FIRST CITIZENS BANCSHARES INC /TN/
Form 10-Q
May 08, 2009

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

[X] QUARTERLY REPORT UNDER SECTION 13 or 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTER ENDED MARCH 31, 2009

[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission file number 0-11709

First Citizens Bancshares, Inc.

(Exact name of registrant as specified in its charter)

Tennessee (State or other jurisdiction of incorporation or organization)	62-1180360 (IRS Employer Identification No.)

P.O. Box 370, One First Citizens Place
Dyersburg, Tennessee 38024

(Address of principal executive offices including zip code)

(731) 285-4410

(Registrant's telephone number, including area code)

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

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

Indicate by a 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 [X]   Non-accelerated filer [ ]

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

Of the registrant's only class of common stock (no par value) there were 3,624,999 shares outstanding as of April 30, 2009.

PART I -FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

FIRST CITIZENS BANCSHARES, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
AS OF MARCH 31, 2009 AND DECEMBER 31, 2008

(In Thousands)

	March 31, 2009 (UNAUDITED)	December 31, 2008 (1)
ASSETS		
Cash and due from banks	$ 13,354	$ 17,888
Federal funds sold	25,509	22,816
Cash and cash equivalents	38,863	40,704
Investment securities:		
Held-to-Maturity, at amortized cost, fair value of $0 at March 31, 2009 and $115 at December 31, 2008	-	115
Available-for-Sale, at fair value	208,351	210,385
Loans (excluding unearned income of $479 at March 31, 2009 and $506 at December 31, 2008)	591,162	596,758
Less: allowance for loan losses	8,430	7,300
Net loans	582,732	589,458
Loans held-for-sale	3,343	2,632
Federal Home Loan Bank and Federal Reserve Bank stocks, at cost	5,684	5,684
Premises and equipment	31,480	31,746
Accrued interest receivable	5,201	5,581
Goodwill	11,825	11,825
Other intangible assets	268	289
Other real estate	5,557	5,424
Bank owned life insurance policies	20,795	20,627
Other assets	10,480	3,032
TOTAL ASSETS	$ 924,579	$ 927,502

LIABILITIES AND SHAREHOLDERS' EQUITY

Deposits				
Demand	$	86,672	$	108,762
Time		378,218		392,840
Savings		256,586		233,313
Total deposits		721,476		734,915
Securities sold under agreements to				
repurchase		39,834		32,765
Federal funds purchased and other short				
term borrowings		1,000		1,000
Long-term debt		75,700		73,843
Other liabilities		7,608		7,971
Total liabilities		845,618		850,494

See accompanying notes to consolidated financial statements.

FIRST CITIZENS BANCSHARES, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS (Continued)
AS OF MARCH 31, 2009 AND DECEMBER 31, 2008
(In Thousands)

		March 31, 2009 (UNAUDITED)		December 31, 2008 (1)
Shareholders' equity:				
Common stock, no par value - 10,000,000				
authorized; 3,717,593 issued and				
outstanding at March 31, 2009 and 3,717,593				
issued and outstanding at December 31, 2008	$	3,718	$	3,718
Surplus		15,331		15,331
Retained earnings		59,618		58,890
Accumulated other comprehensive income		2,735		1,526
Total common stock and retained earnings		81,402		79,465
Less-92,594 treasury shares, at cost as of March 31, 2009				
and 93,094 shares at cost at December 31, 2008		2,441		2,457
Total shareholders' equity		78,961		77,008
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$	924,579	$	927,502

(1) Derived from audited financial statements.

See accompanying notes to consolidated financial statements.

FIRST CITIZENS BANCSHARES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

THREE MONTHS ENDED MARCH 31, 2009 AND 2008
(Dollars in Thousands Except for Per Share Amounts)

	Three Months Ended March 31, 2009	Three Months Ended March 31, 2008
Interest income:		
Interest and fees on loans	$ 9,489	$ 10,952
Interest on investment securities:		
Taxable	1,948	1,728
Tax-exempt	694	557
Dividends	55	88
Other interest income	21	59
Total interest income	12,207	13,384
Interest expense:		
Interest expense on deposits	3,553	4,956
Other interest expense	1,045	1,336
Total interest expense	4,598	6,292
Net interest income	7,609	7,092
Provision for loan losses	2,400	367
Net interest income after provision	5,209	6,725
Other income		
Mortgage banking income	302	311
Income from fiduciary activities	166	191
Service charges on deposit accounts	1,577	1,735
Brokerage fees	277	387
Gain on sale of securities	724	63
Earnings on bank owned life insurance	202	213
Other income	453	401
Total other income	3,701	3,301

FIRST CITIZENS BANCSHARES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED) - (CONTINUED)
THREE MONTHS ENDED MARCH 31, 2009 AND 2008
(Dollars in Thousands Except for Per Share Amounts)

	Three Months Ended March 31, 2009	Three Months Ended March 31, 2008
Other expenses		
Salaries and employee benefits	$ 3,647	$ 4,582
Net occupancy expense	438	440
Depreciation	449	445
Data processing expense	282	200
Legal and professional fees	31	60
Stationary and office supplies	68	58
Amortization of intangibles	21	21
Advertising and promotions	134	175
FDIC insurance premium expense	255	19
Other real estate expense	203	138
Other expenses	1,135	1,191
Total other expenses	6,663	7,329

Net income before income taxes		2,247		2,697
Income taxes		468		566
Net income	$	1,779	$	2,131
Earnings per share	$	0.49	$	0.59
Weighted average number of shares outstanding		3,625,257		3,624,806

See accompanying notes to consolidated financial statements.

FIRST CITIZENS BANCSHARES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY (UNAUDITED)
AS OF MARCH 31, 2009 AND 2008
(In Thousands)

	Three Months Ended			
	March 31, 2009		March 31, 2008	
Balance beginning of period	$	77,008	$	75,031
Net income		1,779		2,131
Other comprehensive income				
Changes in available for sale investments		1,177		1,772
Changes in derivatives		32		(2)
Comprehensive income		2,988		3,901
Cash dividend declared		(1,051)		(1,051)
Common stock issued		-		-
Sale of common stock held in treasury		16		-
Cumulative effect for change in accounting principle (adoption of EITF 06-04)		-		(1,919)
Balance end of period	$	78,961	$	75,962

See accompanying notes to consolidated financial statements.

FIRST CITIZENS BANCSHARES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)
FOR THE THREE MONTHS ENDED MARCH 31, 2009 AND 2008
(Dollars In Thousands)

	Three Months Ended			
	March 31, 2009		March 31, 2008	
Net cash provided by operating activities	$	2,732	$	6,555
Investing activities:				
Proceeds of maturities of held-to-maturity securities		115		-
Purchase of held-to-maturity investments		-		-
Proceeds of maturities of available-for-sale securities		9,332		14,062
Proceeds of sales of available-for-sale securities		16,276		14,851
Purchase of available-for-sale securities		(28,512)		(35,133)
Decrease (Increase) in loans-net		3,323		(14,647)
Proceeds from sale of other real estate		624		449
Purchases of premises and equipment		(183)		(1,433)
Net cash provided (used) by investing activities		975		(21,851)
Financing activities:				
Net increase in demand and savings accounts		1,183		443
Decrease in time deposits		14,622		5,995

Increase in long-term debt		1,857		6,655
Treasury stock sold, net		16		-
Proceeds from sale of common stock		-		-
Cash dividends paid		(1,051)		(1,051)
Net increase in short-term borrowings		7,069		11,965
Net cash provided (used) by financing activities		(5,548)		12,017
Decrease in cash and cash equivalents		1,841		3,279
Cash and cash equivalents at beginning of period		40,704		25,242
Cash and cash equivalents at end of period	$	38,863	$	21,963
Supplemental cash flow disclosures:				
Interest payments, net	$	4,560	$	5,986
Income taxes paid, net		350		-
Transfers from loans to foreclosed assets		1,760		704
Transfers from foreclosed assets to loans		757		-

See accompanying notes to consolidated financial statements.

FIRST CITIZENS BANCSHARES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
MARCH 31, 2009

NOTE 1 - CONSOLIDATED FINANCIAL STATEMENTS

The consolidated balance sheet as of March 31, 2009, the consolidated statements of income for the three month periods ended March 31, 2009 and 2008, and the consolidated statements of cash flows for the three-month periods then ended have been prepared by the company without an audit. The accompanying reviewed condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments necessary to present fairly the financial position, results of operations and cash flows at March 31, 2009 and for all periods presented have been made. Operating results for the reporting periods presented are not necessarily indicative of results that may be expected for the year ending December 31, 2009. For further information, refer to the consolidated financial statements and footnotes thereto included in the company's Annual Report on Form 10-K for the year ended December 31, 2008.

Certain prior year balances have been reclassified to conform with current year presentation. The consolidated financial statements include all accounts of First Citizens Bancshares, Inc. (the "Company"), and its subsidiary, First Citizens National Bank (the "Bank"). First Citizens (TN) Statutory Trusts III and IV are reported under the equity method in accordance with generally accepted accounting principles for Variable Interest Entities for all periods presented. These investments are included in other assets and the proportionate share of income (loss) is included in other non-interest income. The Bank also has two wholly owned subsidiaries, First Citizens Financial Plus and First Citizens Investments, Inc., which are consolidated into its financial statements.

The Bank has a 50% ownership interest in two insurance subsidiaries both of which are accounted for using the equity method. One is White and Associates/First Citizens Insurance, LLC, which is a general insurance agency offering a full line of insurance products. The other is First Citizens/White and Associates Insurance Company whose principal activity is credit insurance. The investment in these subsidiaries is included in Other Assets on the Balance Sheets presented in this report and earnings from these subsidiaries are recorded in Other Income on the Income Statements presented in this report.

NOTE 2 - ORGANIZATION

First Citizens Bancshares, Inc., is a bank holding company chartered December 14, 1982, under the laws of the State of Tennessee. On September 23, 1983, all outstanding shares of common stock of First Citizens National Bank were exchanged for an equal number of shares in First Citizens Bancshares, Inc.

NOTE 3 - CONTINGENT LIABILITIES

There is no material pending or threatened litigation as of the current reportable date that would result in a liability.

NOTE 4 - LOANS AND ALLOWANCE FOR LOAN LOSSES

In conformity with Statement of Financial Accounting Standard (SFAS) No. 114, the Company recognized loans as impaired with carrying values of approximately $14.8 million as of March 31, 2009 and $12.2 million as of December 31, 2008. Specific allocations in the reserve for loan losses related to impaired loans totaled $2.8 million as of March 31, 2009 and $2.0 million at December 31, 2008. Average investment in impaired loans in first quarter 2009 was $13.5 million compared to $10.0 million during year ended December 31, 2008, respectively. Interest income recognized on impaired loans on an accrual basis is approximately $208,000 for first quarter 2009 compared to approximately $150,000 for first quarter 2008.

NOTE 5 - INVESTMENT SECURITIES AND DERIVATIVE TRANSACTIONS

The amortized cost and fair value of securities as of March 31, 2009 and December 31, 2008 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
As of March 31, 2009 (in thousands):				
Securities Held-to-Maturity:				
Obligations of States and Political Subdivisions	$ -	$ -	$ -	$ -
Securities Available-for-Sale:				
U. S. Treasury Securities and Obligations of U. S. Government Agencies and Corporations	$ 133,537	$ 4,822	$ (2)	$ 138,356
Obligations of States and Political Subdivisions	66,313	2,355	(433)	68,236
All Others	3,939	5	(2,185)	1,759
	$ 203,789	$ 7,182	$ (2,620)	$ 208,351
As of December 31, 2008 (in thousands):				
Securities Held-to-Maturity:				
Obligations of States and Political Subdivisions	$ 115	$ -	$ -	$ 115
Securities Available-for-Sale:				
U. S. Treasury Securities and Obligations of U. S. Government Agencies and Corporations	$ 144,596	$ 3,688	$ (14)	$ 148,269
Obligations of States and Political Subdivisions	59,196	1,065	(788)	59,474
All Others	3,939	7	(1,304)	2,642
	$ 207,731	$ 4,760	$ (2,106)	$ 210,385

In reviewing the investment portfolio for other-than-temporary impairment of individual securities, consideration is given but not limited to (1) the length of time in which fair value has been less than cost and the extent of the unrealized loss, (2) the financial condition of the issuer, and (3) the positive intent and ability of the Company to maintain its investment in the issuer for a time that would provide for any anticipated recovery in the fair value. With respect to unrealized losses on securities noted and the analysis performed relating to the securities, management currently believes that declines in market value are not other-than-temporary and asserts positive intent and ability to hold such investments until anticipated recovery.

Generally accepted accounting principles have established accounting and reporting standards for derivative financial instruments, including certain derivative instruments embedded in other contracts and for hedging activities. These standards require that derivatives be reported either as assets or liabilities on the balance sheets and be reflected at fair value. The accounting for changes in the fair value of a derivative instrument depends on the intended use of the derivative and the resulting designation. The Company has one derivative transaction, which is an interest rate swap that was purchased in June 2000. Since a Federal Home Loan Bank Variable LIBOR Borrowing has been designated as the hedged item and in doing so, the Company has effectively fixed the cost of this liability. As a floating rate liability was hedged, there are no significant fluctuations in its market value but there are fluctuations in the cash flows. Thus, the swap is designated as a cash flow hedge, hedging the "benchmark interest rate." The market value gain or loss of the swap is adjusted through other comprehensive income. The purpose of the transaction was to reduce exposure to interest rate risk. Volume of the transaction is $1.5 million and the term is 10 years.

The cash flow hedge has produced negative income because First Citizens swapped a fixed cash flow for a variable cash flow and rates later decreased. The value of the derivative has fluctuated since inception, as have rates, but remains in a negative position as of current quarter end. Value of the derivative improved modestly during the quarter ended March 31, 2009. Accumulated other comprehensive income reflects a negative value of approximately $129,000, gross and $80,000, net of tax. See Note 10 regarding determination of fair value of the derivative.

NOTE 6 - GOODWILL AND INTANGIBLE ASSETS

Goodwill is not amortized and is tested for impairment annually or more frequently if events and circumstances indicate that the asset might be impaired. The goodwill impairment test is conducted in first quarter annually and is a two-step test. The first step, used to identify potential impairment, involves comparing each reporting unit's estimated fair value to its carrying value, including goodwill. Currently the Company has one reporting unit and does not meet the tests to segment per SFAS No. 131. If the estimated fair value of the reporting unit exceeds its carrying value, goodwill is considered not to be impaired. If the carrying value exceeds estimated fair value, there is an indication of potential impairment and the second step is performed to measure the amount of impairment.

If required, the second step involves calculating an implied fair value of goodwill which is determined in a manner similar to the amount of goodwill calculated in a business combination, by measuring the excess of the estimated fair value of the reporting unit, as determined in the first step, over the aggregate estimated fair values of the individual assets, liabilities and identifiable intangibles as if the reporting unit was being acquired in a business combination. If the implied fair value of goodwill exceeds the carrying value of goodwill assigned to the reporting unit, there is no impairment. If the carrying value of goodwill exceeds the implied fair value of the goodwill, an impairment charge is recorded for the excess. An impairment loss cannot exceed the carrying value of goodwill.

Our stock price has historically traded above its book value per common share and tangible book value per common share and was trading above its book value per common share and tangible book value per common share as of March 31, 2009. In the event our stock price were to trade below its book value per common share and tangible book value per common share, an evaluation of the carrying value of goodwill would be performed as of the reporting date. Such a circumstance would be one factor in our evaluation that could result in an eventual goodwill impairment charge. Additionally, should our future earnings and cash flows decline and/or discount rates increase, an impairment charge to goodwill and other intangible assets may also be required.

No impairment of goodwill is recorded in the current or prior reportable periods. Total goodwill as of the reportable date is $11.8 million or 1.28% of total assets or 15.01% of total capital.

Amortization expense of the other identifiable intangibles for the quarter was approximately $21,000 for 2009 and approximately $21,000 for 2008.

NOTE 7 - LONG TERM OBLIGATIONS

In March 2002, the Company. formed a wholly owned subsidiary, First Citizens (TN) Statutory Trust as a Delaware statutory trust. The subsidiary was formed for the purpose of issuing preferred securities and conveying the proceeds to the Company in exchange for long-term, subordinated debentures issued by the Company. The debentures are the sole assets of the trust. The Company owns 100% of the common stock of the trust.

On March 26, 2002, the Company, through its Trust subsidiary, issued 5,000 floating rate Trust Preferred Securities in denominations of $1,000 for a total of $5,000,000, which mature thirty (30) years from the date of issuance. Interest is payable on March 26, June 26, September 26 and December 26 of each year during the term. The interest rate is calculated quarterly equal to the three-month LIBOR interest rate plus 3.6%. Responsibilities of the Company concerning the debentures and related documents constitute a full and unconditional guarantee by the Company of the Trust issuer's preferred securities. In March 2007, First Citizens (TN) Statutory Trust II was terminated and the related debt was refinanced through First Citizens (TN) Statutory Trust IV, which is discussed below.

In March 2005, the Company formed a wholly owned subsidiary First Citizens (TN) Statutory Trust III. The trust is a Delaware statutory trust for the sole purpose of issuing and selling preferred securities and using proceeds from the sale to acquire long term subordinated debentures issued by the Company. Debentures are the sole assets of the trust. The Company owns 100% of the common stock of the trust.

On March 17, 2005 the Company through its wholly owned subsidiary, First Citizens (TN) Statutory Trust III, sold 5,000 of its floating rate Preferred Trust Securities at a liquidation amount of $1,000 per security for an aggregate amount of $5,000,000. For the period beginning on (and including) the date of original issuance and ending on (but excluding) June 17, 2005 the rate per annum was 4.84%. For each successive three-month period beginning on (and including) June 17, 2005, and each succeeding interest payment date at a rate per annum equal to the 3-month LIBOR plus 1.80%. Interest payment dates are: March 17, June 17, September 17, and December 17 during the 30-year term. The entire $5 million in proceeds was used to reduce a revolving line of credit with First Tennessee Bank. The Company's obligation under the debentures and related documents constitute a full and unconditional guarantee by the Company of the trust issuer's obligations under the Preferred Securities.

In March 2007, the Company formed a wholly owned subsidiary First Citizens (TN) Statutory Trust IV. The trust is a Delaware statutory trust for the sole purpose of issuing and selling preferred securities and using proceeds from the sale to acquire long term subordinated debentures issued by the Company. Debentures are the sole assets of the trust. The Company owns 100% of the common stock of the trust.

In March 2007, the Company through its wholly owned subsidiary, First Citizens (TN) Statutory Trust IV, sold 5,000 of its floating rate Trust Preferred Securities at a liquidation amount of $1000 per security for an aggregate amount of $5,000,000. For the period beginning on (and including) the date of original issuance and ending on (but excluding) June 15, 2007 the rate per annum of 7.10%. For each successive period beginning on (and including) June 15, 2007, and each succeeding interest payment date at a rate per annum equal to the 3-month LIBOR plus 1.75%. Interest payment dates are: March 15, June 15, September 15, and December 15 during the 30-year term. The purpose of sale of preferred securities was to refinance debt issued through First Citizens (TN) Statutory Trust II (discussed above) at a lower spread to LIBOR and results in savings of $92,500 annually. The Company's obligation under the debentures and related documents constitute a full and unconditional guarantee by the Company of the Trust issuer's obligations under the Trust Preferred Securities.

Although for accounting presentation, the Preferred Trust Securities are treated as debt, the outstanding balance qualifies as Tier I capital subject to the provision that the amount of the securities included in Tier I Capital cannot exceed twenty-five percent (25%) of total Tier I capital.

The Company is dependent on the profitability of the Bank and its subsidiaries and their ability to pay dividends in order to service its long-term debt.

The Bank has long-term advances from the FHLB totaling approximately $65 million as of March 31, 2009 and $63 million as of December 31, 2008. These advances bear interest at rates which vary from 1.89% to 6.55% with a weighted average rate of 4.85% as of March 31, 2009. Most of the FHLB borrowings have quarterly call features and maturities range from 2009 to 2017. If a convertible advance is called, the Company has the option to pay off the advance without penalty or to have the advance reprice at a variable rate tied to the 90-day LIBOR. If a putable advance is called, the Company is required to re-pay the obligation. Collateral for the FHLB advances consists of the Bank's entire portfolio of fully disbursed, one-to-four family residential mortgages and multi-family residential mortgages as well as the commercial loan portfolio, agriculture portfolio and second mortgages on 1-4 family residential properties. The Bank had additional borrowing capacity of approximately $36 million as of March 31, 2009.

NOTE 8 - REVOLVING LINE OF CREDIT

The Company has a $5 million one-year line of credit with First Tennessee Bank that is renewed annually. As of current quarter end, there is no outstanding balance drawn on this line. Interest on the outstanding balance is payable quarterly and is based on 100 basis points below the base prime rate of First Tennessee Bank.

NOTE 9 - ADOPTION OF EITF 06-04 ACCOUNTING FOR ENDORSEMENT SPLIT DOLLAR LIFE INSURANCE PLANS WITH POSTRETIREMENT BENEFITS

The Company adopted EITF 06-4 effective January 1, 2008. The cumulative adjustment to retained earnings for this change in accounting principle is $1.9 million to accrue the postretirement death benefits for endorsement split dollar life insurance plans. Expense related to these accruals is estimated at $165,000 for the year ended December 31, 2009. Expense related to these plans for first quarter 2009 is approximately $41,000 compared to approximately $66,000 in first quarter 2008. This expense is included in the Salaries and Benefits Expense on the Consolidated Statement of Income.

NOTE 10 - FAIR VALUE MEASUREMENTS

Fair value measurements are used to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. The Company adopted SFAS No. 157, "Fair Value Measurements" ("SFAS 157") effective January 1, 2008 for all applicable financial and non-financial assets and liabilities. SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosure requirements regarding fair value measurements. This standard does not expand the use of fair value in any new circumstances but clarifies the principle that fair value should be based on assumptions that market participants would use when pricing the asset or liability. The standard outlines the following three acceptable valuation techniques that may be used to measure fair value:

a. Market approach-The market approach uses prices and other relevant information generated by market transactions involving identical or similar assets or liabilities. This technique includes matrix pricing that is a mathematical technique used principally to value debt securities without relying solely on quoted prices for specific securities but rather by relying on securities' relationship to other benchmark quoted securities.

b. Income approach-The income approach uses valuation techniques to convert future amounts such as earnings or cash flows to a single present discounted amount. The measurement is based on the value indicated by current market expectations about those future amounts. Such valuation techniques include present value techniques, option-pricing models (such as Black-Scholes-Merton formula and a binomial model), and multi-period excess earnings method (used to measure fair value of certain intangible assets).

c. Cost approach-The cost approach is based on current replacement cost which is the amount that would currently be required to replace the service capacity of an asset.

Valuation techniques are selected as appropriate for the circumstances and for which sufficient data is available. Valuation techniques are to be consistently applied but a change in valuation techniques or its application may be made if the change results in a measurement that is equally or more representative of fair value in the circumstances. Revisions resulting from a change in valuation technique or its application are accounting for as a change in accounting estimate (in accordance with SFAS No. 154, "Accounting Changes and Error Corrections") which does not require the change in accounting estimate to be accounted for by restating or retrospectively adjusting amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.

SFAS 157 also establishes a hierarchy that prioritizes information used to develop those assumptions. The level in the hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company considers an input to be significant if it drives more than 10% of the total fair value of a particular asset or liability. The hierarchy is as follows:

Level 1 Inputs (Highest ranking): Unadjusted quoted prices in active markets for identical assets or liabilities that the entity has the ability to access at the measurement date.

Level 2 Inputs: Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Such inputs may include quoted prices for similar assets or liabilities in active markets, and inputs other than quoted market prices that are observable for the assets and liabilities such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 Inputs (Lowest ranking): Unobservable inputs for determining fair values of assets and liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets and liabilities.

Assets and liabilities may be measured for fair value on a recurring basis (daily, weekly, monthly or quarterly) or on a non-recurring basis in periods subsequent to initial recognition. Recurring valuations are measured regularly for investment securities and the cash flow hedge. Loans held for sale, other real estate and impaired loans are measured at fair value on a non-recurring basis and do not necessarily result in a change in the amount recorded on the balance sheet. Generally, these assets have non-recurring valuations that are the result of application of other accounting pronouncements that require the assets be assessed for impairment or at the lower of cost or fair value. Fair values of loans held for sale are considered Level 2. Fair values for other real estate and impaired loans are considered Level 3.

The Company obtains fair value measurements for securities and the cash flow hedge from a third party vendor. The cash flow hedge and the majority of the available-for-sale securities are valued using Level 2 inputs. Collateralized debt obligation securities that are backed by trust preferred securities and account for less than 2% of the available-for-sale securities portfolio are valued using Level 3 inputs. The fair value measurements reported in Level 2 are primarily matrix pricing that considers observable data (such as dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and terms and conditions of bonds, and other factors). Fair value measurements for trust-preferred securities are obtained through the use of valuation models that include unobservable inputs which are considered Level 3.

Effective January 1, 2008, the Company adopted provisions of SFAS No. 159, "The Fair Value Option for Financial Assets and Fi