups, reductions in real estate values or markets, business closings or lay-offs, inclement weather, natural disasters and international instability. Additionally, deposit levels may be affected by a number of factors, including rates paid by competitors, general interest rate levels, returns available to customers on alternative investments and general economic conditions. Accordingly, we may be required from time to time to rely on secondary sources of liquidity to meet withdrawal demands or otherwise fund operations. While we believe that these sources are currently adequate, there can be no assurance they will be sufficient to meet future liquidity demands.

***Our profitability depends significantly on economic conditions in the communities in the State of Tennessee where we do business.***

Our success depends on the general economic conditions of the specific local markets in Middle Tennessee where we operate. Local economic conditions have a significant impact on the demand for our products and services as well as the ability of our customers to repay loans, the value of the collateral securing loans, and the stability of our deposit funding sources. A significant decline in general economic conditions, caused by inflation, recession, acts of terrorism, outbreak of hostilities, or other international or domestic occurrences, unemployment, changes in securities markets or other factors could impact local economic conditions and, in turn, have a material adverse effect on our financial condition and results of operations.

**Item 1B. Unresolved Staff Comments.**

None.

**Item 2. Properties.**



At December 31, 2006, the Bank maintained a main office in Columbia, Tennessee, 17 other offices (four of which are located on real property that is leased) and nine separate automatic teller or cash dispensing machine locations. For more information on these properties owned by the Corporation and the Bank, please refer to Note 7 and Note 9 of the Notes to Consolidated Financial Statements, which are a part of the Annual Report that is included as an exhibit to this filing. The Bank currently has a parcel of land located at Higgs Road in Lewisburg, Tennessee and a building located at 564 East Commerce Street in Lewisburg, Tennessee, that were transferred from premises and equipment to other assets held for sale.

**Item 3. Legal Proceedings.**

The Corporation and the Bank are, from time to time, subject to claims or suits arising in the ordinary course of business. Neither the Corporation nor the Bank currently is a party to any proceeding that, in management's opinion, would have a material adverse effect on the Corporation's financial condition or results of operations.

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

No matter was submitted during the fourth quarter of the fiscal year ended December 31, 2006 to a vote of the shareholders of the Corporation, through the solicitation of proxies or otherwise.

**PART II**

**Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

A discussion of the Corporation's common stock, related shareholder matters and purchases of equity securities is incorporated herein by reference to the Management's Discussion and Analysis of Financial Condition and Results of Operations and the Notes to Consolidated Financial Statements, each of which is a part of the Annual Report that is included as an exhibit to this filing. There were no sales of unregistered securities of the Corporation.

The following table provides information regarding purchases of the Corporation's common stock made by the Corporation during the fourth quarter of 2006:

| Period             | (a) total Number of Shares Purchased | (b) Average Price Paid per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plan or Programs | (d) Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs |
|--------------------|--------------------------------------|----------------------------------|---|--|
| October 1, 2006 -  |                                      |                                  |   |  |
| October 31, 2006   | \$ -                                 | \$ 50                            | \$ -  | \$ -   |
| November 1, 2006 - |                                      |                                  |   |  |
| November 30, 2006  | \$ 13,550                            | \$ 50                            | \$ -  | \$ -   |
| December 1, 2006 - |                                      |                                  |   |  |
| December 31, 2006  | \$ 41,750                            | \$ 50                            | \$ -  | \$ -   |
| <b>Total</b>       | <b>\$ 55,300</b>                     | <b>\$ 50</b>                     | <b>\$ -</b>   | <b>\$ -</b>  |

**Item 6. Selected Financial Data.**

The selected financial data is incorporated herein by reference to the table entitled "Selected Financial Information" in the Management's Discussion and Analysis of Financial Condition and Results of Operations, which is a part of the Annual Report that is included as an exhibit to this filing.

**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 is incorporated herein by reference to the Management's Discussion and Analysis of Financial Condition and Results of Operations, which is a part of the Annual Report that is included as an exhibit to this filing.

**Item 7A. Quantitative and Qualitative Disclosures About Market Risk.**

A discussion of the market risk of the Corporation and the Bank as of December 31, 2006 related to the investment debt and equity securities held by the Corporation and the Bank is incorporated by reference to Note 3 in the Notes to Consolidated Financial Statements, which is a part of the Annual Report that is included as an exhibit to this filing. A discussion of the market risk in the loan portfolio of the Bank is incorporated by reference to Note 4 in the Notes to Consolidated Financial Statements and the section entitled "LOANS AND LOAN QUALITY" in the Management's Discussion and Analysis of Financial Condition and Results of Operations, both of which are a part of the Annual Report that is included as an exhibit to this filing. A discussion of the rate sensitivity of all earning assets and interest-bearing liabilities of the Corporation and the Bank is incorporated by reference to the section entitled "LIQUIDITY AND CAPITAL RESOURCES" in the Management's Discussion and Analysis of Financial Condition and Results of Operations, which is a part of the Annual Report that is included as an exhibit to this filing.

**Item 8. Financial Statements and Supplementary Data.**

Financial statements and supplementary data are incorporated herein by reference to the Consolidated Financial Statements and Notes to Consolidated Financial Statements, both of which are a part of the Annual Report that is included as an exhibit to this filing.

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

None.

**Item 9A. Controls and Procedures**

**Conclusion Regarding the Effectiveness 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 Securities and Exchange Act of 1934, as amended (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 Securities and Exchange Commission under the Exchange Act is recorded, processed, summarized and reported on a timely basis.

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, the Corporation has included a report of management's assessment of the design and operating effectiveness of its internal controls as part of this report. The Corporation's independent registered public accounting firm also attested to, and reported on, management's assessment of the effectiveness of internal control over financial reporting. Management's report and the independent registered public accounting firm's attestation report are included with our Consolidated Financial Statements in the Annual Report that is an exhibit to this filing under the captions entitled "Management's Report on Internal Control

Over Financial Reporting" and "Report of Independent Registered Public Accounting Firm" and are incorporated herein by reference.

**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 fourth quarter of 2006 that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

**Item 9B. Other Information.**

None.

**PART III**

**Item 10. Directors, Executive Officers and Corporate Governance.**

Reference is made to the "Director Nominee Information Table" and the sections entitled "Executive Officers," "Committees of the Board," "Section 16 (a) Beneficial Ownership Reporting Compliance" and " Code of Ethics" in the Corporation's definitive Proxy Statement, which information is incorporated herein by reference.

**Item 11. Executive Compensation.**

Reference is made to the sections entitled "Compensation of Directors and Officers", "Compensation Committee Interlocks and Insider Participation" and "Compensation Committee Report" in the Corporation's definitive Proxy Statement, which information is incorporated herein by reference.

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

Reference is made to the section entitled "Security Ownership of Certain Beneficial Owners and Management" in the Corporation's definitive Proxy Statement, which information is incorporated herein by reference.

**Item 13. Certain Relationships and Related Transactions; and Director Independence.**

Reference is made to the "Director Nominatee Information Table" and the section entitled "Compensation Committee Report on -Related Party Transactions" in the Corporation's definitive Proxy Statement, which information is incorporated herein by reference.

**Item 14. Principal Accounting Fees and Services.**

Reference is made to the section entitled "Report of the Bank's Audit/Compliance/CRA Committee" in the Corporation's definitive Proxy Statement, which information is incorporated herein by reference.

**Part IV**

**Item 15. Exhibits, Financial Statement Schedules.**

(a) (1) Financial statements are incorporated herein by reference to the Consolidated Financial Statements and Notes to Consolidated Financial Statements, which are a part of the Annual Report that is included as an exhibit to this filing.

Edgar Filing: FIRST FARMERS & MERCHANTS CORP - Form 10-K

(2) All financial statement schedules are omitted because they are not applicable or not required, or because the required information is included in the Consolidated Financial Statements referenced in Item 15(a)(1).

(b) The following exhibits are filed herewith:

3.1 Charter (1)

3.2 Articles of Amendment to Charter (1)

3.3 Amended and Restated By-laws (2)

4.1 Form of Specimen Stock Certificate (1)

10.1 Profit Sharing Plan (3)

10.2 First Amendment to Profit Sharing Plan (3)

10.3 Second Amendment to Profit Sharing Plan (3)

10.4 Executive Salary Continuation Agreement between First Farmers and Merchants National Bank and Waymon L. Hickman, dated December 1, 1992 (3)

10.5 Memorandum of Understanding among First Farmers and Merchants National Bank and Merchants Corporation, and Waymon L. Hickman, dated June 17, 2002 (3)

10.6 Change in Control Agreement between First Farmers and Merchants National Bank and Leslie R. (Berry) Brooks, dated June 28, 2002 (3)

10.7 Stock Repurchase Agreement, dated as of June 23, 2006, between University of Tennessee and First Farmers and Merchants Corporation (4)

10.8 Form of Benefits Agreement entered into between First Farmers and Merchants Bank and Thomas Randall Stevens, the Bank's and the Corporation's Chairman and Chief Executive Officer, on January 26, 2007, and John P. Tomlinson, III, the Bank's and Corporation's Chief Administrative Officer, On January 29, 2007 (5)

13.1 Annual Report to Shareholders

21.1 List of Subsidiaries

31.1 Certification of the Chief Executive Officer of First Farmers and Merchants Corporation Pursuant to Rule 13a-14(1) 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(1) 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

Edgar Filing: FIRST FARMERS & MERCHANTS CORP - Form 10-K

- (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, File Number 0-10972, as filed with the Securities and Exchange Commission on May 7, 2004.
- (2) Incorporated by reference from the First Farmers and Merchants Corporation Current Report on Form 8-K, File Number 0-10972, as filed with the Securities and Exchange Commission on December 21, 2005.
- (3) Incorporated by reference from the First Farmers and Merchants Corporation Amendment No. 2 to the Annual Report on Form 10-K/A for the year ended December 31, 2003, File Number 0-10972, as filed with the Securities and Exchange Commission on July 19, 2004.
- (4) Incorporated by reference from the First Farmers and Merchants Corporation Current Report on Form 8-K. File Number 0-10972, as filed with the Securities and Exchange Commission on July 10, 2006.



Signatures -- continued

|                                  |                |                                  |                |
|----------------------------------|----------------|----------------------------------|----------------|
| /s/ Kenneth A. Abercrombie       |                | /s/ Joseph W. Remke, III         |                |
| Kenneth A. Abercrombie, Director |                | Joseph W. Remke, III, Director   |                |
| Date                             | March 16, 2006 | Date                             | March 16, 2006 |
| /s/ James L Bailey, Jr.          |                | /s/ T. Randy Stevens III         |                |
| James L. Bailey, Jr., Director   |                | T. Randy Stevens, Director       |                |
| Date                             | March 16, 2006 | Date                             | March 16, 2006 |
| /s/ Hulet M. Chaney              |                | /s/ John P. Tomlinson, III       |                |
| Hulet M. Chaney, Director        |                | John P. Tomlinson, III, Director |                |
| Date                             | March 16, 2006 | Date                             | March 16, 2006 |
| /s/ H. Terry Cook, Jr            |                | /s/ William R. Walter            |                |
| H. Terry Cook, Jr., Director     |                | William R. Walter, Director      |                |
| Date                             | March 16, 2006 | Date                             | March 16, 2006 |
| /s/ Tom Napier Gordon            |                | /s/ Dan C. Wheeler               |                |
| Tom Napier Gordon, Director      |                | Dan C. Wheeler, Director         |                |
| Date                             | March 16, 2006 | Date                             | March 16, 2006 |
| /s/ O. Rebecca Hawkins           |                | /s/ David S. Williams            |                |
| O. Rebecca Hawkins, Director     |                | David S. Williams, Director      |                |
| Date                             | March 16, 2006 | Date                             | March 16, 2006 |
| /s/ James E. York                |                | /s/ W. Donald Wright             |                |
| James E. York, Director          |                | W. Donald Wright, Director       |                |
| Date                             | March 16, 2006 | Date                             | March 16, 2006 |

EXHIBIT INDEX

FIRST FARMERS AND MERCHANTS CORPORATION

- 3.1 Charter (1)
- 3.2 Articles of Amendment to Charter (1)
- 3.3 Amended and Restated By-laws (2)
- 4.1 Form of Specimen Stock Certificate (1)

Edgar Filing: FIRST FARMERS & MERCHANTS CORP - Form 10-K

10.1 Profit Sharing Plan (3)

10.2 First Amendment to Profit Sharing Plan (3)

10.3 Second Amendment to Profit Sharing Plan (3)

10.4 Executive Salary Continuation Agreement between First Farmers and Merchants National Bank and Waymon L. Hickman, dated December 1, 1992 (3)

10.5 Memorandum of Understanding among First Farmers and Merchants National Bank and Merchants Corporation, and Waymon L. Hickman, dated June 17, 2002 (3)

10.6 Change in Control Agreement between First Farmers and Merchants National Bank and Leslie R. (Berry) Brooks, dated June 28, 2002 (3)

10.7 Stock Repurchase Agreement, date as of June 23, 2006, between University of Tennessee and First Farmers and Merchants Corporation (4)

10.8 Form of Benefits Agreement entered into between First Farmers and Merchants Bank and Thomas Randall Stevens, the Bank's and the Corporation's Chairman and Chief Executive Officer, on January 26, 2007, and John P. Tomlinson, III, the Bank's and Corporation's Chief Administrative Officer, On January 29, 2007 (5)

13.1 Annual Report to Shareholders

21.1 List of Subsidiaries

31.1 Certification of the Chief Executive Officer of First Farmers and Merchants Corporation Pursuant to Rule 13a-14(1) 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(1) 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, File Number 0-10972, as filed with the Securities and Exchange Commission on May 7, 2004.

(2) Incorporated by reference from the First Farmers and Merchants Corporation Current Report on Form 8-K, File Number 0-10972, as filed with the Securities and Exchange Commission on December 21, 2005.

(3) Incorporated by reference from the First Farmers and Merchants Corporation Amendment No. 2 to the Annual Report on Form 10-K/A for the year ended December 31, 2003, File Number 0-10972, as filed with the Securities and Exchange Commission on July 19, 2004.

(4) Incorporated by reference from the First Farmers and Merchants Corporation Current Report on Form 8-K. File Number 0-10972, as filed with the Securities and Exchange Commission on July 10, 2006.



FIRST FARMERS AND MERCHANTS CORPORATION

Exhibit 21.1

List of Subsidiaries

Direct and Indirect Ownership

First Farmers and Merchants Bank

F&M West Inc.

Maury Tenn Inc.

COMPARATIVE PERFORMANCE

Set forth below is a graph comparing the yearly change in the cumulative total shareholder return on the Common Stock ("FF&M" in the graph) against the cumulative total return of the S&P 500 Index and the S&P Major Regional Bank Index\*\* for the period of five years commencing December 31, 2001 and ending December 31, 2006.

**COMPARISON OF FIVE-YEAR CUMULATIVE TOTAL RETURN**

VALUE OF \$100 INVESTED ON DECEMBER 31, 2001 AT:

|                             | <u>2001</u> | <u>2002</u> | <u>2003</u> | <u>2004</u> | <u>2005</u> | <u>2006</u> |
|-----------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| FF&M *                      | \$ 100.00   | \$ 110.29   | \$ 117.65   | \$ 132.36   | \$ 141.19   | \$ 147.07   |
| S&P MAJOR REGIONAL BANKS ** | 100.00      | 100.08      | 135.63      | 153.25      | 155.02      | 178.42      |
| S & P 500 ***               | 100.00      | 77.90       | 100.24      | 111.12      | 116.63      | 135.10      |

[CM1]

\* Assumes that the value of the investment in FF&M stock was \$100 on December 31, 2001, **with no dividend reinvestment.**

\*\* Assumes that the value of the investment in the index was \$100 on December 31, 2001, with all dividends reinvested.

\*\*\* Assumes that the value of the investment in the index was \$100 on December 31, 2001, with all dividends reinvested.

## 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. These forward-looking statements may be identified by, among other things, the use of forward-looking terminology such as "believes," "expects," "hopes," "may," "plans," "will," or "anticipates," or the negatives of such terms. We caution you not to place undue reliance on such forward-looking statements in this report because results could differ materially from those anticipated as a result of a variety of factors. These forward-looking statements include, without limitation, those relating to the quality of service provided to customers, the effect of fluctuating interest rates on net interest income, the stability of market rates during 2007, capital expenditures, cash dividends and the adequacy of allowance for loans losses. Factors that could affect our results include, but are not limited to, changes in economic conditions; fluctuations in prevailing interest rates and the effectiveness of our risk monitoring systems; our ability to maintain credit quality; our ability to provide market competitive products and services; laws and regulations affecting financial institutions in general; our ability to operate and integrate new technology; the effectiveness of our interest rate hedging strategies; government fiscal and monetary policies; changes in our operating or expansion strategy; the availability of and costs associated with maintaining and/or obtaining adequate and timely sources of liquidity; limitations on our ability to pay dividends and to meet our cash obligations; assumption and judgments about the collectability of our loan portfolio; our ability to compete with other financial services companies and other factors generally understood to affect the financial results of financial services companies.

## EXECUTIVE OVERVIEW

### General

First Farmers and Merchants Corporation (the "Corporation") was incorporated on March 31, 1982 as a Tennessee corporation. As of December 31, 2006, the only direct subsidiary of the Corporation was First Farmers and Merchants Bank (the "Bank") which conducts the principal business of the consolidated company. The Bank was organized in 1954 as a successor to a state bank that was organized in 1909. Previously, the Bank was a national bank and on July 5, 2005, the Bank returned to being a state-chartered bank and its name changed from First Farmers and Merchants National Bank to First Farmers and Merchants Bank. The Bank has direct and indirect subsidiaries through which it holds F&M West, Incorporated, Maury Tenn, Incorporated and Maury Tenn Properties,

Incorporated. The principal executive offices of the Corporation are located at 816 South Garden Street, Columbia, Maury County, Tennessee. Management of the Corporation evaluates the financial condition of the Corporation in terms of the Bank's operations within its service area. In 2006, Management made the decision to close and consolidate some branches in Marshall, Giles and Lawrence Counties. The changes allowed the Bank to use resources in a more efficient way and helped position the Bank for long-term sustained growth. The following branches were closed and consolidated into area branches: Lewisburg East, Lewisburg Downtown, Pulaski West College and Leoma.

**All dollar amounts in this report, other than per-share amounts, are in thousands unless otherwise noted.**

### **Financial Condition**

The Corporation's assets consist primarily of its investment in the Bank and other smaller investments. Its primary activities are conducted through the Bank. The Bank is committed to providing quality services in diverse markets and a changing interest rate environment. Management hopes to provide Bank customers the quality service of a community bank and the safety and strength of a regional bank.

### **Financial Condition (Continued)**

At December 31, 2006, the Corporation's consolidated total assets were \$820,084, its consolidated net loans were \$466,091, its total deposits were \$698,962 and its total shareholders' equity was \$103,807. The economic climate in the Corporation's market area of Middle Tennessee showed stable conditions in 2006. This economic stabilization can be seen in the increase in loan volume and total deposits-- net loans were up 3.1% at December 31, 2006 compared to December 31, 2005. Total deposits were up 2.2%. Total shareholders' equity was up 0.7%. Retained earnings, capital stock and additional paid-in capital were down 0.2%.

### **Results of Operations**

Consolidated net income in 2006 was down 8.6% compared to 2005. Net interest income was down 1.9% over the same periods. In 2006, a reduction (credit) of \$636,000 was made in the allowance for possible loan and lease losses. The amount of these credits was based upon unexpected loss recoveries and substantial reductions in the level of criticized assets. Net income was \$7,725 for 2006 compared to \$8,452 for 2005 and \$8,594 for 2004. On a per common share basis, net income was \$1.33 for 2006 versus \$1.45 for 2005 and \$1.47 for 2004.

The accompanying tables and the discussion and financial information are presented to aid in understanding the Corporation's financial position and results of operations. The emphasis of this discussion is on the years 2006, 2005 and 2004; however, financial information for prior years will also be presented where appropriate. This discussion should be read in conjunction with the Consolidated Financial Statements and the NOTES TO CONSOLIDATED FINANCIAL STATEMENTS included elsewhere in this report.

## **FINANCIAL CONDITION**

The Corporation's financial condition depends on the quality and nature of its assets, its liability and capital structure, the market and economic conditions and the quality of its personnel.

### **Net Interest Margin**

Net interest margin is defined as the difference between the revenue from earning assets, primarily interest income, and interest expense related to interest-bearing liabilities. The maintenance of the net interest margin at a level that, when coupled with noninterest revenues, exceeds additions to the allowance for loan losses, noninterest

expenses and income taxes, and yields an acceptable profit is critical for success in the banking industry. Net interest margin is a function of the average balances of earning assets and interest-bearing liabilities and the yields earned and rates paid on those balances.

Management activities are planned to maintain a satisfactory spread between the yields on earning assets and the related cost of interest-bearing funds. The gross interest spread is determined by comparing the taxable equivalent gross interest margin to average earning assets before deducting the allowance for loan losses. This ratio reflects the overall profitability of earning assets, including both those funded by interest-bearing sources and those that do not generate interest (primarily noninterest-bearing demand deposits). This ratio is most often used when analyzing a banking institution's overall gross margin profitability compared to that of other financial institutions. The incremental interest spread compares the difference between the yields on earning assets and the cost of interest-bearing funds. Management uses calculation and similar ratios to assist in pricing decisions for interest-related products. Table A presents the average daily balances, the components of the gross interest margin (on a taxable equivalent basis), the yield or rate, and the incremental and gross interest spread for each of the last three years by major categories of assets and liabilities.

**Net Interest Margin (Continued)**

**Table A - Distribution of Assets, Liabilities, and Shareholders' Equity, Interest Rates and Interest Differential**

|   | YEAR ENDED DECEMBER 31, |                |                  |                   |                |                  |                   |                |          |  |
|---|-------------------------|----------------|------------------|-------------------|----------------|------------------|-------------------|----------------|----------|--|
|   | 2006                    |                |                  | 2005              |                |                  | 2004              |                |          |  |
|   | Average Balance         | Rate/<br>Yield | Interest         | Average Balance   | Rate/<br>Yield | Interest         | Average Balance   | Rate/<br>Yield | Interest |  |
| <b>ASSETS</b>                               |                         |                |                  |                   |                |                  |                   |                |          |  |
| Interest earning assets                     |                         |                |                  |                   |                |                  |                   |                |          |  |
| Loans, net                                  | \$167,545               | 6.80 %         | \$ 31,771        | \$ 440,781        | 6.27 %         | \$ 27,626        | \$ 419,627        | 5.9            |          |  |
| Bank deposits                               | 138                     | 3.62           | 5                | 48                | 2.08           | 1                | 244               | 1.2            |          |  |
| Taxable securities                          | 165,736                 | 3.99           | 6,605            | 224,688           | 3.85           | 8,651            | 266,483           | 3.9            |          |  |
| Tax exempt securities                       | 96,281                  | 7.49           | 7,211            | 72,810            | 6.59           | 4,799            | 53,900            | 7.3            |          |  |
| Federal funds sold                          | 8,798                   | 5.00           | 440              | 7,185             | 3.07           | 221              | 7,563             | 1.1            |          |  |
| <b>TOTAL EARNING ASSETS</b>                 | <b>738,498</b>          | <b>6.23</b>    | <b>\$ 46,032</b> | <b>745,512</b>    | <b>5.54</b>    | <b>\$ 41,298</b> | <b>747,817</b>    | <b>5.2</b>     |          |  |
| Noninterest earning assets                  |                         |                |                  |                   |                |                  |                   |                |          |  |
| Cash and due from banks                     | 22,638                  |                |                  | 25,108            |                |                  | 26,604            |                |          |  |
| Bank premises and equipment                 | 11,544                  |                |                  | 12,264            |                |                  | 12,834            |                |          |  |
| Other assets                                | 34,793                  |                |                  | 36,681            |                |                  | 40,000            |                |          |  |
| <b>TOTAL ASSETS</b>                         | <b>\$807,473</b>        |                |                  | <b>\$ 819,565</b> |                |                  | <b>\$ 827,255</b> |                |          |  |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b> |                         |                |                  |                   |                |                  |                   |                |          |  |
| Interest bearing liabilities                |                         |                |                  |                   |                |                  |                   |                |          |  |
| Time and savings deposits:                  |                         |                |                  |                   |                |                  |                   |                |          |  |
| NOW and money market accounts               | \$209,814               | 0.88 %         | \$ 1,848         | \$ 235,524        | 0.66 %         | \$ 1,551         | \$ 238,616        | 0.6            |          |  |
| Savings                                     | 93,854                  | 0.99           | 933              | 107,597           | 0.95           | 1,027            | 111,730           | 0.9            |          |  |
| Time  | 166,868                 | 3.91           | 6,519            | 161,929           | 2.80           | 4,533            | 173,376           | 2.2            |          |  |
| Time over \$100,000                         | 92,521                  | 4.37           | 4,039            | 79,012            | 3.32           | 2,626            | 72,027            | 2.7            |          |  |
| <b>TOTAL INTEREST BEARING</b>               |                         |                |                  |                   |                |                  |                   |                |          |  |
| <b>DEPOSITS</b>                             | <b>563,057</b>          | <b>2.37</b>    | <b>13,339</b>    | <b>584,062</b>    | <b>1.67</b>    | <b>9,737</b>     | <b>595,749</b>    | <b>1.4</b>     |          |  |

Edgar Filing: FIRST FARMERS & MERCHANTS CORP - Form 10-K

|  |                 |               |                  |            |        |          |            |      |
|--|-----------------|---------------|------------------|------------|--------|----------|------------|------|
| Federal funds purchased and securities sold under agreements to repurchase | <b>8,753</b>    | <b>4.99</b>   | <b>437</b>       | 5,403      | 2.81   | 152      | 4,056      | 1.2  |
| Other liabilities  | <b>257</b>      | <b>4.67</b>   | <b>12</b>        | 322        | 2.80   | 9        | 385        | 1.5  |
| <b>TOTAL INTEREST BEARING LIABILITIES</b>                                  | <b>572,067</b>  | <b>2.41</b>   | <b>\$ 13,788</b> | 589,787    | 1.68   | \$ 9,898 | 600,190    | 1.4  |
| Noninterest bearing liabilities  |                 |               |                  |            |        |          |            |      |
| Demand deposits  | <b>117,242</b>  |               |                  | 115,183    |        |          | 115,207    |      |
| Other liabilities  | <b>12,831</b>   |               |                  | 11,637     |        |          | 10,892     |      |
| <b>TOTAL LIABILITIES</b>   | <b>702,140</b>  |               |                  | 716,607    |        |          | 726,289    |      |
| Shareholders' equity   | <b>105,333</b>  |               |                  | 102,958    |        |          | 100,966    |      |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>                          | <b>\$07,473</b> |               |                  | \$ 819,565 |        |          | \$ 827,255 |      |
| Spread between combined rate earned and combined rates paid*               |                 | <b>3.82 %</b> |                  |            | 3.86 % |          |            | 3.85 |
| Net yield on interest-earning assets*                                      |                 | <b>4.37 %</b> |                  |            | 4.21 % |          |            | 4.13 |

\* Taxable equivalent basis

Notes:

1. U.S. government, government agency and corporate debt securities plus equity securities in the available-for-sale and held-to-maturity categories are taxable securities. Most municipal debt securities are nontaxable and classified as held-to-maturity.
2. The taxable equivalent adjustment has been computed based on a 34% federal income tax rate and has given effect to the disallowance of interest expense, for federal income tax purposes, related to certain tax-free assets. Loans include nonaccrual loans for all years presented.
3. The average balances of the amortized cost of available-for-sale securities were used in the calculations in this table.

**Net Interest Margin (Continued)**

Table B sets forth, for the periods indicated, a summary of consolidated changes in interest earned and interest paid, reflected by the interest generated by volume changes and the interest generated by changes in the yield or rate. On a tax equivalent basis, net interest income increased \$844,000 for the year ending December 31, 2006 as financial products repriced in the rising rate environment. Interest paid on interest-bearing deposits was up primarily because of the higher interest rates.

**TABLE B - Volume and Yield/Rate Variances**

(Taxable Equivalent Basis - In Thousands)

|  | 2006 Compared to 2005 |             |                         | 2005 Compared to 2004 |             |                         |
|--|-----------------------|-------------|-------------------------|-----------------------|-------------|-------------------------|
|  | Volume                | Yield /Rate | Net Increase (Decrease) | Volume                | Yield /Rate | Net Increase (Decrease) |
| <b>Revenue earned on</b>   |                       |             |                         |                       |             |                         |
| Loans, net   | \$ 1,678              | \$ 2,467    | \$ 4,145                | \$ 1,252              | \$ 1,536    | \$ 2,788                |
| Bank deposits  | 2                     | 2           | 4                       | (2)                   | -           | (2)                     |
| Investment securities  |                       |             |                         |                       |             |                         |
| Taxable securities   | (2,270)               | 224         | (2,046)                 | (1,642)               | (179)       | (1,821)                 |
| Tax-free securities  | 1,547                 | 865         | 2,412                   | 1,386                 | (537)       | 849                     |
| Federal funds Sold   | 50                    | 169         | 219                     | (4)                   | 138         | 134                     |
| Total interest earning assets  | 1,007                 | 3,727       | 4,734                   | 990                   | 958         | 1,948                   |
| <b>Interest paid on</b>  |                       |             |                         |                       |             |                         |
| NOW and money market accounts  | (170)                 | 467         | 297                     | (20)                  | (5)         | (25)                    |
| Savings deposits   | (131)                 | 37          | (94)                    | (39)                  | 13          | (26)                    |
| Time deposits  | 138                   | 1,848       | 1,986                   | (252)                 | 963         | 711                     |
| Time deposits over \$100,000   | 448                   | 965         | 1,413                   | 192                   | 456         | 648                     |
| Federal funds purchased and securities sold under agreements to repurchase | 94                    | 191         | 285                     | 17                    | 83          | 100                     |
| Short term debt  | (2)                   | 5           | 3                       | (1)                   | 4           | 3                       |
| Total interest-bearing funds   | 377                   | 3,513       | 3,890                   | (103)                 | 1,514       | 1,411                   |
| <b>Net interest earnings</b>   | \$ 630                | \$ 214      | \$ 844                  | \$ 1,093              | \$ (556)    | \$ 537                  |

Notes:

1. The change in interest earned or paid resulting from both volume and rate or yield has been allocated to change because of volume and change because of rate or yield in proportion to the relationship of the absolute dollar amounts of the change in each. Loans include nonaccrual loans for all years presented.
2. The computation of the taxable equivalent adjustment has given effect to the disallowance of interest expense, for federal income tax purposes, related to certain tax-free assets.
3. U.S. government, government agency and corporate debt securities plus equity securities in the available-for-sale and held-to-maturity categories are taxable securities. Most municipal debt securities are nontaxable and classified as held-to-maturity.

**Assets and Liabilities**

Average earning assets decreased 0.9% as of December 31, 2006 compared to December 31, 2005 and decreased 0.3% as of December 31, 2005 compared to December 31, 2004. Stable local economic conditions contributed to the nominal change during 2006. The economic climate in the Corporation's market area of Middle Tennessee showed some improvement in 2006 as loan growth remained stable throughout the year. As a financial institution, the Bank's primary earning asset is loans. At December 31, 2006, average net loans represented 63.3% of average earning assets. Average net loans were up 6.1% as of December 31, 2006 compared to December 31, 2005 and increased 5.0% as of December 31, 2005 compared to December 31, 2004.

Average investments, 35.5% of average earning assets at December 31, 2006, decreased 11.1% from year end 2005 compared to a 7.1% decrease at the end of 2005 from year end 2004. Maturing securities and other available funds were invested in loans and provided a source of funds to the decrease in deposits. Average total assets declined 1.5% during 2006 compared to a decrease during 2005 of 0.9%.

The Bank's average deposits declined 3.6% as of December 31, 2006 compared to December 31, 2005 as interest rate competition increased from existing banks and non banks as well as the emergence of new banking organizations in our service area. The Bank's average deposits declined 2.0% as of December 31, 2005 compared to December 31, 2004. Interest bearing transaction accounts were down 10.9% from the average at December 31, 2005. Time deposits under \$100 increased 3.1% as of December 31, 2006 compared to December 31, 2005 and time deposits over \$100 increased 17.1% primarily because the Bank increased its reliance on short term large dollar

certificates of deposit. Average savings deposits decreased 12.8% as of December 31, 2006 compared to December 31, 2005. As reflected by these changes, the Bank experienced a shift of funds by its customers out of savings deposits and into time deposits. Savings deposits have historically been steady providing a core, low cost, source of funding.

### **Assets and Liabilities (Continued)**

Customer relationship development helped maintain a stable base in noninterest-bearing deposits. The Bank's noninterest-bearing deposits have remained strong and were 17.0% of average total deposits at December 31, 2006, 16.4% of average total deposits at December 31, 2005 and 16.1% of average total deposits at 12/31/04. This core of noninterest-bearing funds remained strong for 2006.

The Corporation and the Bank do not have any long-term debt or other obligations with the exception of certain operating leases that are discussed in Note 8 of the Notes To Consolidated Financial Statements included elsewhere in this report.

## **RESULTS OF OPERATIONS**

### **LIQUIDITY AND CAPITAL RESOURCES**

The Bank uses a formal asset and liability management process to ensure adequate liquidity and control interest rate risk. The Bank's goal of liquidity management is to provide adequate funds to meet loan demand and any potential unexpected deposit withdrawals. The Bank accomplishes this goal by striving for consistent core deposit growth, holding adequate liquid assets and maintaining unused capacity to borrow funds. The Bank's objective of interest rate risk management is to maintain reasonable stability in the gross interest margin despite changes in the level of interest rates and the spread among interest rates.

#### **Liquidity**

At December 31, 2006, the Bank had approximately \$129.0 million of cash and due from banks, securities and other short-term investments maturing within one year compared to \$91.3 million as of a year earlier. In the normal course of business, the Bank has established lines of credit for short-term borrowings for the management of daily liquidity needs. At December 31, 2006, the unused lines of credit were \$55.0 million.

#### **Interest Rate Risk**



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 those that can be repriced to current market rates within a defined time period. The Asset/Liability Committee measures near-term risk (within the next 12 months) to net interest income resulting from changes in interest rates. The model incorporates the Bank's assets and liabilities, together with forecasted changes in the balance sheet mix and assumptions that reflect the current interest rate environment, to simulate the effect of possible changes in interest rates on net interest income. As a policy, budgeted financial goals are monitored on a monthly basis by the Asset/Liability Committee where the actual dollar change in net interest income given different interest rate movements is reviewed. A negative dollar change in net interest income for a 12-month period of less than 4.5% of net interest income given a three hundred basis point shift in interest rates is considered an acceptable rate risk position. At December 31, 2006, if interest rates were to fall 300 basis points (3.0%) over the next 12 months, net interest income would be \$553.8 less than currently projected if rates were to rise by 300 basis points. This would be a decline in net interest income of 2.1%, which is within policy guidelines established by the Bank's Board of Directors.

### **Interest Rate Risk (Continued)**

**TABLE C - Rate Sensitivity of Earning Assets and Interest-Bearing Liabilities**

| <b>As of December 31, 2006</b>         | <b>Three Months<br/>or Less</b> | <b>Three to Six<br/>Months</b> | <b>Six to 12<br/>Months</b> | <b>Over One<br/>Year</b> | <b>Total</b> |
|--|---------------------------------|--------------------------------|-----------------------------|--------------------------|--------------|
| <b>Earning assets</b>                  |                                 |                                |                             |                          |              |
| Bank time deposits                     | \$ 2,573                        | \$ -                           | \$ -                        | \$ -                     | \$ 2,573     |
| Taxable investment securities          | 5,999                           | 9,966                          | 33,618                      | 85,418                   | 135,001      |
| Tax-exempt investment securities       | 2,280                           | 1,455                          | 666                         | 88,846                   | 93,247       |
| Loans and leases, net of deferred fees | 77,122                          | 24,986                         | 49,216                      | 322,029                  | 473,353      |
| Total earning assets                   | 87,974                          | 36,407                         | 83,500                      | 496,293                  | 704,174      |
| <b>Interest-bearing liabilities</b>    |                                 |                                |                             |                          |              |
| NOW and money market accounts          | 124,386                         | -                              | -                           | 78,368                   | 202,754      |
| Savings                                | -                               | -                              | -                           | 87,689                   | 87,689       |
| Time                                   | 62,243                          | 59,993                         | 31,627                      | 20,219                   | 174,082      |
| Time over \$100,000                    | 37,431                          | 36,961                         | 11,462                      | 5,650                    | 91,504       |
| Other short-term debt                  | 3,040                           | -                              | -                           | -                        | 3,040        |
| Total interest bearing liabilities     | 227,100                         | 96,954                         | 43,089                      | 191,926                  | 559,069      |
| Period gap                             | (139,126)                       | (60,547)                       | 40,411                      | 304,367                  | 145,105      |
| Cummulative gap                        | \$ (139,126)                    | \$ (199,673)                   | \$ (159,262)                | \$ 145,105               |              |

Another tool used to monitor the Bank's overall interest rate sensitivity is a gap analysis. Table C shows the Bank's rate-sensitive position at December 31, 2006, as measured by a gap analysis (the difference between the earning asset and interest-bearing liability amounts scheduled to be repriced to current market rates in subsequent periods). In the short term, deposits are subject to rate changes sooner than loans and investments. Management anticipates rates to remain stable in 2007 and has determined the Bank to be in an acceptable rate risk position. Table A provides additional information regarding the largest components of interest-bearing liabilities.

### **Capital**

Historically, internal growth has financed the capital needs of the Bank. The Corporation and the Bank do not have any long-term debt and do not have major plans for material capital expenditures in the next 12 months. At December 31, 2006, the Corporation had a ratio of Tier I Capital to average assets of 12.45%. This compares to a ratio of Tier I capital to average assets of 12.13% at December 31, 2005. This ratio shows a slight increase because retained earnings, capital stock and additional paid-in capital were stable and average total assets declined 1.5%

during 2006.

Cash dividends declared in 2006 were 50.5% of net income. The payout ratio for 2005 was 42.2%. The Corporation plans to continue an average annual payout ratio over 20% while continuing to maintain a capital to asset ratio reflecting financial strength and adherence to regulatory guidelines.

The minimum guideline for the ratio of total capital to risk-weighted assets is 8%. Tier 1 Capital generally consists of common stock. Tier I Capital must equal at least 4% of risk-weighted assets. As of December 31, 2006, the Corporation's ratios of Tier I Capital to risk-weighted assets and total Capital to risk-weighted assets were 19.25% and 20.50%, respectively. At December 31, 2005, the comparable

ratios were 18.70% and 19.96%, respectively. Please refer to Note 11 in the Notes to Consolidated Financial Statements included elsewhere in this report for more information on the capital strength of the Corporation and the Bank.

## **LOANS AND LOAN QUALITY**

As with most commercial banking institutions, the Bank's loan portfolio is the largest component of earning assets and, therefore, provides the highest amount of revenue. The loan portfolio also contains, as a result of credit quality, the highest exposure to risk. When analyzing potential loans, management assesses both interest rate objectives and credit quality objectives in determining whether to make a given loan and the appropriate pricing for that loan. The Bank maintains a diversified portfolio in order to spread its risk and reduce its exposure to economic downturns that may occur in different segments of the economy or in particular industries. As of December 31, 2006, total loans maturing and repricing after one year, which have predetermined interest rates and floating or adjustable interest rates are \$299 million and \$57 million, respectively. The composition of the loan portfolio is disclosed in detail in Note 4 in the Notes to Consolidated Financial Statements included elsewhere in this report.

The lending activities of the Bank are subject to written underwriting standards and policies established by the Bank's Board of Directors and management that include loan review procedures and approvals. Applications for loans are taken by designated employees at 15 of the Bank's offices. Depending primarily on the amount of the loan, there are various approval levels required, including an Executive Committee of the Bank's Board of Directors that meets weekly.

The Bank has a credit administration function that is responsible for assisting loan officers in underwriting new loans, reviewing problem loans, monitoring the status of problem loans from period to period and assisting in their resolution. This review process also includes semi-annual reviews by an outside party to assess the quality of the loan portfolio independently. Management has concluded that this independent review has served to strengthen underwriting practices. The analysis and review by the Bank's credit administration department also include a formal review that is prepared quarterly to assess the risk in the loan portfolio and to determine the adequacy of the allowance for loan losses. Loan reviews of all relationships aggregating \$250 and greater are completed on an annual schedule. At December 31, 2006 loans totaling \$11.4 million, or 2.4% of the portfolio, were classified as other assets especially mentioned. This compares to loans totaling \$5.1 million so classified at December 31, 2005. There were no loans classified as doubtful at December 31, 2006 and December 31, 2005. The bank closed the year with \$5.6 million in classified assets, which includes substandard loans, doubtful loans and Other Real Estate Owned ("OREO"). This represents a decrease of \$4.9 million or 46.8% from December 31, 2005. Classified assets represented 5.3% of Tier I Capital and ALLL, which was down from 10.1% at 12/31/05 and below the Bank's objective of 12.0%. Overall credit quality was improved as some problem loans have been resolved and credit underwriting has improved. For most of 2006, delinquency levels remained well below the year-end level of 1.2% and well below both the Bank's target level and peer group average. Loans that are impaired and not accruing interest were more actively monitored to determine

those for which more aggressive action plans should be taken. The Bank ended 2006 with a net recovery of \$104. The payoff of several large classified credits was a major contributor to the decline in classified loans. Management believes that the allowance for loan losses was adequate at December 31, 2006.

Table D summarizes average loan balances and reconciles the allowance for loan losses at December 31, 2002, 2003, 2004, 2005 and 2006. Additions or reductions to the allowance, which have been included in operating expenses, are also included. First mortgage loans secured by one to four-family residential properties make up 38.4% of the total loan portfolio. The Bank continues to have a concentration in residential mortgage loans; however, management of the Bank remains comfortable with this concentration of loan type given the strong underwriting practices within this portfolio and the

acceptable level of historical losses. The environment for commercial, industrial and commercial real estate lending remains largely unchanged in the seven counties within which the Bank operates. The Bank does not have any industry concentrations as measured by regulatory guidelines. However, the Bank does have heavy exposure among five broad industry categories-- construction, manufacturing, real estate rental and leasing, other services, and public administration. Given the level of exposure in each of these

### LOANS AND LOAN QUALITY (Continued)

categories, the particular industries are monitored closely to ensure that underwriting practices and policies, as well as allowance levels, match the level of risk posed. Please refer to Note 1 in the Notes to Consolidated Financial Statements included elsewhere in this report.

Loans having recorded investments of \$2.0 million and \$2.3 million at December 31, 2006 and 2005, have been identified as impaired and are not accruing interest in accordance with the provision of SFAS 114. These type of loans are considered nonaccrual loans and represent 0.4% and 0.5% of gross loans as of December 31, 2006 and 2005, respectively. Interest received on these loans during 2006 was \$122, during 2005 was \$136, and during 2004 was \$170. The gross interest income that would have been recorded if the loans had been current in accordance with their original terms and had been outstanding throughout the period or since origination, if held for part of the period, was \$200, \$251, and \$475 for the years ended December 31, 2006, 2005, and 2004, respectively. The Bank has no loans that are past due 90 days or more and no "troubled debt restructurings" as defined in SFAS 15 that are not included in nonaccrual loans as of December 31, 2006 and 2005. Please refer to Note 1 and Note 4 in the Notes to Consolidated Financial Statements that are included elsewhere in this material for more information on the Bank's policy regarding loan impairment.

### TABLE D - THE LOAN PORTFOLIO

| (Dollars In Thousands)   | <b>2006</b>       | 2005       | December 31,<br>2004 | 2003       | 2002       |
|--|-------------------|------------|----------------------|------------|------------|
| Average amount of gross loans outstanding                          | <b>\$ 475,226</b> | \$ 448,868 | \$ 428,671           | \$ 456,187 | \$ 524,248 |
| Balance of allowance for possible loan losses at beginning of year | <b>7,794</b>      | 8,509      | 10,123               | 11,375     | 6,707      |
| Balance from acquisition   | -                 | -          | -                    | -          | 536        |
| Loans charged off  |                   |            |                      |            |            |
| Loans secured by real estate                                       | <b>207</b>        | 287        | 364                  | 958        | 1,549      |
| Commercial and industrial loans                                    | <b>94</b>         | 138        | 1,017                | 296        | 580        |

Edgar Filing: FIRST FARMERS & MERCHANTS CORP - Form 10-K

|  |              |          |          |           |           |
|--|--------------|----------|----------|-----------|-----------|
| Loans to individuals   | <b>62</b>    | 126      | 299      | 712       | 1,517     |
| <b>TOTAL LOANS CHARGED OFF</b>   | <b>363</b>   | 551      | 1,680    | 1,966     | 3,646     |
| Recoveries of loans previously charged off                                       |              |          |          |           |           |
| Loans secured by real estate   | <b>110</b>   | 555      | 187      | 22        | 3         |
| Commercial and industrial loans  | <b>92</b>    | 73       | 259      | 67        | 54        |
| Loans to individuals   | <b>265</b>   | 98       | 297      | 192       | 271       |
| <b>TOTAL RECOVERIES</b>  | <b>467</b>   | 726      | 743      | 281       | 328       |
| <b>NET LOANS CHARGED OFF</b>   | <b>(104)</b> | (175)    | 937      | 1,685     | 3,318     |
| Provision (reduction) charged (credited)<br>to operating expenses                | <b>(636)</b> | (890)    | (677)    | 433       | 7,450     |
| <b>BALANCE AT END OF YEAR</b>  | \$ 7,262     | \$ 7,794 | \$ 8,509 | \$ 10,123 | \$ 11,375 |
| Ratio of net charge-offs during the period<br>to average gross loans outstanding | -0.02 %      | -0.04 %  | 0.22 %   | 0.37 %    | 0.63 %    |

### Interest Income

Total interest income increased 8.5% during 2006 as most financial products repriced in the rising interest rate environment. Interest and fees earned on loans was 73.6% of gross interest income during 2006 and increased 15.6% in 2006 compared to 2005 as a result of the financial products repricing and loan volume remaining stable throughout the year. Interest and fees earned on loans increased 10.7% during 2005 compared to 2004 as a result of higher yields and increasing loan volume. Interest earned on securities and other investments was 25.3% of gross interest income during 2006 and was down 9.3% primarily because of the decrease in volume. A gain of \$51,000 on the sale of available-for-sale investment securities was realized in the fourth quarter of 2006.

### Interest Expense

Total interest expense increased 39.3% during 2006, compared to a 16.6% increase during 2005, and a 25.6% decrease during 2004. The higher interest rate environment led to increased costs for consumer and municipal certificates of deposit. The cost of interest-bearing deposits is monitored quarterly by the Asset/Liability Committee. The net interest margin (tax equivalent net interest income divided by average earning assets) was 4.37%, 4.21% and 4.13% for years ending December 31, 2006, December 31, 2005 and December 31, 2004.

Net interest income on a fully taxable equivalent basis is influenced primarily by changes in: (i) the volume and mix of earning assets and sources of funding; (ii) market rates of interest; and (iii) income tax rates. The impact of some of these factors can be controlled by management policies and actions. External factors can also have a

significant impact on changes in net interest income from one period to another. Some examples of such factors are: (i) the strength of credit demands by customers; (ii) Federal Reserve Board monetary policy; and (iii) fiscal and debt management policies of the federal government, including changes in tax laws.

### **Noninterest Income and Expenses**

Noninterest income decreased 0.4% during 2006. The gain on sale of available-for-sale securities provided a \$51,000 gain in 2006, whereas 2005 reflected a \$513,000 gain. Income from fiduciary services offered in the Bank's Trust department was up 4.6%, representing 20.6% of total noninterest income. Noninterest income decreased 1.3% during 2005 and increased 12.8% during 2004.

**Noninterest Income and Expenses (Continued)**

Noninterest expenses, excluding the provision for possible loan losses, increased 2.2% during 2006. Increases in salaries and employee benefits contributed to this increase. Noninterest expenses, excluding the provision for possible loan losses, increased 1.8% during 2005. Noninterest expenses decreased 0.6 % during 2004.

**Net Income**

Net income was 8.6% lower in 2006 than in 2005. The increase in interest expense was a primary reason for the decline. Net income was 1.7% lower in 2005 than in 2004. The decrease in noninterest income and increase in noninterest expenses contributed to the decline.

**Off-Balance Sheet Arrangements**

As of December 31, 2006, the Bank was 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 standby letters of credit. Please refer to Note 10 of the Notes to Consolidated Financial Statements included elsewhere in this report for more information on the Bank's commitments and contingencies. Please refer to Table C in "Liquidity and Capital Resources" for a summary of our earning assets and interest-bearing liabilities by maturities that are included in the Consolidated Balance Sheet.

**IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS ON THE FINANCIAL STATEMENTS**

SFAS No. 156, "Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140." SFAS No. 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes a contractual obligation to service a financial asset in certain circumstances. All separately recognized servicing assets and servicing liabilities are required to be initially measured at fair value. Subsequent measurement methods include the amortization method, whereby servicing assets or servicing liabilities are amortized in proportion to and over the period of estimated net servicing income or net servicing loss, or the fair value method, whereby servicing assets or servicing liabilities are measured at fair value at each reporting date and changes in fair value are reported in earnings in the period in which they occur. If the amortization method is used, an entity must assess servicing assets or servicing liabilities for impairment or increased obligation based on the fair value at each reporting date. SFAS no. 156 is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the impact of SFAS

No. 156 on its consolidated financial statements.

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement on Financial Accounting Standards ("SFAS") No. 158, "Employers' Accounting for Defined Benefit pension

**IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS ON THE FINANCIAL STATEMENTS  
(Continued)**

and other Postretirement Plans - An amendment of SFAS No. 87, 88, 106 and 132(R)." SFAS 158 requires that the funded status of defined benefit postretirement plans be recognized on a company's balance sheet, and changes in the funded status be reflected in comprehensive income, effective fiscal years ending after December 15, 2006, which the Company has adopted. SFAS 158 also requires companies to measure the funded status of such plans as of the date of its fiscal year-end, effective for years ending December 15, 2008.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatement in Current Year Financial Statements" ("SAB 108"). SAB 108 provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 establishes an approach that requires quantification of financial statement errors based on the effects of each error to the company's balance sheet and statement of operations and the related financial statement disclosures. The Company's adoption of SAB 108 is part of the implementation of the other post retirement benefits.

In 2006, the Company adopted FASB Staff Position No. FAS 115-1 and 124-1, "The Meaning of Other-Than Temporary Impairment and Its Application to Certain Investments" ("FSP 115-1"). In conjunction with the adoption of SAB 108, the Corporation disclosed its liability for medical benefits provided to retired employee. The effects on the financial statements are described in Note 2 of the NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

**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 of America and with general practices within the banking industry. In connection with the application of those principles, Bank management has made judgments and estimates that, in the case of the determination of the allowance for loan losses ("ALLL"), the recognition of deferred income tax assets has been critical to the determination of the Bank's financial position, results of operations and cash flows.

**Allowance for Loan Losses**

Management of the Bank 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 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 our 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 impaired loans 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.

**CRITICAL ACCOUNTING POLICIES (Continued)**

More detailed historical data is being accumulated by category of retail and commercial 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 management, input from independent loan reviews and reviews that may have been conducted by bank regulators as part of their usual examination process.

The following table gives a breakdown of the allowance for loan losses per loan category:

|  |           | <b>2006</b>  |              |
|--|-----------|--------------|--------------|
|  | Amount    |              | Percent      |
| Commercial Real Estate - Mortgage        | \$        | 1,886        | 26 %         |
| Commercial Real Estate - Construction    |           | 319          | 4 %          |
| Commercial Real Estate - Other           |           | 1,222        | 17 %         |
| <b>Total Commercial</b>                  |           | <b>3,427</b> | <b>47 %</b>  |
| Consumer Real Estate - Mortgage          |           | 1,510        | 21 %         |
| Consumer Real Estate - Construction      |           | 140          | 2 %          |
| Consumer Real Estate - Other             |           | 904          | 12 %         |
| <b>Total Consumer</b>                    |           | <b>2,554</b> | <b>35 %</b>  |
| Other                                    |           | 1,281        | 18 %         |
| <b>Total Allowance For Loan Losses</b>   | <b>\$</b> | <b>7,262</b> | <b>100 %</b> |
| <b><u>Deferred Income Tax Assets</u></b> |           |              |              |



Edgar Filing: FIRST FARMERS & MERCHANTS CORP - Form 10-K

Deferred income tax assets consist mainly of the tax effect of excess provisions for loan losses over actual losses incurred, the unrealized loss on available-for-sale securities, and deferred compensation. The Corporation and the Bank have paid taxes for many years. Management believes that it is more likely than not that these assets will be realized in future years.

**Selected Financial Information**

(Dollars in Thousands, Except Per Share Data)

|   | 2006      | 2005      | 2004      | 2003      | 2002      |
|---|-----------|-----------|-----------|-----------|-----------|
|   |           | Restated  | Restated  | Restated  | Restated  |
| Interest Income                                     |           |           |           |           |           |
| Interest and fees on loans                          | \$ 31,246 | \$ 27,038 | \$ 24,426 | \$ 28,388 | \$ 37,116 |
| Income on investment securities                     |           |           |           |           |           |
| Taxable interest                                    | 6,345     | 8,443     | 10,263    | 11,045    | 11,390    |
| Exempt from federal income tax                      | 4,221     | 3,266     | 2,568     | 2,738     | 3,214     |
| Dividends   | 180       | 137       | 213       | 130       | 166       |
|   | 10,746    | 11,846    | 13,044    | 13,913    | 14,770    |
| Other interest income                               | 445       | 222       | 94        | 250       | 299       |
| Total Interest Income                               | 42,437    | 39,106    | 37,564    | 42,551    | 52,185    |
| Interest Expense                                    |           |           |           |           |           |
| Interest on deposits                                | 13,339    | 9,736     | 8,429     | 11,388    | 17,767    |
| Interest on other short term borrowings             | 449       | 162       | 58        | 21        | 39        |
| Total Interest Expense                              | 13,788    | 9,898     | 8,487     | 11,409    | 17,806    |
| Net Interest Income                                 | 28,649    | 29,208    | 29,077    | 31,142    | 34,379    |
| Provision For Possible Loan Losses                  | (636)     | (890)     | (677)     | 433       | 7,450     |
| Net Interest Income After Provision for Loan Losses | 29,285    | 30,098    | 29,754    | 30,709    | 26,929    |
| Noninterest Income                                  |           |           |           |           |           |
| Trust department income                             | 2,322     | 2,220     | 2,088     | 1,806     | 1,781     |
| Service fees on deposit accounts                    | 7,739     | 7,208     | 7,189     | 7,217     | 7,175     |
| Other service fees, commissions, and fees           | 424       | 372       | 408       | 433       | 435       |
| Other operating income                              | 751       | 1,018     | 873       | (15)      | 611       |
| Securities gains                                    | 51        | 513       | 917       | 737       | 124       |
| Total Noninterest Income                            | 11,287    | 11,331    | 11,475    | 10,178    | 10,126    |
| Noninterest Expense                                 |           |           |           |           |           |
| Salaries and employee benefits                      | 16,918    | 16,447    | 16,217    | 15,645    | 13,412    |
| Net occupancy expense                               | 2,143     | 2,353     | 2,289     | 2,184     | 2,187     |
| Furniture and equipment expense                     | 1,138     | 1,220     | 1,317     | 1,422     | 1,461     |
| Other operating expenses                            | 10,547    | 10,076    | 9,724     | 10,437    | 9,515     |
| Total Noninterest Expense                           | 30,746    | 30,096    | 29,547    | 29,688    | 26,575    |
| Income Before Provision For income Taxes            | 9,826     | 11,333    | 11,682    | 11,199    | 10,480    |
| Provision For Income Taxes                          | 2,101     | 2,881     | 3,088     | 2,889     | 2,188     |
| Net Income  | \$ 7,725  | \$ 8,452  | \$ 8,594  | \$ 8,310  | \$ 8,292  |
| Earnings Per Common Share                           | \$ 1.33   | \$ 1.45   | \$ 1.47   | \$ 1.42   | \$ 1.42   |
| Weighted Average Shares Outstanding                 | 5,826,589 | 5,840,000 | 5,840,000 | 5,840,000 | 5,840,000 |

Share and per share data have been restated to give retroactive effect to the two-for-one stock split effected as a stock dividend declared on April 20, 2004.

(See Note 1 of Notes to Consolidated Financial Statements)

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors

First Farmers and Merchants Corporation

Columbia, Tennessee

We have audited the consolidated balance sheets of First Farmers and Merchants Corporation and its subsidiaries (collectively, the "Corporation") as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of First Farmers and Merchants Corporation and subsidiaries as of December 31, 2006 and 2005, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, effective January 1, 2006, the Corporation adopted Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of SFAS 87, 88, 106 and 132 (R)*.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Corporation's internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control-Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 16, 2007, expressed an unqualified opinion on management's assessment of the effectiveness of the Corporation's internal control over financial reporting and an unqualified opinion on the effectiveness of the Corporation's internal control over financial reporting.

Nashville, Tennessee

March 16, 2007

**FIRST FARMERS AND MERCHANTS CORPORATION**

COLUMBIA, TENNESSEE

**Management Report on Internal Control Over Financial Reporting.**

The management of First Farmers and Merchants Corporation is responsible for establishing and maintaining adequate internal control over financial reporting. The Corporation's internal control system was designed to provide reasonable assurance to the Corporation's management and board of directors regarding the preparation and fair presentation of published financial statement. All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

The Corporation's management assessed the effectiveness of the Corporation's internal control over financial reporting as of December 31, 2006. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in "Internal Control-Integrated Framework." Based on our assessment we believe that, as of December 31, 2006, the Corporation's internal control over financial reporting is effective based on those criteria.

The Corporation's independent registered public accounting firm has issued an audit report on management's assessment of the Corporation's internal control over financial reporting. This report appears on page 39 of this annual report.

/s/ T. Randy Stevens

/s/ Patricia P. Moody

T. Randy Stevens, Chief Executive Officer  
and Chairman

Patricia P. Moody, Assistant Treasurer  
(principal financial officer and  
principal accounting officer)

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors

First Farmers & Merchants Corporation

Columbia, Tennessee

We have audited management's assessment, included in the accompanying Report on Management's Assessment of Internal Control over Financial Reporting, that First Farmers & Merchants Corporation maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). First Farmers & Merchants Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit 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 effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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.

In our opinion, management's assessment that First Farmers & Merchants Corporation maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in *Internal Control-Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also in our opinion, First Farmers & Merchants Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of First Farmers & Merchants Corporation as of December 31, 2006 and 2005, and the related consolidated statements of income, shareholders' equity and cash flows for each of the years in the three year period ended December 31, 2006, and our report dated March 16, 2007 expressed an unqualified opinion on those consolidated financial statements.

Nashville, Tennessee

March 16, 2007

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY  
CONSOLIDATED BALANCE SHEETS**

|                    |  | December 31,   | December 31,      |
|--------------------|--|--|-------------------|
|                    |  | 2006   | 2005              |
|                    |  |  | (Restated)        |
|                    |  | <i>(Dollars In Thousands, Except Per Share Data)</i> |                   |
| <b>ASSETS</b>      |  |  |                   |
|                    | Cash and due from banks  | \$ 45,558  | \$ 28,489         |
|                    | Interest-bearing deposits in banks   | 2,573  | 49                |
|                    | Federal funds sold   | 26,850   | -                 |
|                    | Total cash and cash equivalents  | 74,981   | 28,538            |
|                    | Securities   |  |                   |
|                    | Available for sale (amortized cost \$149,040<br>and \$195,449, respectively)                         | 147,001  | 191,931           |
|                    | Held to maturity (fair value \$82,109<br>and \$90,810, respectively)                                 | 81,247   | 89,832            |
|                    | Total securities   | 228,248  | 281,763           |
|                    | Loans, net of deferred fees  | 473,353  | 459,897           |
|                    | Allowance for possible loan losses   | (7,262)  | (7,794)           |
|                    | Net loans  | 466,091  | 452,103           |
|                    | Bank premises and equipment, at cost<br>less allowance for depreciation                              | 10,428   | 11,909            |
|                    | Core deposit and other intangibles   | 9,874  | 10,930            |
|                    | Other assets   | 30,462   | 27,755            |
|                    | <b>TOTAL ASSETS</b>  | <b>\$ 820,084</b>                                    | <b>\$ 812,998</b> |
| <b>LIABILITIES</b> |  |  |                   |
|                    | Deposits   |  |                   |
|                    | Noninterest-bearing  | \$ 142,933   | \$ 117,065        |
|                    | Interest-bearing (including certificates of deposit<br>over \$100: 2006 - \$91,504; 2005 - \$94,471) | 556,029  | 566,523           |
|                    | Total deposits   | 698,962  | 683,588           |
|                    | Federal funds purchased and securities sold<br>under agreements to repurchase                        | 2,654  | 13,132            |
|                    | Dividends payable  | 1,971  | 1,869             |
|                    | Other short-term liabilities   | 385  | 521               |
|                    | Accounts payable and accrued liabilities   | 12,305   | 10,816            |
|                    | <b>TOTAL LIABILITIES</b>   | <b>716,277</b>                                       | <b>709,926</b>    |

COMMITMENTS AND CONTINGENCIES

Notes 8 and 10

|                             |   |                   |            |
|-----------------------------|---|-------------------|------------|
| <b>SHAREHOLDERS' EQUITY</b> | Common stock - \$10 par value, 8,000,000 shares authorized; 5,760,000 and 5,840,000 issued and outstanding shares as of 12/31/06 and 12/31/05, respectively | <b>57,600</b>     | 58,400     |
|                             | Additional paid-in capital  | <b>1,120</b>      | 4,320      |
|                             | Retained earnings   | <b>46,342</b>     | 42,515     |
|                             | Accumulated other comprehensive income (loss)   | <b>(1,255)</b>    | (2,163)    |
|                             | <b>TOTAL SHAREHOLDERS' EQUITY</b>   | <b>103,807</b>    | 103,072    |
|                             | <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>   | <b>\$ 820,084</b> | \$ 812,998 |

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

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF INCOME**

*(Dollars In Thousands, Except Per Share Data)*

Years Ended December 31,  
**2006** 2005 2004  
(Restated)(Restated)

**INTEREST & DIVIDEND  
INCOME**

|   | \$            | \$     | \$     |
|---|---------------|--------|--------|
| Interest and fees on loans                  | <b>31,246</b> | 27,038 | 24,426 |
| Income on investment securities             |               |        |        |
| Taxable interest                            | <b>6,345</b>  | 8,443  | 10,263 |
| Exempt from federal income tax              | <b>4,221</b>  | 3,266  | 2,568  |
| Dividends                                   | <b>180</b>    | 137    | 213    |
|   | <b>10,746</b> | 11,846 | 13,044 |
| Other interest income                       | <b>445</b>    | 222    | 94     |
| <b>TOTAL INTEREST &amp; DIVIDEND INCOME</b> | <b>42,437</b> | 39,106 | 37,564 |

**INTEREST EXPENSE**

|   |               |       |       |
|---|---------------|-------|-------|
| Interest on deposits                    | <b>13,339</b> | 9,736 | 8,429 |
| Interest on other short-term borrowings | <b>449</b>    | 162   | 58    |
| <b>TOTAL INTEREST EXPENSE</b>           | <b>13,788</b> | 9,898 | 8,487 |

**NET INTEREST INCOME** **28,649** 29,208 29,077

## PROVISION FOR POSSIBLE LOAN LOSSES

|                                |  |          |          |          |
|--------------------------------|--|----------|----------|----------|
|                                | (RECOVERIES) NET                                       | (636)    | (890)    | (677)    |
|                                | NET INTEREST INCOME AFTER<br>PROVISION FOR LOAN LOSSES |          |          |          |
|                                | (RECOVERIES)   | 29,285   | 30,098   | 29,754   |
| <b>NONINTEREST INCOME</b>      | Trust department income                                | 2,322    | 2,220    | 2,088    |
|                                | Service fees on deposit accounts                       | 7,739    | 7,208    | 7,189    |
|                                | Other fees and commissions                             | 424      | 372      | 408      |
|                                | Other operating income                                 | 751      | 1,018    | 873      |
|                                | Securities gains                                       | 51       | 513      | 917      |
|                                | TOTAL NONINTEREST INCOME                               | 11,287   | 11,331   | 11,475   |
| <b>NONINTEREST<br/>EXPENSE</b> | Salaries and employee benefits                         | 16,918   | 16,447   | 16,217   |
|                                | Net occupancy expense                                  | 2,143    | 2,353    | 2,289    |
|                                | Furniture and equipment expense                        | 1,138    | 1,220    | 1,317    |
|                                | Other operating expenses                               | 10,547   | 10,076   | 9,724    |
|                                | TOTAL NONINTEREST EXPENSES                             | 30,746   | 30,096   | 29,547   |
|                                | INCOME BEFORE PROVISION FOR<br>INCOME TAXES            | 9,826    | 11,333   | 11,682   |
|                                | PROVISION FOR INCOME TAXES                             | 2,101    | 2,881    | 3,088    |
|                                | NET INCOME   | \$ 7,725 | \$ 8,452 | \$ 8,594 |

**BASIC EARNINGS****PER SHARE**

Weighted average shares outstanding

|           |         |           |
|-----------|---------|-----------|
| \$        | \$      | \$        |
| 1.33      | 1.45    | 1.47      |
| 5,826,588 | 840,000 | 5,840,000 |

Share and per share data have been restated to give retroactive effect to the two-for-one stock split effected as a stock dividend declared on April 20, 2004. The accompanying notes are an integral part of the consolidated financial statements.

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

| <i>(Dollars In Thousands, Except Per Share Data)</i>   | Common           | Additional<br>Paid-in | Retained         | Accumulated<br>Other<br>Comprehensive<br>Income | Total             |
|--|------------------|-----------------------|------------------|---|-------------------|
| Years Ended December 31, 2006, 2005, and<br>2004   | Stock            | Capital               | Earnings         | (Loss)<br>\$                                    | \$                |
| BALANCE AT JANUARY 1, 2004 - Restated  | \$ 29,200        | \$ 4,320              | \$ 61,794        | 4,067   | 99,381            |
| Comprehensive income   |                  |                       |                  |   |                   |
| Net income - Restated  |                  |                       | 8,594            |   | 8,594             |
| Change in net unrealized loss on securities<br>available-for-sale, net of reclassification<br>adjustment and tax effects |                  |                       |                  | (3,507)   | (3,507)           |
| Total comprehensive income   |                  |                       |                  |   | 5,087             |
| Two-for-one stock split - See Note 1   | 29,200           |                       | (29,200)         |   | -                 |
| Cash dividends declared, \$0.59 per share *  |                  |                       | (3,446)          |   | (3,446)           |
| BALANCE AT DECEMBER 31, 2004 -<br>Restated   | 58,400           | 4,320                 | 37,742           | 560   | 101,022           |
| Comprehensive income   |                  |                       |                  |   |                   |
| Net income - Restated  |                  |                       | 8,452            |   | 8,452             |
| Change in net unrealized loss on securities<br>available-for-sale, net of reclassification<br>adjustment and tax effects |                  |                       |                  | (2,723)   | (2,723)           |
| Total comprehensive income   |                  |                       |                  |   | 5,729             |
| Cash dividends declared, \$0.63 per share  |                  |                       | (3,679)          |   | (3,679)           |
| BALANCE AT DECEMBER 31, 2005 -<br>Restated   | <b>58,400</b>    | <b>4,320</b>          | <b>42,515</b>    | <b>(2,163)</b>                                  | <b>103,072</b>    |
| Comprehensive income   |                  |                       |                  |   |                   |
| Net income   |                  |                       | 7,725            |   | 7,725             |
| Change in net unrealized gain on securities<br>available-for-sale, net of reclassification<br>adjustment and tax effects |                  |                       |                  | 908   | 908               |
| Total comprehensive income   |                  |                       |                  |   | 8,633             |
| Repurchase of common stock   | (800)            | (3,200)               |                  |   | (4,000)           |
| Cash dividends declared, \$0.67 per share  |                  |                       | (3,898)          |   | (3,898)           |
| BALANCE AT DECEMBER 31, 2006   | <b>\$ 57,600</b> | <b>\$ 1,120</b>       | <b>\$ 46,342</b> | <b>\$ (1,255)</b>                               | <b>\$ 103,807</b> |

\*Cash dividends per share amount for 2004 are restated to give retroactive effect to the two-for-one stock split as of April 20, 2004.

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)*

|                   |  | Years ended De |           |
|-------------------|--|----------------|-----------|
|                   |  | 2006           | 2005      |
|                   |  | \$ 7,725       | \$ 8,325  |
|                   |  | (Restat        | (Restat   |
| <b>OPERATING</b>  | Net income   | \$ 7,725       | \$ 8,325  |
| <b>ACTIVITIES</b> | Adjustments to reconcile net income to net cash provided by operating activities |                |           |
|                   | Excess (deficiency) of provision for possible loan losses over net charge-offs   | (532)          | (7)       |
|                   | Provision for depreciation and amortization of premises and equipment            | 1,119          | 1,325     |
|                   | Securities gains   | (51)           | (5)       |
|                   | Real estate contributed to government organization                               | 22             | -         |
|                   | Amortization of deposit base intangibles   | 1,056          | 1,056     |
|                   | Amortization of investment security premiums, net of accretion of discounts      | 1,072          | 2,072     |
|                   | Increase in cash surrender value of life insurance contracts                     | (408)          | (5)       |
|                   | (Increase) decrease in   |                |           |
|                   | Deferred income taxes  | (262)          | (1)       |
|                   | Interest receivable  | 575            | -         |
|                   | Other assets   | (5)            | -         |
|                   | Increase (decrease) in   |                |           |
|                   | Interest payable   | 896            | -         |
|                   | Other liabilities  | 847            | -         |
|                   | Total adjustments  | 4,328          | 4,328     |
|                   | Net cash provided by operating activities  | 12,054         | 12,653    |
| <b>INVESTING</b>  | Proceeds from maturities, calls, and sales of                                    |                |           |
| <b>ACTIVITIES</b> | available-for-sale securities  | 65,854         | 92,325    |
|                   | Proceeds from maturities and calls of held-to-maturity securities                | 8,483          | 11,325    |
|                   | Purchases of investment securities   |                |           |
|                   | Available-for-sale   | (20,365)       | (63,625)  |
|                   | Held-to-maturity   | -              | (24,825)  |
|                   | Net increase in loans  | (13,456)       | (10,825)  |
|                   | Proceeds from sale of assets   | 45             | -         |
|                   | Purchase of life insurance premium   | (2,757)        | (2,325)   |
|                   | Purchases of premises and equipment  | (379)          | (725)     |
|                   | Net cash provided by (used in) investing activities                              | 37,425         | 3,925     |
| <b>FINANCING</b>  | Net increase (decrease) in noninterest-bearing                                   |                |           |
| <b>ACTIVITIES</b> | and interest-bearing deposits  | 15,374         | (10,225)  |
|                   | Net increase (decrease) in short term borrowings                                 | (10,614)       | 3,325     |
|                   | Repurchase of Common Stock   | (4,000)        | -         |
|                   | Cash dividends   | (3,796)        | (3,525)   |
|                   | Net cash used in financing activities  | (3,036)        | (9,925)   |
|                   | Increase (decrease) in cash and cash equivalents                                 | 46,443         | 6,325     |
|                   | Cash and cash equivalents at beginning of period                                 | 28,538         | 22,213    |
|                   | Cash and cash equivalents at end of period                                       | \$ 74,981      | \$ 28,538 |

Supplemental disclosures of cash flow information

Cash paid during the period for expenses

Interest on deposits and borrowed funds

\$ 12,891 \$ 9,

Income Taxes

2,332 2,

Land and building transferred from premises and equipment to other assets held for sale

\$ 684 \$

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

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 - GENERAL AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Accounting Policies**

The accounting principles followed and the methods of applying those principles conform with accounting principles generally accepted in the United States of America and to general practices in the banking industry. The significant accounting policies applicable to First Farmers and Merchants Corporation (the "Corporation") are summarized as follows.

**Principles of Consolidation**

The accompanying consolidated financial statements present the accounts of the Corporation and its wholly-owned subsidiary, First Farmers and Merchants Bank (the "Bank"). The Bank has direct and indirect subsidiaries through which it holds F&M West Inc., Maury Tenn, Inc., and Maury Tenn Properties, Inc. Material intercompany accounts and transactions have been eliminated in consolidation.

**Subsidiary Charter**

The Corporation's subsidiary Bank received regulatory approval to convert its national charter to a state charter, which conversion became effective as of July 5, 2005. On that date, the Bank converted to a Tennessee state-chartered bank and its name changed from First Farmers and Merchants National Bank to First Farmers and Merchants Bank.

**Use of Estimates in the Preparation of Financial Statements**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management of the Corporation and the Bank to make estimates and assumptions that affect the reported amounts of assets and liabilities. Those estimates and assumptions also affect disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of the allowance for loan losses and the valuation of foreclosed real estate, deferred tax assets and the liability related to post retirement benefits.

**Stock Split**

On April 20, 2004, the Corporation's shareholders approved a two-for-one stock split effected in the form of a 100% stock dividend to shareholders of record on April 20, 2004. In accordance with state corporate legal requirements, the transaction was recorded by a transfer from retained earnings to common stock in the amount of \$29,200,000 (\$10 for each additional share issued). All per share and share data in the accompanying consolidated financial statements and footnotes have been restated to give retroactive effect to this transaction.

**Significant Group Concentrations of Credit Risk**

Most of the Bank's activities are with customers located within its service area, which is comprised of Maury, Lawrence, Marshall, Hickman, Dickson, Giles, Williamson and adjacent counties in southern middle Tennessee. Approximately 80% of the Bank's loans were made to customers in the Maury and

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 -GENERAL AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

Lawrence county markets as of December 31, 2006. Maury County is the source of 54.2% of the Bank's loan portfolio, including most of the Bank's participation and out-of-territory loans. Note 3 discusses the types of securities in which the Bank invests. Note 4 discusses the types of lending in which the Bank engages. First mortgage loans secured by one to four family residential properties make up 38.4% of the total loan portfolio. This represents the largest component of the real estate secured loans. Management

of the Bank recognizes this concentration and believes the risk is acceptable given the quality of underwriting, current market conditions and historical loss experience.

The loans secured by non-farm/non-residential real estate comprise 21% of the loan portfolio. Of this portfolio of loans, 68% are owner-occupied. The loan segment type is classified as "true" commercial real estate - loans whose repayment is dependent upon rental income or the sale, refinancing or permanent financing of the underlying property. The Bank's risk is geographically dispersed and continues to be well diversified across several property types with no areas of excessive exposure.

Current commercial real estate loan stratification reports indicate that the commercial construction and development portfolio remains well diversified with an acceptable level of speculative exposure. Of the loans secured by commercial type real estate, 56% are in the owner-occupied category.

The Bank continues to monitor and manage its exposure to single borrowing entity and its exposure to groups of borrowers within the same industry. Within the commercial loan portfolio, the Bank continues to report heavy exposure in four broad industry categories.

**Cash and Due From Banks**

Included in cash and due from banks are reserve amounts that are legally required to be maintained on an average balance in the form of cash and balances due from the Federal Reserve Bank and other banks. At December 31, 2006, the Bank was required to maintain approximately \$4.6 million at the Federal Reserve Bank. Interest-bearing deposits in banks mature within one year and are carried at cost. From time to time throughout the year, the Bank's balances due from other financial institutions exceeded FDIC insurance limits. Management considers this to be a normal business risk.

**Cash Equivalents**

Cash equivalents include cash on hand, cash due from banks and federal funds sold. Federal funds are sold for one-day periods. Interest-bearing deposits in banks included in cash equivalents mature within 90 days.

## **Securities**

Trading account securities that are bought and held principally for the purpose of selling them in the near term are carried at market value. Gains and losses, both realized and unrealized, are included in other operating income. There were no securities classified as trading in 2006 or 2005.

Debt securities that the Bank has the positive intent and ability to hold to maturity are classified as held-to-maturity and reported at amortized cost. Securities not classified as held-to-maturity or trading, including equity securities with readily determinable fair values, are classified as available-for-sale and reported at fair value, with unrealized gains and losses, net of deferred tax, excluded from earnings and reported in other comprehensive income.

## **FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

#### **NOTE 1-GENERAL AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of individual available-for-sale and held-to-maturity securities below their cost that are other than temporary are included in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment in the issuer for a period of time

sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sales of securities are recorded on the trade date and are determined using the specific identification method.

## **Loans**

The Bank grants mortgage, commercial and consumer loans to customers. Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff generally are stated at their outstanding unpaid principal balances, net of any deferred fees or costs on originated loans, or unamortized premiums or discounts on purchased loans.

Interest on loans is accrued daily. Loan origination fees and related direct costs are deferred and recognized ratably over the life of the loan as an adjustment of yield. Interest accruals are discontinued when loans are 90 days past due or when interest is not expected to be collected. Interest income

previously accrued on such loans is reversed against current period interest income. Interest income on loans in nonaccrual status is recognized only to the extent of the excess of cash payments received over principal payments due.

## **Allowance for Possible Loan Losses**

The allowance for possible loan losses is established through provisions for loan losses charged against income. Loan losses are charged against the allowance when management determines that the uncollectibility of a

loan has been confirmed. Subsequent recoveries, if any, are credited to the allowance account in the period received.

The adequacy of the allowance for possible loan losses is evaluated 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 Bank's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect a borrower's ability to repay (including the timing of future payments), the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors are considered in this evaluation. This process is inherently subjective as it requires material estimates that are susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans. The allowance for possible loan losses is maintained at a level believed adequate by management to absorb estimated losses inherent in the loan portfolio.

A loan is considered impaired when it is probable that the Bank will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed.

## **FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

#### **NOTE 1-GENERAL AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

Impairment is measured on a loan-by-loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. The Bank evaluates smaller-balance homogeneous loans collectively for impairment. Loans secured by one to four

family residential properties, consumer installment loans and line of credit loans are considered smaller-balance homogeneous loans.

#### **Other Real Estate**

Other real estate, which is included in other assets, represents real estate acquired through foreclosure and is stated at the lower of fair value, net of estimated selling costs, or cost, at the date of foreclosure. If, at the time of foreclosure, the fair value of the real estate is less than the Bank's carrying value of the related loan, a write-down is recognized through a charge to the allowance for possible loan losses, and the fair value becomes the new cost for subsequent accounting. If the Bank later determines

that the cost of the property cannot be recovered through sale or use, a write-down is recognized by a charge to operations.

When a property is not in a condition suitable for sale or use at the time of foreclosure, completion and holding costs, including such items as real estate taxes, maintenance and insurance, are capitalized up to the estimated net realizable value of the property. However, when a property is in a condition for sale or use at the time of foreclosure, or the property is already carried at its estimated net realizable value, any subsequent holding costs are expensed.

Legal fees and any other direct costs relating to foreclosures are charged to operations when incurred. The Bank had no other real estate at December 31, 2006, and \$196,000 at December 31, 2005. Properties that were included in other real estate were sold at losses of \$24,000 during 2006, which are included in other operating expense. Losses of \$51,000 and \$458,000 were realized on sales of other real estate during 2005 and 2004, respectively.

### **Premises and Equipment**

Premises and equipment are stated at cost, less accumulated depreciation and amortization. The provision for depreciation is computed principally on an accelerated method over the estimated useful life of an asset, which ranges from 15 to 50 years for buildings and from three to 33 years for equipment. Costs of major additions and improvements are capitalized. Expenditures for maintenance and repairs are charged to operations as incurred. Gains or losses from the disposition of property are reflected in operations, and the asset accounts and related allowances for depreciation are reduced.

### **Servicing**

Loans serviced for others are not included in the accompanying consolidated balance sheets. The unpaid principal balances of mortgage and other loans serviced for others were \$8.0 million and \$14.2 million at December 31, 2006 and 2005, respectively. The present value of servicing income is expected to approximate an adequate compensation cost for servicing these loans. Therefore, no servicing asset has been recorded.

### **Income Taxes**

The Corporation and the Bank file a consolidated federal income tax return. Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences

## **FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

#### **NOTE 1-GENERAL AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. Income tax expense is the tax payable or refundable for the period, plus or minus the change in deferred tax assets and liabilities during the period.

### **Trust Department Income**

Trust department income is recognized on the accrual basis in the applicable period earned.

### **Earnings Per Share**

Basic earnings per share represent income available to shareholders divided by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share reflect additional shares of common stock that would have been outstanding if potentially dilutive shares of common stock had been issued, as well as any adjustment to income that would result from the assumed conversion. For the years ended December 31, 2006, 2005 and 2004, there were no potentially dilutive shares of common stock issuable.

### **Comprehensive Income**

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income. A schedule of other comprehensive income is shown in the following table (dollars in thousands):

|                                   | Years Ended December 31, |            |            |
|-----------------------------------|--------------------------|------------|------------|
|                                   | 2006                     | 2005       | 2004       |
| Unrealized holding gains (losses) |                          |            |            |
| on available-for-sale securities  | \$ 1,528                 | \$ (3,916) | \$ (4,786) |
| Reclassification adjustment for   |                          |            |            |
| gains realized in income          | (51)                     | (513)      | (917)      |
| Tax effect - (expense) benefit    | (569)                    | 1,706      | 2,196      |
| Other comprehensive income (loss) | \$ 908                   | \$ (2,723) | \$ (3,507) |

### **Intangible Assets**

Goodwill is accounted for in accordance with Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* ("SFAS 142"), which addresses the financial accounting and reporting for acquired goodwill and other intangible assets with indefinite lives. Pursuant to SFAS 142, intangible assets must be periodically tested for impairment. The Bank completed its impairment review during 2006, which indicated that there was no impairment. Deposit base intangibles are amortized using the straight-line method over their estimated useful lives of 72 to 180 months. Total amortization expense charged to operations amounted to \$1,056,000, in 2006, \$1,056,000, in 2005 and \$1,056,000 in 2004.

## **FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1-GENERAL AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)****Segment Reporting**

Segments are strategic business units that offer different products and services and are managed separately. At December 31, 2006, the Corporation and the Bank did not have any identified segments.

**Recent Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement on Financial Accounting Standards ("SFAS") No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - An amendment of SFAS No. 87, 88, 106 and 132(R)." SFAS 158 requires that the funded status of defined benefit postretirement plans be recognized on a company's balance sheet, and changes in the funded status be reflected in comprehensive income, effective fiscal years ending after December 15, 2006, which the Corporation has adopted. SFAS 158 also requires companies to measure the funded status of such plans as of the date of its fiscal year-end, effective for years ending December 15, 2008.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatement in Current Year Financial Statements" ("SAB 108"). SAB 108 provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 establishes an approach that requires quantification of financial statement errors based on the effects of each error to the company's balance sheet and statement of operations and the related financial statement disclosures. In conjunction with the adoption of SAB 108, the Corporation has recorded its liability for medical benefits provided to retired employee. The effects on the financial statements are described in Note 2.

In 2006, the Corporation adopted FASB Staff Position No. FAS 115-1 and 124-1, "The Meaning of Other-Than Temporary Impairment and Its Application to Certain Investments" ("FSP 115-1").

**NOTE 2 - RESTATEMENT OF PRIOR YEAR FINANCIAL STATEMENTS**

As part of the Corporation's year-end financial review, the Corporation determined that it had not properly recognized the liability for retiree and employee medical benefits in its financial statements for the years ended December 31, 2005 and 2004, resulting in an adjustment to the Corporation's financial statements for those years. As of December 31, 2005 other assets increased \$1,959 and accounts payable and accrued liabilities increased \$5,088 related to retiree medical benefits and \$310 related to employee medical benefits. The effects of the adjustments on the Corporation's retained earnings and income statements are in the following table (dollars in thousands):

|  |    | 2005    |    | 2004    |
|--|----|---------|----|---------|
| Retained Earnings, beginning of year   | \$ | (3,166) | \$ | (2,904) |
| Retained Earnings, end of year         | \$ | (3,439) | \$ | (3,166) |
| Income before provision for income tax | \$ | (444)   | \$ | (426)   |
| Income tax benefit                     |    | 171     |    | 164     |
| Net income                             | \$ | (273)   | \$ | (262)   |
| Earnings per share                     | \$ | (0.05)  | \$ | (0.04)  |

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**



**NOTE 3 - SECURITIES**

Securities with an amortized cost of \$108,053,000 and \$103,553,000 at December 31, 2006 and 2005, respectively (fair value of \$106,122,000 at December 31, 2006 and \$101,146,000 at December 31, 2005), were pledged to secure deposits and for other purposes as required or permitted by law. The fair value is established by an independent pricing service as of the approximate dates indicated. The differences between the amortized cost and fair value reflect current interest rates and represent the potential gain (or loss) if the portfolio had been liquidated on that date. Security gains (or losses) are realized only in the event of dispositions prior to maturity.

The amortized cost and fair value of securities available for sale and held to maturity at December 31, 2006 and 2005 are summarized as follows (dollars in thousands):

|                                   | Amortized<br>Cost | Gross<br>Gains | Unrealized<br>Losses | Fair<br>Value |
|-----------------------------------|-------------------|----------------|----------------------|---------------|
| <b>December 31, 2006</b>          |                   |                |                      |               |
| Available-for-sale securities     |                   |                |                      |               |
| U.S. Treasury                     | \$ 4,185          | \$ -           | \$ 86                | \$ 4,099      |
| U.S. Government agencies          | 117,459           | 7              | 1,842                | 115,624       |
| Mortgage backed securities        | 252               | 1              | -                    | 253           |
| States and political subdivisions | 24,101            | 47             | 166                  | 23,982        |
| Other securities                  | 3,043             | -              | -                    | 3,043         |
|                                   | \$ 149,040        | \$ 55          | \$ 2,094             | \$ 147,001    |
| Held-to-maturity securities       |                   |                |                      |               |
| U.S. Government agencies          | \$ 6,356          | \$ -           | \$ 119               | \$ 6,237      |
| States and political subdivisions | 70,960            | 1,066          | 209                  | 71,817        |
| Other securities                  | 3,931             | 124            | -                    | 4,055         |
|                                   | \$ 81,247         | \$ 1,190       | \$ 328               | \$ 82,109     |
| December 31, 2005                 |                   |                |                      |               |
| Available-for-sale securities     |                   |                |                      |               |
| U.S. Treasury                     | \$ 5,257          | \$ 1           | \$ 93                | \$ 5,165      |
| U.S. Government agencies          | 167,121           | 19             | 3,121                | 164,019       |
| Mortgage backed securities        | 343               | 5              | -                    | 348           |
| States and political subdivisions | 19,837            | 34             | 363                  | 19,508        |
| Other securities                  | 2,891             | -              | -                    | 2,891         |
|                                   | \$ 195,449        | \$ 59          | \$ 3,577             | \$ 191,931    |
| Held-to-maturity securities       |                   |                |                      |               |
| U.S. Government agencies          | \$ 6,486          | \$ -           | \$ 143               | \$ 6,343      |
| States and political subdivisions | 76,425            | 1,489          | 620                  | 77,294        |
| Other securities                  | 6,921             | 252            | -                    | 7,173         |
|                                   | \$ 89,832         | \$ 1,741       | \$ 763               | \$ 90,810     |

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 3 - SECURITIES (Continued)**

At December 31, 2006, the Bank did not hold investment securities of any single issuer, other than obligations of the U.S. Treasury and other U.S. government agencies, whose aggregate book value exceeded ten percent of shareholders' equity.

Proceeds from the maturity, call or sale of available-for-sale securities were \$65,854,000, \$92,564,000 and \$43,016,000 during 2006, 2005 and 2004, respectively. Proceeds from the maturity or call of held-to-maturity securities were \$8,483,000, \$11,161,000 and \$20,026,000 during 2006, 2005 and 2004, respectively.

The fair values of all securities at December 31, 2006 either equaled or exceeded the cost of those securities, or the decline in fair value is considered temporary. The information in the table below classifies the investments with unrealized losses at December 31, 2006 according to the term of the unrealized loss. Management evaluates securities for other-than-temporary impairment periodically, or more frequently when circumstances require an evaluation. An impairment judgment is based on (a) the amount of time and loss, (b) the financial condition of the issuer, and (c) the Bank's intent and ability to hold the investment long enough for any anticipated recovery in value.

The following table presents the Bank's investments with unrealized losses at December 31, 2006 and 2005 according to the term of the unrealized loss (dollars in thousands):

| 2006                              | Less than 12 months |                   | 12 months or Greater |                   | Total      |                   |
|-----------------------------------|---------------------|-------------------|----------------------|-------------------|------------|-------------------|
|                                   | Fair Value          | Unrealized Losses | Fair Value           | Unrealized Losses | Fair Value | Unrealized Losses |
| Type of Security                  |                     |                   |                      |                   |            |                   |
| U.S. Treasury                     | \$ 998              | \$ 1              | \$ 3,101             | \$ 85             | \$ 4,099   | \$ 86             |
| U.S. Government agencies          | 112                 | 0                 | 113,865              | 1,961             | 113,977    | 1,961             |
| States and political subdivisions | 7,087               | 66                | 26,152               | 309               | 33,239     | 375               |
|                                   | \$ 8,197            | \$ 67             | \$ 143,118           | \$ 2,355          | \$ 151,315 | \$ 2,422          |
|                                   |                     |                   |                      |                   |            |                   |
| 2005                              | Less than 12 months |                   | 12 months or Greater |                   | Total      |                   |
| Type of Security                  | Fair Value          | Unrealized Losses | Fair Value           | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasury                     | \$ -                | \$ -              | \$ 3,160             | \$ 93             | \$ 3,160   | \$ 93             |
| U.S. Government agencies          | 69,177              | 1,042             | 86,137               | 2,222             | 155,314    | 3,264             |
| States and political subdivisions | 36,939              | 761               | 5,780                | 221               | 42,719     | 982               |
|                                   | \$ 106,116          | \$ 1,803          | \$ 95,077            | \$ 2,536          | \$ 201,193 | \$ 4,339          |

At December 31, 2006, 84 of 98 U.S. government agency securities had recorded unrealized losses for a period longer than 12 months. Their amortized cost was approximately \$145.5 million compared to a fair value of approximately \$143.1 million. As these securities declined in value when interest rates began to rise, and not because of the credit quality of the issuer, and because the Bank had both the intent and ability to hold the investments, the securities were not considered other-than-temporarily impaired.

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 3 - SECURITIES (Continued)**

The following table shows the amortized cost, fair value and weighted yields (for tax-exempt obligations on a fully taxable basis assuming a 34% tax rate) of investment securities at December 31, 2006 by contractual or legal maturity. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

| (Dollars in Thousands)               | Amortized<br>Cost | Fair<br>Value     | Yield<br>(Unaudited) |
|--------------------------------------|-------------------|-------------------|----------------------|
| <b>Available-for-sale securities</b> |                   |                   |                      |
| U.S. Treasury                        |                   |                   |                      |
| Within one year                      | \$ 999            | \$ <b>998</b>     | 4.7 %                |
| After one but within five years      | 3,186             | <b>3,101</b>      | 3.5 %                |
| U.S. Government agencies             |                   |                   |                      |
| Within one year                      | 49,074            | <b>48,585</b>     | 3.5 %                |
| After one but within five years      | 63,403            | <b>62,063</b>     | 4.1 %                |
| After five but within ten years      | 4,982             | <b>4,976</b>      | 4.8 %                |
| Mortgage backed securities           |                   |                   |                      |
| After one but within five years      | 252               | <b>253</b>        | 6.3 %                |
| States and political subdivisions    |                   |                   |                      |
| After one but within five years      | 264               | <b>291</b>        | 11.0 %               |
| After five but within ten years      | 390               | <b>390</b>        | 6.2 %                |
| After ten years                      | 23,447            | <b>23,301</b>     | 6.1 %                |
| Other securities                     |                   |                   |                      |
| After ten years                      | 3,043             | <b>3,043</b>      | 8.5 %                |
|                                      | \$ 149,040        | \$ <b>147,001</b> |                      |
| <b>Held-to-maturity securities</b>   |                   |                   |                      |
| U.S. Government agencies             |                   |                   |                      |
| After one but within five years      | \$ 6,356          | \$ 6,237          | 4.0 %                |
| States and political subdivisions    |                   |                   |                      |
| Within one year                      | <b>4,401</b>      | 4,425             | 7.6 %                |
| After one but within five years      | <b>18,086</b>     | 18,518            | 7.2 %                |
| After five but within ten years      | <b>20,367</b>     | 20,650            | 6.4 %                |
| After ten years                      | <b>28,106</b>     | 28,224            | 6.3 %                |
| Other securities                     |                   |                   |                      |
| After one but within five years      | <b>3,931</b>      | 4,055             | 7.2 %                |
|                                      | \$ 81,247         | \$ 82,109         |                      |

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 4 - LOANS**

The following table presents the Bank's loans by category as of December 31, 2006 and 2005 (dollars in thousands):

|  | <b>2006</b> |                | <b>2005</b> |         |
|--|-------------|----------------|-------------|---------|
| Commercial, financial and agricultural | \$          | <b>53,293</b>  | \$          | 50,951  |
| Tax exempt municipal loans             |             | <b>22,978</b>  |             | 27,695  |
| Real estate                            |             |                |             |         |
| Construction                           |             | <b>22,135</b>  |             | 13,516  |
| Commercial mortgages                   |             | <b>100,435</b> |             | 98,670  |
| Residential mortgages                  |             | <b>218,242</b> |             | 212,497 |
| Other                                  |             | <b>32,124</b>  |             | 31,533  |
| Retail loans                           |             | <b>23,737</b>  |             | 24,394  |
| Lease financing receivables            |             | <b>712</b>     |             | 889     |
|  |             | <b>473,656</b> |             | 460,145 |
| Less:                                  |             |                |             |         |
| Net unamortized loan origination fees  |             | <b>(303)</b>   |             | (248)   |
| Allowance for possible loan losses     |             | <b>(7,262)</b> |             | (7,794) |
| Total net loans                        | \$          | <b>466,091</b> | \$          | 452,103 |

The following table presents the maturities of the Bank's loans by category as of December 31, 2006 (dollars in thousands):

|  | Within   |               | One to     |               | After      |              | Total |               |
|--|----------|---------------|------------|---------------|------------|--------------|-------|---------------|
|  | One Year |               | Five Years |               | Five Years |              |       |               |
| Commercial, financial and agricultural | \$       | <b>21,853</b> | \$         | <b>24,476</b> | \$         | <b>6,964</b> | \$    | <b>53,293</b> |

Edgar Filing: FIRST FARMERS & MERCHANTS CORP - Form 10-K

|                             |            |            |            |            |
|-----------------------------|------------|------------|------------|------------|
| Tax exempt municipal loans  | 2,532      | 6,274      | 14,172     | 22,978     |
| Real estate                 |            |            |            |            |
| Construction                | 19,438     | 1,691      | 1,006      | 22,135     |
| Commercial mortgages        | 18,857     | 40,614     | 40,964     | 100,435    |
| Residential mortgages       | 71,843     | 81,364     | 65,035     | 218,242    |
| Other                       | 3,406      | 12,844     | 15,874     | 32,124     |
| Retail loans                | 13,323     | 10,317     | 97         | 23,737     |
| Lease financing receivables | 63         | 649        | -          | 712        |
| Total                       | \$ 151,315 | \$ 178,229 | \$ 144,112 | \$ 473,656 |

Loans having recorded investments of \$1,954,000 at December 31, 2006 have been identified as impaired and are not accruing interest. The total allowance for possible loan losses related to these loans was \$293,000. Impaired loans had recorded investments of approximately \$2,264,000 at December 31, 2005, with \$303,000 of the allowance for possible loan losses related to these loans. Interest received on impaired loans during 2006 was \$122,000, during 2005 was \$136,000 and during 2004 was \$170,000.

Certain related parties (primarily directors and senior officers of the Corporation or the Bank, including their affiliates, families and companies in which they hold ten percent or more ownership) were customers of, and had loans and other transactions with, the Bank in the ordinary course of business. An analysis of the activity with respect to such loans for the years ended December 31, 2006 and 2005 is shown in the table below. These totals exclude loans made in the ordinary course of business to other companies with which neither the Corporation nor the Bank had a relationship other than the association of one of its directors in the capacity of officer or director. These loan transactions were made on substantially the same terms as those prevailing at the time for comparable loans to other persons. They did

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 4 - LOANS (Continued)**

not involve more than the normal risk of collectibility or present other unfavorable features. No related party loans were charged off in 2006 or 2005.

**Aggregate of Certain Related Party Loans**

|                              |    | 2006  |    | 2005  |
|------------------------------|----|-------|----|-------|
| Balance at Beginning of Year | \$ | 3,778 | \$ | 3,975 |
| Additions                    |    | 569   |    | 1,225 |
| Amount Collected             |    | 1,050 |    | 1,422 |
| Balance at End of Year       | \$ | 3,297 | \$ | 3,778 |

**NOTE 5 - ALLOWANCE FOR POSSIBLE LOAN LOSSES**

The following table summarizes the changes in the allowance for possible loan losses for the years ended December 31, 2006, 2005 and 2004 (dollars in thousands):

|      |      |      |
|------|------|------|
| 2006 | 2005 | 2004 |
|------|------|------|

|  |    |              |    |       |    |         |
|--|----|--------------|----|-------|----|---------|
| Balance at beginning of year                                   | \$ | <b>7,794</b> | \$ | 8,509 | \$ | 10,123  |
| Provision (reduction) charged (credited) to operating expenses |    | <b>(636)</b> |    | (890) |    | (677)   |
| Loan losses and recoveries:                                    |    |              |    |       |    |         |
| Loans charged off  |    | <b>(363)</b> |    | (551) |    | (1,680) |
| Recoveries on loans previously charged off                     |    | <b>467</b>   |    | 726   |    | 743     |
| Balance at end of year   | \$ | <b>7,262</b> | \$ | 7,794 | \$ | 8,509   |

In September 2002, the Bank voluntarily entered into a written agreement with the Office of the Comptroller of the Currency ("OCC"). The agreement related to asset quality and management and board oversight of the lending function. After loan quality and management of the lending function improved in 2003 and in April 2004, the Bank received written notice from the OCC that the agreement was terminated effective April 7, 2004. In the opinion of management, based on conditions presently known, the allowance for possible loan losses was adequate at December 31, 2006.

## NOTE 6 - BANK PREMISES AND EQUIPMENT

The following table presents the Bank's assets by category at December 31, 2006 and 2005 (dollars in thousands):

|  |    | <b>2006</b>     |    | 2005     |
|--|----|-----------------|----|----------|
| Land   | \$ | <b>1,661</b>    | \$ | 1,952    |
| Premises   |    | <b>13,383</b>   |    | 14,294   |
| Furniture and equipment                          |    | <b>7,126</b>    |    | 6,966    |
| Leasehold improvements                           |    | <b>1,559</b>    |    | 1,552    |
|  |    | <b>23,729</b>   |    | 24,764   |
| Less allowance for depreciation and amortization |    | <b>(13,301)</b> |    | (12,855) |
|  | \$ | <b>10,428</b>   | \$ | 11,909   |

## FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 6 - BANK PREMISES AND EQUIPMENT (Continued)

Annual provisions for depreciation and amortization of bank premises and equipment totaled \$1,119,000 for 2006, \$1,268,000 for 2005 and \$1,249,000 for 2004. Included in premises, furniture and equipment cost and allowance for depreciation and amortization are certain fully depreciated assets totaling approximately \$4,887,000 at December 31, 2006. During 2006, one building with a book value of \$684,000 was transferred from premises and equipment to long-lived assets held for sale, which is included in other assets.

#### NOTE 7 - LIMITATION ON SUBSIDIARY DIVIDENDS

The Corporation and the Bank are subject to state laws and regulations of the Federal Reserve Bank and the Tennessee Department of Financial Institutions. Under these regulations, the amount of dividends that may be paid is

limited only to the extent that the remaining balance of retained earnings is at least equal to the capital stock amounts of the Bank; however, future dividends will be dependent on the level of earnings, capital and liquidity requirement and considerations of the Bank and the Corporation.

#### NOTE 8 - LEASES

Real property for four of the Bank's office locations and certain equipment are leased under noncancelable operating leases expiring at various times through 2011. In most cases, the leases provide for one or more renewal options of five to ten years under the same or similar terms. In addition, various items of office equipment are leased under cancelable operating leases. Total rental expense incurred under all operating leases, including short-term leases with terms of less than one month, amounted to \$34,000, \$35,000 and \$35,000 for equipment leases and \$277,000, \$242,000 and \$220,000 for building leases in 2006, 2005 and 2004, respectively. Future minimum lease commitments as of December 31, 2006 under all noncancelable operating leases with initial terms of one year or more are shown in the following table (dollars in thousands):

| Year  | Lease<br>Payments |
|-------|-------------------|
| 2007  | \$ 250            |
| 2008  | 144               |
| 2009  | 62                |
| 2010  | 54                |
| 2011  | 53                |
| Total | \$ 563            |

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 9 - FEDERAL AND STATE INCOME TAXES**

The following table presents components of income tax expense attributable to continuing operations for the years ended December 31, 2006, 2005 and 2004 (dollars in thousands):

|                                  | <b>2006</b>     | 2005     | 2004     |
|----------------------------------|-----------------|----------|----------|
| Current:                         |                 |          |          |
| Federal                          | \$ 1,906        | \$ 2,272 | \$ 2,658 |
| State                            | 457             | 729      | 697      |
| Total current                    | <b>2,363</b>    | 3,001    | 3,355    |
| Deferred:                        |                 |          |          |
| Federal                          | (217)           | (99)     | (222)    |
| State                            | (45)            | (21)     | (45)     |
| Total deferred                   | <b>(262)</b>    | (120)    | (267)    |
| Total provision for income taxes | \$ <b>2,101</b> | \$ 2,881 | \$ 3,088 |

Deferred Tax Effects of Principal Temporary Differences

|  | <b>2006</b>     | 2005     | 2004     |
|--|-----------------|----------|----------|
| Allowance for possible loan losses                         | \$ 2,773        | \$ 2,978 | \$ 3,255 |
| Deferred compensation                                      | 1,252           | 1,128    | 1,044    |
| Write down of other real estate                            | 14              | 14       | 150      |
| Amortization of core deposit intangible                    | 1,126           | 898      | 673      |
| Recognition of nonaccrual loan income                      | (67)            | (93)     | 30       |
| Unrealized gains (losses) on available-for-sale securities | 785             | 1,354    | (351)    |
| Deferred post retirement benefit                           | 2,139           | 1,959    | 1,788    |
| Lease financing depreciations, net of rent                 | (338)           | (327)    | (763)    |
| Accelerated depreciation                                   | (150)           | (150)    | (150)    |
| Amortization of goodwill                                   | (1,076)         | (861)    | (646)    |
| Other  | (357)           | (492)    | (447)    |
| Net deferred tax asset                                     | \$ <b>6,101</b> | \$ 6,408 | \$ 4,583 |

Reconciliation of Total Income Taxes Reported with the Amount of Income Taxes Computed at the Federal Statutory Rate (34% Each Year)

|  | <b>2006</b> | 2005     | 2004     |
|--|-------------|----------|----------|
| Tax expense at statutory rate                | \$ 3,341    | \$ 3,853 | \$ 3,972 |
| Increase (decrease) in taxes resulting from: |             |          |          |
| Tax exempt interest                          | (1,782)     | (1,430)  | (1,097)  |
| Nondeductible interest expense               | 182         | 108      | 71       |
| Employee benefits                            | (137)       | (190)    | (150)    |
| Other nondeductible expenses                 |             |          |          |



Edgar Filing: FIRST FARMERS & MERCHANTS CORP - Form 10-K

|   |          |          |          |
|---|----------|----------|----------|
| (nontaxable income) - net                     | 18       | 21       | 21       |
| State income taxes net of federal tax benefit | 273      | 486      | 450      |
| Dividend income exclusion                     | (1)      | (1)      | (24)     |
| Charitable contribution of real estate        | (59)     | -        | -        |
| Other   | 266      | 34       | (155)    |
| Total provision for income taxes              | \$ 2,101 | \$ 2,881 | \$ 3,088 |
| Effective tax rate                            | 21.4 %   | 25.4 %   | 26.4 %   |

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 10 - COMMITMENTS AND CONTINGENCIES**

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 standby 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 particular financial instruments.

The total outstanding loan commitments and standby letters of credit in the normal course of business at December 31, 2006 were approximately \$95 million and \$13 million, respectively. Loan commitments are agreements to lend to a customer provided there is not a 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. The commitments for equity lines of credit may expire without being used. Therefore, the total commitment amounts do not necessarily represent future cash requirements. Standby 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 Bank's loan portfolio is well-diversified with loans generally secured by tangible personal property, real property, bank deposit accounts or stock. The 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 each customer.

Various legal claims have arisen from time to time in the normal course of business which, in the opinion of management, should not have a material effect on the Corporation's operating results and financial condition.

**NOTE 11 - SHAREHOLDERS' EQUITY**

The Corporation and the Bank are subject to federal regulatory risk-adjusted capital adequacy standards. Failure to meet capital adequacy requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that could have a material adverse effect on the operating results and financial condition of the Corporation and the Bank. The applicable regulations require 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 regulation to ensure capital adequacy require the Corporation and the Bank to maintain minimum amounts and ratios of Total Capital and Tier I Capital to risk-weighted assets and of Tier I Capital to average assets. Actual capital amounts and ratios are presented in the table below. Management believes, as of December 31, 2006, that the Corporation and the Bank met all capital adequacy requirements to which they were subject.

## FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 11 - SHAREHOLDERS' EQUITY (Continued)

(Dollars in Thousands)

| As of December 31, 2006                  |              | Actual     |         | For Minimum Capital Adequacy Purposes |              | For Minimum Regulatory Compliance Purposes |              |
|--|--------------|------------|---------|---------------------------------------|--------------|--|--------------|
|  |              | Amount     | Ratio   | Amount                                | Ratio > or = | Amount                                     | Ratio > or = |
| Total Capital (to Risk Weighted Assets)  | Consolidated | \$ 101,920 | 19.83 % | \$ 41,117                             | 8.00 %       | -  | -            |
|  | Bank         | 99,677     | 19.47 % | 40,956                                | 8.00 %       | 51,195                                     | 10.00 %      |
| Tier I Capital (to Risk Weighted Assets) | Consolidated | 95,509     | 18.58 % | 20,562                                | 4.00 %       | -  | -            |
|  | Bank         | 93,267     | 18.22 % | 20,476                                | 4.00 %       | 30,714                                     | 6.00 %       |
| Tier I Capital (to Average Assets)       | Consolidated | 95,509     | 12.01 % | 31,810                                | 4.00 %       | -  | -            |
|  | Bank         | 93,267     | 11.73 % | 31,805                                | 4.00 %       | 39,756                                     | 5.00 %       |
| As of December 31, 2005 - Restated       |              |            |         |                                       |              |  |              |
| Total Capital (to Risk Weighted Assets)  | Consolidated | \$ 101,124 | 19.35 % | 41,808                                | 8.00 %       | -  | -            |
|  | Bank         | 99,760     | 19.17 % | 41,632                                | 8.00 %       | 52,040                                     | 10.00 %      |
| Tier I Capital (to Risk Weighted Assets) | Consolidated | 94,577     | 18.09 % | 20,913                                | 4.00 %       | -  | -            |
|  | Bank         | 93,238     | 17.91 % | 20,824                                | 4.00 %       | 31,236                                     | 6.00 %       |
| Tier I Capital (to Average Assets)       | Consolidated | 94,577     | 11.74 % | 32,224                                | 4.00 %       | -  | -            |
|  | Bank         | 93,238     | 11.60 % | 32,151                                | 4.00 %       | 40,189                                     | 5.00 %       |

#### NOTE 12 - FAIR VALUES OF FINANCIAL INSTRUMENTS

The following table presents the fair value of the Bank's financial instruments as of December 31, 2006 and 2005 (dollars in thousands):

|  | December 31, 2006 |            | December 31, 2005 |            |
|--|-------------------|------------|-------------------|------------|
|  | Carrying Amount   | Fair Value | Carrying Amount   | Fair Value |
| <b>Financial assets</b>  |                   |            |                   |            |
| Cash and due from banks  | \$ 45,558         | \$ 45,558  | \$ 28,489         | \$ 28,489  |
| Interest-bearing deposits in banks   | 2,573             | 2,573      | 49                | 49         |
| Federal funds sold   | 26,850            | 26,850     | -                 | -          |
| Securities available-for-sale  | 147,001           | 147,001    | 191,931           | 191,931    |
| Securities held-to-maturity  | 81,247            | 82,109     | 89,832            | 90,810     |
| Loans, net   | 466,091           | 446,252    | 452,103           | 434,927    |
| Accrued interest receivable  | 4,878             | 4,878      | 5,452             | 5,452      |
| <b>Financial liabilities</b>   |                   |            |                   |            |
| Deposits   | 698,962           | 697,910    | 683,588           | 681,858    |
| Federal funds purchased and securities sold under agreements to repurchase | 2,654             | 2,654      | 13,132            | 13,132     |
| Other short term liabilities   | 385               | 385        | 521               | 521        |
| Accrued interest payable   | 3,052             | 3,052      | 2,156             | 2,156      |
| <b>Off-balance sheet credit related instruments:</b>                       |                   |            |                   |            |
| Commitments to extend credit   | -                 | 22         | -                 | 65         |

## FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 12- FAIR VALUES OF FINANCIAL INSTRUMENTS (Continued)

Estimated fair values have been determined by the Bank using the best available data. Many of the Bank's financial instruments, however, lack an available trading market as characterized by a willing buyer and willing seller engaging in an unforced, unforced transaction. Therefore, significant estimations and present value calculations were used by the Bank for the purposes of this disclosure. Changes in assumptions or the estimation methodologies used could have a material effect on the estimated fair values included in this Note 12.

#### Financial assets

Cash and cash equivalents are considered to be carried at their fair value and have not been valued differently from historical cost accounting. Both securities available-for-sale and held-to-maturity are valued by an independent pricing service as discussed in Note 3. A present value discounted cash flow methodology was used to value the net loan portfolio. The discount rate used in these calculations was the current rate at which new loans in the same classification for regulatory reporting purposes would be made. This rate was adjusted for credit loss and assumed prepayment risk. For loans with floating interest rates, it is assumed that estimated fair values generally approximate the recorded book balances.

**Financial liabilities**

Deposits with stated maturities have been valued using a present value discounted cash flow with a discount rate approximating the current market for similar liabilities. Financial instrument liabilities with no stated maturities have an estimated fair value equal to both the amount payable on demand and the recorded book balance. For deposits with floating interest rates, it is assumed that estimated fair values generally approximate the recorded book balances. The carrying amount of other short-term borrowings is considered to approximate fair value.

Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing.

The Bank's remaining assets and liabilities that are not considered financial instruments have not been valued differently from historical cost accounting. Management is concerned that reasonable comparability between financial institutions may be distorted because of the wide range of permitted valuation techniques and numerous estimates that must be made given the absence of active secondary markets for many of the financial instruments. This lack of uniform valuation methodologies also introduces a greater degree of subjectivity to these estimated fair values.

At December 31, 2006, the Bank had outstanding standby letters of credit and commitments to extend credit. These off-balance sheet financial instruments are generally exercisable at the market rate prevailing at the date the underlying transaction will be completed. Please refer to Note 10 for more information about off-balance sheet financial instruments.

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****NOTE 13 - QUARTERLY RESULTS OF OPERATIONS (Unaudited)**

The following table presents unaudited quarterly interim financial information for the Corporation for the years ending December 31, 2006 and 2005 (dollars in thousands, except per share amount):

|   | <b>2006</b> | <b>First<br/>Quarter<br/>Restated</b> | <b>Second<br/>Quarter<br/>Restated</b> | <b>Third<br/>Quarter<br/>Restated</b> | <b>Fourth<br/>Quarter</b> | <b>Total</b> |
|---|-------------|---------------------------------------|--|---------------------------------------|---------------------------|--------------|
| Interest income   |             | \$ 10,064                             | \$ 10,714                              | \$ 10,779                             | \$ 10,880                 | \$ 42,437    |
| Interest expense  |             | 3,065                                 | 3,224                                  | 3,590                                 | 3,909                     | 13,788       |
| Net interest income                                     |             | 6,999                                 | 7,490                                  | 7,189                                 | 6,971                     | 28,649       |
| Provision for possible loan losses<br>(recoveries), net |             | -                                     | -                                      | (421)                                 | (215)                     | (636)        |
| Noninterest expenses, net of<br>noninterest income      |             | 5,079                                 | 5,089                                  | 4,443                                 | 4,848                     | 19,459       |

Edgar Filing: FIRST FARMERS & MERCHANTS CORP - Form 10-K

|  |    |                  |                  |                  |                  |                  |
|--|----|------------------|------------------|------------------|------------------|------------------|
| Income before income taxes                             |    | <b>1,920</b>     | <b>2,401</b>     | <b>3,167</b>     | <b>2,338</b>     | <b>9,826</b>     |
| Income taxes   |    | <b>276</b>       | <b>484</b>       | <b>950</b>       | <b>391</b>       | <b>2,101</b>     |
| Net income   |    | <b>\$ 1,644</b>  | <b>\$ 1,917</b>  | <b>\$ 2,217</b>  | <b>\$ 1,947</b>  | <b>\$ 7,725</b>  |
| Basic earnings per share                               |    | <b>\$ 0.28</b>   | <b>\$ 0.33</b>   | <b>\$ 0.38</b>   | <b>\$ 0.34</b>   | <b>\$ 1.33</b>   |
| Weighted average shares outstanding per quarter        |    | <b>5,840,000</b> | <b>5,840,000</b> | <b>5,819,716</b> | <b>5,807,338</b> | <b>5,826,589</b> |
|  |    | First            | Second           | Third            | Fourth           |                  |
|  |    | Quarter          | Quarter          | Quarter          | Quarter          |                  |
|  |    | Restated         | Restated         | Restated         | Restated         | Total            |
| 2005 (Restated)  |    |                  |                  |                  |                  |                  |
| Interest income  | \$ | 9,394            | \$ 9,647         | \$ 9,962         | \$ 10,103        | \$ 39,106        |
| Interest expense                                       |    | 2,189            | 2,363            | 2,587            | 2,759            | 9,898            |
| Net interest income                                    |    | 7,205            | 7,284            | 7,375            | 7,344            | 29,208           |
| Provision for possible loan losses<br>(recoveries) net |    | (796)            | -                | (94)             | -                | (890)            |
| Noninterest expenses, net of<br>noninterest income     |    | 5,049            | 4,640            | 4,103            | 4,973            | 18,765           |
| Income before income taxes                             |    | 2,952            | 2,644            | 3,366            | 2,371            | 11,333           |
| Income taxes   |    | 868              | 679              | 916              | 418              | 2,881            |
| Net income   | \$ | 2,084            | \$ 1,965         | \$ 2,450         | \$ 1,953         | \$ 8,452         |
| Basic earnings per share                               | \$ | 0.36             | \$ 0.34          | \$ 0.42          | \$ 0.33          | \$ 1.45          |
| Weighted average shares outstanding per quarter        |    | 5,840,000        | 5,840,000        | 5,840,000        | 5,840,000        | 5,840,000        |

**NOTE 14 - DEPOSITS**

The Bank does not have any foreign offices and all deposits are serviced in its 18 domestic offices. Maturities of time deposits of \$100,000 or more at December 31, 2006 and 2005 are presented in the following table (dollars in thousands):

|                | <b>2006</b>      | 2005      |
|----------------|------------------|-----------|
| Under 3 months | \$ <b>36,828</b> | \$ 24,087 |
| 3 to 12 months | <b>49,026</b>    | 49,958    |
| Over 12 months | <b>5,650</b>     | 20,426    |
| Total          | \$ <b>91,504</b> | \$ 94,471 |

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 14 - DEPOSITS (Continued)**

The following table presents maturities of interest-bearing deposits as of December 31, 2006 (dollars in thousands):

|                                       |      |         |
|---------------------------------------|------|---------|
| Interest bearing transaction accounts | \$   | 290,443 |
|                                       | 2007 | 238,922 |
|                                       | 2008 | 20,008  |
|                                       | 2009 | 2,674   |
|                                       | 2010 | 1,940   |
|                                       | 2011 | 2,042   |

Total \$ 556,029

**NOTE 15 - SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE**

Securities sold under agreements to repurchase, which are classified as secured borrowings, generally mature within one to four days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction.

**NOTE 16 - CONDENSED FINANCIAL INFORMATION OF THE CORPORATION**

The following tables present the condensed balance sheets, statements of income and cash flows of the Corporation as of December 31, 2006 and 2005 (dollars in thousands, except per share amounts):

**CONDENSED BALANCE SHEETS**

|  | As of December 31, |            |
|--|--------------------|------------|
|  | 2006               | 2005       |
|  |                    | (Restated) |
| Cash   | \$ 23              | \$ 37      |
| Investment in bank subsidiary - at equity  | 101,565            | 101,733    |
| Investment in credit life insurance company - at cost  | 54                 | 54         |
| Investment in other securities   | 17                 | 17         |
| Dividends receivable from bank subsidiary  | 3,000              | 1,869      |
| Cash surrender value - life insurance  | 2,722              | 1,960      |
| Total assets   | \$ 107,381         | \$ 105,670 |
| Liabilities  |                    |            |
| Payable to bank subsidiary   | \$ 719             | \$ -       |
| Payable to directors   | 854                | 729        |
| Other payable  | 31                 | -          |
| Dividends payable  | 1,971              | 1,869      |
| Total liabilities  | 3,575              | 2,598      |
| Shareholders' equity   |                    |            |
| Common stock - \$10 par value, 8,000,000 shares authorized;<br>5,760,000 and 5,840,000 shares issued and outstanding,<br>as of 12/31/06 and 12/31/05, respectively | 57,600             | 58,400     |
| Additional paid-in capital   | 1,120              | 4,320      |
| Retained earnings  | 46,341             | 42,515     |
| Accumulated other comprehensive income   | (1,255)            | (2,163)    |
| Total shareholders' equity   | 103,806            | 103,072    |
| Total liabilities and shareholders' equity   | \$ 107,381         | \$ 105,670 |

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****NOTE 16 - CONDENSED FINANCIAL INFORMATION OF THE CORPORATION (Continued)****CONDENSED STATEMENTS OF INCOME**

|  | Years ended December 31, |               |
|--|--------------------------|---------------|
|  | 2006                     | 2005 Restated |
| Operating income   |                          |               |
| Dividends from bank subsidiary   | \$ 7,852                 | \$ 3,679      |
| Other dividend income  | 3                        | 4             |
| Interest income  | -                        | 1             |
| Other  | 65                       | 98            |
| Operating expenses   | (195)                    | (161)         |
| Income before equity in undistributed net<br>income of bank subsidiary | 7,725                    | 3,621         |
| Equity in undistributed net income of bank subsidiary                  | -                        | 4,831         |
| Net Income   | \$ 7,725                 | \$ 8,452      |

**CONDENSED STATEMENTS OF CASH FLOWS**

|   | Years Ended December 31, |               |
|---|--------------------------|---------------|
|   | 2006                     | 2005 Restated |
| Operating activities  |                          |               |
| Net income for the year   | \$ 7,725                 | \$ 8,452      |
| Adjustments to reconcile net income to net cash<br>provided by operating activities |                          |               |
| Equity in undistributed net income of bank subsidiary                               | -                        | (4,831)       |
| Increase in cash surrender value of life insurance contracts                        | (43)                     | (103)         |
| Increase in other assets  | -                        | (117)         |
| Increase in payables  | 156                      | 70            |
| Total adjustments   | 113                      | (4,981)       |
| Net cash provided by operating activities   | 7,838                    | 3,471         |
| Investing activities  |                          |               |
| Return of equity  | (56)                     | -             |
| Proceeds of held to maturity and available for sale securities                      | -                        | (1)           |
| Purchase of single premium life insurance policy                                    | (719)                    | -             |
| Net cash used by investing activities   | (775)                    | (1)           |
| Financing activities  |                          |               |
| Payment to repurchase common stock  | (4,000)                  | -             |

|                                       |         |         |
|---------------------------------------|---------|---------|
| Advance from subsidiary               | 719     | -       |
| Cash dividends paid                   | (3,796) | (3,562) |
| Net cash used in financing activities | (7,077) | (3,562) |
| Increase (decrease) in cash           | (14)    | (92)    |
| Cash at beginning of year             | 37      | 129     |
| Cash at end of year                   | \$ 23   | \$ 37   |

## FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 17 - EMPLOYEE BENEFIT PLANS

The Bank contributes to a defined contribution, profit-sharing plan covering employees who meet participation requirements. The amount of the contribution is discretionary as determined by the Bank's Board of Directors up to the maximum deduction allowed for federal income tax purposes. Contributions to the plan, which amounted to \$1,507,000, \$1,542,000 and \$1,471,000 in 2006, 2005 and 2004, respectively, are included in salaries and employee benefits expense.

In 1992, the Bank formalized a nonqualified salary continuation plan for certain key officers. In connection with this plan, the value of the single premium universal life insurance policies (\$876,000 at December 31, 2006 and \$853,000 at December 31, 2005) purchased in 1993 to fund the plan and the related liability (\$283,000 at December 31, 2006 and \$347,000 at December 31, 2005) were included in other assets and other liabilities, respectively. Net noncash income recognized on these policies of \$20,000 in 2006, \$18,000 in 2005 and \$30,000 in 2004 is included in the above asset values. The principal cost of the plan is accrued over the anticipated remaining period of active employment, based on the present value of the expected retirement benefit. Expense related to this plan was \$11,000 in 2006, \$30,000 in 2005 and \$46,000 in 2004.

In 1993, the Corporation and the Bank implemented a deferred compensation plan that permits directors to defer their director's fees and earn interest on the deferred amount. Liability increases for current deferred fees, net of benefits paid, of \$203,000 for 2006, \$264,000 for 2005 and \$259,000 for 2004 have been recognized in the accompanying consolidated financial statements. In connection with this plan, a single premium universal life insurance policy was purchased on the life of each director who elected to participate. In 2006, the total life insurance purchased was \$2,757,000. Net noncash income recognized on these policies of \$181,000 in 2006, 147,000 in 2005 and \$245,000 in 2004 is included in the cash surrender values of \$9,133,000, \$6,199,000 and 5,592,000 reported in other assets at December 31, 2006, 2005 and 2004, respectively.

In 1996, the Bank established an officer group term replacement/split-dollar plan to provide life insurance benefits that would continue after retirement. A single premium universal life insurance policy was purchased to fund the plan and a split-dollar agreement was made with an irrevocable trust that specified the portion of the insurance proceeds that would become part of the trust. The value of this policy (\$1,140,000 at December 31, 2006, and \$1,114,000 at December 31, 2005) is included in other assets, and net noncash income recognized on this policy of \$26,000 in 2006, \$11,000 in 2005 and \$42,000 in 2004 are included in the above asset values.



In 2002, the Bank implemented a Director Split-Dollar Life Insurance Plan and an Executive Split-Dollar Life Insurance Plan. The Bank purchased a single premium whole life insurance policy on the life of each participant and endorsed a portion of the policy death benefits to the insured's estate, a trust, or another individual. The total life insurance purchased was \$3,735,000 in 2002, \$190,000 in 2003 and \$253,000 in 2004. Additional single premium universal life insurance policies, totaling \$154,000 in 2005, were purchased for new participants. Net noncash income was recognized on these policies of \$181,000 in 2006 and \$382,000 in 2005 and is included in the asset value of \$5,205,000, which is a part of other assets.

The Bank is beneficiary on the insurance policies that fund the salary continuation plan, the deferred compensation plan, the group term replacement/split-dollar plan and the split-dollar life insurance plans. These policies had an aggregate current death benefit of \$24 million at December 31, 2006.

## FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 18 - POST RETIREMENT BENEFIT PLAN

The Corporation sponsors a defined benefit postretirement health care plan covering substantially all employees with 25 years of work experience with the Bank. Retirement may be requested at age 60 with 15 years of work experience with the Bank. In September 2006 the FASB issued FASB 158, "Employer's Accounting for Defined Benefit Pension and other Postretirement Plans, which amends FASB Statement No. 87, 88, 106, and 132R. FASB No. 158 requires employers to (a) recognize the overfunded or underfunded status of a single-employer defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in comprehensive income. FASB 106 requires companies to accrue the cost of postretirement health care and life insurance benefits within the employees' active service periods. The plan is contributory, with the retiree contributing \$100 per month and the Corporation paying additional costs necessary to keep the coverage in force. The plan is not funded.

The following tables provide further information about the plan:

#### Obligations and Funded Status

|   |    | Post Retirement Benefits |         |
|---|----|--------------------------|---------|
|   |    | 2006                     | 2005    |
| Fair value of plan assets at December 31, 2006                    | \$ | -                        | -       |
| Benefit obligation at December 31, 2006                           |    | 5,557                    | 5,088   |
| Funded status   |    | (5,557)                  | (5,088) |
| Prepaid (accrued) benefit cost recognized<br>in the balance sheet |    | (5,557)                  | (5,088) |
| Service cost  |    | 194                      | 180     |
| Interest cost   |    | 415                      | 368     |

|   |     |     |
|---|-----|-----|
| Employer contributions  | 140 | 65  |
| Plan participants contributions   | 50  | 39  |
| Benefits paid   | 190 | 104 |
| Weighted -average assumptions used to determine benefit obligations at December 31:                   |     |     |
| Discount rate   | 8 % | 8 % |
| Weighted-average assumptions used to determine net periodic benefit cost for years ended December 31: |     |     |
| Discount rate   | 8 % | 8 % |

## FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### NOTE 18 - POST RETIREMENT BENEFIT PLAN (Continued)

The following table gives the expected benefit payments through a 10 year cash flow projection.

| Year           | Gross Benefits | Participant Contributions | Company Benefits |
|----------------|----------------|---------------------------|------------------|
| 2007           | \$ 234         | \$ 60                     | \$ 174           |
| 2008           | 271            | 69                        | 202              |
| 2009           | 307            | 79                        | 228              |
| 2010           | 358            | 91                        | 267              |
| 2011           | 394            | 103                       | 291              |
| 2012 and later | 2,901          | 730                       | 2,171            |
|                | \$ 4,465       | \$ 1,132                  | \$ 3,333         |

The following table gives the Health Care Cost Trend (HCCTR), which is applied to gross charges, net claims and retiree paid premiums to reflect the Corporation's past practice and stated ongoing intention to maintain relatively constant cost sharing between the Corporation and retirees.

| Annual Increase in Gross Medical, Rx and Administrative Charges |              |          |  |
|---|--------------|----------|--|
| Year  | Pre Medicare | Medicare |  |
| 2006  | 12.00%       | 8.00%    |  |
| 2007  | 11.00%       | 7.50%    |  |
| 2008  | 10.00%       | 7.00%    |  |
| 2009  | 9.00%        | 6.50%    |  |
| 2010  | 8.00%        | 6.00%    |  |
| 2011  | 7.00%        | 5.50%    |  |
| 2012  | 6.00%        | 5.00%    |  |
| 2013 and later  | 5.00%        | 5.00%    |  |

The next table gives the effect of a one percentage point increase and decrease in the assumed health care cost trend rates on the aggregate of the service and interest cost components of net periodic postretirement health care benefit cost and accumulated obligation for the benefits.

| Effect of Health Care Cost Trend Rate |    |       |
|---------------------------------------|----|-------|
| 1% Increase in HCCTR                  |    |       |
| Effect on Service and interest costs  | \$ | 107   |
| Effect on APBO 12/31/2006             | \$ | 902   |
| 1% Decrease in HCCTR                  |    |       |
| Effect on Service and interest costs  | \$ | (87)  |
| Effect on APBO 12/31/2006             | \$ | (736) |

## **FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARY**

### **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION**

#### **SHAREHOLDER INFORMATION**

The 5,760,000 shares of common stock of the Corporation outstanding at December 31, 2006 had an estimated market value of \$280.0 million and were held by 2,574 shareholders. Located primarily in the corporation's market area. These identifiable individuals consist of 2,056 record holders, and 218 joint holders. A small number of shareholders are not identified individually because some bank nominees, including the Bank's Trust Department, are listed as record owners when, in fact, these holdings represent more than one beneficial owner. No single shareholder's ownership exceeded five percent at year end.

Edgar Filing: FIRST FARMERS & MERCHANTS CORP - Form 10-K

There is no established public trading market for shares of the Corporation's common stock. The table below shows the high and low price of the Corporation's common stock taken from reported prices by those buyers and sellers willing to disclose this information. This table also shows the semi-annual dividend paid per share of common stock, in each of the last three years. In 2006, the Corporation repurchased 80,000 shares of its common stock in several privately negotiated transactions. On April 20, 2004, the Corporation's shareholders approved a two-for-one split effected in the form of a 100% stock dividend to shareholders of record on that date. All share data in the table have been restated to give retroactive effect to this transaction.

|                           | High            | Low             | Dividend    |
|---------------------------|-----------------|-----------------|-------------|
| <b>2006</b> First Quarter | \$ <b>48.00</b> | \$ <b>48.00</b> | \$ -        |
| Second Quarter            | <b>49.00</b>    | <b>48.00</b>    | <b>0.33</b> |
| Third Quarter             | <b>50.00</b>    | <b>49.00</b>    | -           |
| Fourth Quarter            | <b>50.00</b>    | <b>50.00</b>    | <b>0.34</b> |
| 2005                      |                 |                 |             |
| First Quarter             | \$ 45.00        | \$ 45.00        | \$ -        |
| Second Quarter            | 47.00           | 45.00           | 0.31        |
| Third Quarter             | 48.00           | 48.00           | -           |
| Fourth Quarter            | 48.00           | 48.00           | 0.32        |
| 2004                      |                 |                 |             |
| First Quarter             | \$ 40.00        | \$ 40.00        | \$ -        |
| Second Quarter            | 42.00           | 40.00           | 0.29        |
| Third Quarter             | 45.00           | 42.00           | -           |
| Fourth Quarter            | 45.00           | 45.00           | 0.30        |

**ADDITIONAL FINANCIAL DATA**

The following table presents consolidated comparative data for the Corporation for the years shown:

|                     | (Dollars In Thousands) |            |            |            |            |
|---------------------|------------------------|------------|------------|------------|------------|
|                     | <b>2006</b>            | 2005       | 2004       | 2003       | 2002       |
| Average assets      | <b>\$ 805,334</b>      | \$ 817,606 | \$ 825,467 | \$ 867,100 | \$ 890,525 |
| Average loans (net) | <b>\$ 467,545</b>      | \$ 440,781 | \$ 419,627 | \$ 444,942 | \$ 513,553 |
| Average deposits    | <b>\$ 680,299</b>      | \$ 699,245 | \$ 710,956 | \$ 755,709 | \$ 785,702 |
| Return on           |                        |            |            |            |            |
| average assets      | <b>0.96%</b>           | 1.03%      | 1.04%      | 0.96%      | 0.93%      |
| Return on           |                        |            |            |            |            |
| average equity      | <b>7.10%</b>           | 7.97%      | 8.28%      | 8.09%      | 8.71%      |
| Tier 1 capital      |                        |            |            |            |            |
| to average assets   | <b>12.16%</b>          | 11.99%     | 11.14%     | 10.29%     | 8.79%      |

