

PICO HOLDINGS INC /NEW

Form 10-Q

November 09, 2011

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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FORM 10-Q

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

For the quarterly period ended September 30, 2011

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 033-36383

PICO HOLDINGS, INC.

(Exact Name of Registrant as Specified in Its Charter)

California

(State or other jurisdiction of  
incorporation)

33-36383

(Commission File Number)

94-2723335

(IRS Employer  
Identification No.)

7979 Ivanhoe Avenue, Suite 300

La Jolla, California 92037

(Address of principal executive offices) (Zip code)

Registrant's Telephone Number, Including Area Code:

(858) 456-6022

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes ☒ No ☐

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

Large accelerated filer

☒

Accelerated filer

☐

Non-accelerated filer

☐

Smaller reporting company

☐

(Do not check if a smaller reporting  
company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

On November 9, 2011, the registrant had 22,704,904 shares of common stock, \$0.001 par value outstanding.

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PICO HOLDINGS, INC.

FORM 10-Q

For the Nine Months Ended September 30, 2011

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## Part I: Financial Information

## Item I: Condensed Consolidated Financial Statements

## PICO HOLDINGS, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	September 30, 2011 (Unaudited)	December 31, 2010
<b>ASSETS</b>		
Available-for-sale investments:		
Fixed maturities	\$39,436	\$41,010
Equity securities	48,856	110,410
Total available-for-sale investments	88,292	151,420
Other investments	2,060	7,228
Total investments	90,352	158,648
Cash and cash equivalents	94,374	114,759
Notes and other receivables, net	9,924	9,251
Reinsurance receivables	13,446	14,551
Real estate and water assets, net	352,861	355,570
Property and equipment, net	74,129	12,590
Net deferred income taxes		20,039
Other assets	13,559	7,094
Total assets	\$648,645	\$692,502
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Reserves for unpaid losses and loss adjustment expenses	\$21,385	\$22,816
Debt	63,059	45,743
Deferred compensation	35,794	37,879
Other liabilities	12,908	15,340
Total liabilities	133,146	121,778
Commitments and contingencies		
Common stock, \$.001 par value; authorized 100,000 shares, 27,122 issued and 22,705 outstanding at September 30, 2011, and 27,117 issued and 22,700 outstanding at December 31, 2010	27	27
Additional paid-in capital	545,470	542,072
Retained earnings	38,889	88,830
Accumulated other comprehensive income	825	15,327
Treasury stock, at cost (common shares: 4,417 in 2011 and in 2010)	(78,152)	(78,152)
Total PICO Holdings, Inc. shareholders' equity	507,059	568,104
Noncontrolling interest in subsidiaries	8,440	2,620
Total shareholders' equity	515,499	570,724
Total liabilities and shareholders' equity	\$648,645	\$692,502

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



## PICO HOLDINGS, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS - UNAUDITED

(In thousands, except per share data)

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Revenues:				
Sale of real estate and water assets	\$14,444	\$51	\$22,156	\$3,791
Net investment income	872	1,619	3,350	4,981
Net realized gain on sale and impairment of investments	5,781	5,203	18,291	10,016
Other	443	624	1,374	2,134
Total revenues	21,540	7,497	45,171	20,922
Costs and expenses:				
Operating and other costs	8,787	9,566	24,424	28,758
Impairment loss on real estate and water assets	16,224		16,224	
Cost of real estate and water assets sold	9,922	5	15,845	2,453
Depreciation and amortization	428	351	1,091	1,003
Interest		328	146	1,237
Total costs and expenses	35,361	10,250	57,730	33,451
Loss before income taxes	(13,821)	) (2,753)	) (12,559)	) (12,529)
Provision (benefit) for federal, foreign, and state income taxes	27,342	(1,613)	) 26,759	(4,757)
Equity in loss of unconsolidated affiliate	(1,576)	) (942)	) (5,293)	) (2,413)
Net loss	(42,739)	) (2,082)	) (44,611)	) (10,185)
Noncontrolling interests	(7,182)	) 764	(5,330)	) 2,305
Net loss attributable to PICO Holdings, Inc.	\$(49,921)	) \$(1,318)	) \$(49,941)	) \$(7,880)
Net loss per common share – basic and diluted:	\$(2.20)	) \$(0.06)	) \$(2.20)	) \$(0.35)
Weighted average shares outstanding	22,700	22,657	22,700	22,621

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

## PICO HOLDINGS, INC.

## CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY AND COMPREHENSIVE LOSS - UNAUDITED

NINE MONTHS ENDED SEPTEMBER 30, 2011 AND 2010

(In thousands)

	Common Stock Shares Outstanding	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock, Shares	Treasury Stock, at Cost	Non- controlling Interest	Comprehensive Loss attributable to PICO Holdings, Inc.	Total
Beginning balance, January 1, 2011	27,117	\$ 27	\$542,072	\$88,830	\$ 15,327	4,417	\$(78,152)	\$ 2,620		\$570,724
Stock-based compensation expense	5		3,398							3,398
Changes in ownership of noncontrolling interest								490		490
Comprehensive loss:										
Net loss				(49,941 )				5,330	\$(49,941 )	(44,611 )
Other comprehensive loss, net of tax:										
Unrealized loss on securities					(12,746 )				(12,746 )	(12,746 )
Foreign currency translation					(1,756 )				(1,756 )	(1,756 )
Other comprehensive loss									(14,502 )	(14,502 )
Comprehensive loss									\$(64,443 )	\$(59,113 )
Ending balance, September 30, 2011	27,122	\$ 27	\$545,470	\$38,889	\$ 825	4,417	\$(78,152)	\$8,440		\$515,499

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	Common Stock Shares Outstanding	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock, Shares	Treasury Stock, at Cost	Non- controlling Interest	Comprehensive Loss attributable to PICO Holdings, Inc.	Total
Beginning balance, January 1, 2010	27,020	\$ 27	\$ 539,792	\$ 100,002	\$ 21,094	4,425	\$(78,272)	\$(2,948)		\$ 579,695
Stock-based compensation expense	5		3,838							3,838
Exercise of restricted stock unit	92		(2,086)	)						(2,086)
Stock-based compensation income tax benefits (deficiencies)			(1,157)	)						(1,157)
Disposition of treasury stock from deferred compensation plans			136				120			256
Comprehensive loss:										
Net loss				(7,880)	)			(2,305)	)	\$(7,880)
Other comprehensive loss, net of tax:										
Unrealized loss on securities					(1,323)	)			(1,323)	)
Foreign currency translation					(400)	)			(400)	)
Other comprehensive loss									(1,723)	)
Comprehensive loss									\$(9,603)	)
Ending balance, September 30, 2010	27,117	\$ 27	\$ 540,523	\$ 92,122	\$ 19,371	4,425	\$(78,152)	\$(5,253)		\$ 568,638

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



PICO HOLDINGS, INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS - UNAUDITED  
 (In thousands)

	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
<b>OPERATING ACTIVITIES:</b>		
Net cash used in operating activities	\$(26,590)	) \$(56,033)
<b>INVESTING ACTIVITIES:</b>		
Purchases of investments	(13,468)	) (29,258)
Proceeds from sale of investments	72,857	24,168
Proceeds from maturity of investments	2,386	22,608
Purchases of property and equipment	(61,757)	) (932)
Other investing activities, net	(102)	) 9
Net cash provided by (used in) investing activities	(84)	) 16,595
<b>FINANCING ACTIVITIES:</b>		
Debt issuance costs	(4,107)	)
Repayment of debt	(7,508)	) (2,590)
Proceeds from debt	18,886	
Net cash provided by (used in) financing activities	7,271	(2,590)
Effect of exchange rate changes on cash	(982)	) (1,189)
<b>DECREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(20,385)</b>	<b>) (43,217)</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<b>114,759</b>	<b>154,545</b>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$94,374</b>	<b>\$111,328</b>
<b>SUPPLEMENTAL CASH FLOW INFORMATION:</b>		
Payment for federal, foreign, and state income taxes	\$16	\$2,463
Interest paid, net of amounts capitalized	\$97	\$1,225
Non-cash investing and financing activities:		
Mortgage incurred to purchase real estate	\$5,276	\$2,970

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

PICO HOLDINGS, INC. AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of PICO Holdings, Inc. and subsidiaries (collectively, the "Company" or "PICO") have been prepared in accordance with the interim reporting requirements of Form 10-Q, pursuant to the rules and regulations of the United States Securities and Exchange Commission (the "SEC"). Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America ("U.S. GAAP") for complete consolidated financial statements.

In the opinion of management, all adjustments and reclassifications considered necessary for a fair and comparable presentation of the financial statements presented have been included and are of a normal recurring nature. Operating results presented are not necessarily indicative of the results that may be expected for the year ending December 31, 2011.

These condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements and notes thereto contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2010 filed with the SEC.

The preparation of financial statements in accordance with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses for each reporting period. The significant estimates made in the preparation of the Company's consolidated financial statements relate to the assessment of other-than-temporary impairments, the application of the equity method of accounting, unpaid losses and loss adjustment expenses, real estate and water assets, deferred income taxes, stock-based compensation, and contingent liabilities. While management believes that the carrying value of such assets and liabilities are appropriate as of September 30, 2011, and December 31, 2010, it is reasonably possible that actual results could differ from the estimates upon which the carrying values were based.

Stock-Based Compensation:

At September 30, 2011, the Company had one stock-based payment arrangement outstanding:

The PICO Holdings, Inc. 2005 Long Term Incentive Plan (the "Plan"): The Plan provides for the grant or award of various equity incentives to PICO employees, non-employee directors, and consultants. A total of 2,654,000 shares of common stock are issuable under the Plan and it provides for the issuance of incentive stock options, non-statutory stock options, free-standing stock-settled stock appreciation rights ("SAR"), restricted stock awards ("RSA"), performance shares, performance units, restricted stock units ("RSU"), deferred compensation awards, and other stock-based awards. The Plan allows for broker assisted cashless exercises and net-settlement of income taxes and employee withholding taxes. Upon exercise of a SAR and RSU, the employee will receive newly issued shares of PICO Holdings common stock with a fair value equal to the in-the-money value of the award, less applicable federal, state and local withholding and income taxes (however, the holder of an RSU can elect to pay withholding taxes in cash).

The Company has three different equity incentive awards outstanding under the Plan at September 30, 2011, and during the three and nine months ended September 30, 2011, the Company recorded \$1.1 million and \$3.4 million of stock-based compensation expense, respectively. During the three and nine months ended September 30, 2010, the company recorded \$1.3 million and \$3.8 million of stock-based compensation expense, respectively.

A summary of activity of the RSU and RSA is as follows:

	RSU	RSA
Outstanding at January 1, 2011	594,000	4,200
Granted		5,046
Vested		(4,200 )
Outstanding at September 30, 2011	594,000	5,046
Unrecognized compensation cost (in thousands)	\$ 11,124	\$ 98

#### Stock-Settled Stock Appreciation Rights:

There were no SAR granted or exercised during the nine months ended 2011 or 2010. However, 10,000 SAR expired worthless during the nine months ended September 30, 2011.

There was no compensation expense recognized for SAR during the three and nine months ended September 30, 2011 as there were no unvested SAR in those periods. Compensation expense recognized for SAR for the three and nine months ended September 30, 2010, was \$182,000 and \$728,000 respectively. At September 30, 2011, there are no unvested SAR.

A summary of SAR activity is as follows:

	SAR	Weighted Average Exercise Price	Weighted Average Contractual Term
Outstanding at January 1, 2011	1,822,079	\$36.15	5.5 years
Expired	(10,000)	\$33.76	
Outstanding and exercisable at September 30, 2011	1,812,079	\$36.15	5 years

At September 30, 2011, none of the outstanding SAR were in-the-money.

#### Deferred Compensation:

The Company reports the investment returns generated in the deferred compensation accounts within the Company's financial statements (with a corresponding increase in the trust assets) and an expense is reported in operating and other costs for increases in the market value of the assets held with a corresponding increase in the deferred compensation liability (except in the case of PICO stock, which is reported as treasury stock, at cost). In the event the trust assets decline in value, the Company reverses previously expensed compensation.

At September 30, 2011 and December 31, 2010, the Company had \$35.8 million and \$37.9 million, respectively, recorded as deferred compensation payable to various members of management and certain non-employee members of the board of directors of the Company. The assets of the plan are held in Rabbi Trust accounts. Such accounts hold various investments that are consistent with the Company's investment policy, and accounted and reported for as available-for-sale securities in the accompanying condensed consolidated balance sheets. Assets of the trust will be distributed according to predetermined payout elections established by each participant.

The deferred compensation liability decreased by \$2.1 million during the nine months ended September 30, 2011 primarily due to \$3.4 million in distributions of plan assets to participants, offset by an increase in the fair value of the assets of \$1.3 million. Included in operating and other costs in the accompanying condensed consolidated statements of operations for the three and nine months ended September 30, 2011 is a recovery of compensation expense of \$918,000 and an expense of \$1.3 million, respectively. For the three and nine months ended September 30, 2010, operating and other costs includes compensation expense of \$3.8 million and \$5.5 million, respectively.

#### Real Estate and Water Assets, Impairment of Intangible Assets:

All real estate and tangible water assets are classified as held and used until management commits to a plan to sell the assets, the asset is available for sale in its present condition, is being actively marketed for sale, and it is probable that the asset will be sold within the next year. At September 30, 2011 and December 31, 2010, the Company had \$6.3 million and \$4.3 million of real estate classified as held for sale, respectively.

The Company's intangible assets consist primarily of certain water rights, water credits, and the exclusive right to use assets that the Company constructed and later dedicated to various municipalities located in select markets in Nevada, primarily in Washoe and Lyon counties. The rights have indefinite useful lives and are therefore not amortized. Intangible assets with indefinite lives are tested for impairment at least annually, or more frequently if events or changes in circumstances indicate that the asset may be impaired, by comparing the fair value of the assets to their carrying amounts.

In response to specific events and changes in circumstances during the third quarter of 2011, the Company completed impairment testing for its intangible assets. The fair value of these assets is calculated using discounted cash flow models that incorporate a wide range of assumptions including current asset pricing, price escalation, discount rates, absorption rates, and timing of sales, and costs. These models are sensitive to minor changes in any of the input variables. Given the dramatic and prolonged slow-down in housing starts and sales in the North Valleys of Reno, Nevada, and the recent decline in market prices for similar assets, the Company adjusted its assumptions and judgments in the model for the price, timing and absorption of water sales from our prior projections for the Fish Springs water credits and pipeline rights and Carson Lyon water assets. These changes in assumptions and judgments resulted in a fair value of the Fish Springs asset of approximately \$84.9 million compared to its carrying value of \$101.1 million. Consequently, an impairment charge of \$16.2 million was recorded in the third quarter of 2011, to reduce the carrying value to fair value. This is the only such impairment charge recorded on this asset and there were no other impairment charges on any other intangible assets recorded in the period.

Due to the impairment charge recorded on the Fish Springs water asset, the Company reassessed the previous method of attributing the 49% partner's share of the losses at Fish Springs. Accordingly, the Company reversed previously attributed losses amounting to \$7.4 million in the third quarter of 2011 such that the 49% partner's noncontrolling interest balance is now zero.

#### Notes and Other Receivables:

Notes and other receivables include installment notes from the sale of real estate and water assets. These notes generally have terms ranging from three to ten years, with interest rates from 8% to 10%. The Company records a provision for doubtful accounts to allow for any specific accounts which may be unrecoverable and is based upon an analysis of the Company's prior collection experience, customer creditworthiness, current economic trends and underlying value of the real estate. The notes are typically secured by the assets which allows the Company to recover the underlying property if and when a buyer defaults. No significant provision for bad debts was required on any installment notes from the sale of real estate and water assets during the nine months ended September 30, 2011 and 2010.

#### Operating and Other Costs:

Operating and other costs include a foreign currency gain or loss that results primarily from a Swiss Franc denominated loan from PICO Holdings to one of its subsidiaries. For the three and nine months ended September 30, 2011 the Company reported a foreign currency loss of \$1.7 million and a gain of \$1.1 million, respectively. For the three and nine months ended September 30, 2010, the Company reported a foreign currency gain of \$2.9 million and \$1.8 million, respectively.

#### Accounting for Income Taxes:

The Company's provision for income tax expense includes federal, foreign and state income taxes currently payable and those deferred because of temporary differences between the income tax and financial reporting bases of the assets and liabilities. The liability method of accounting for income taxes also requires the Company to reflect the effect of a tax rate change on accumulated deferred income taxes in income in the period in which the change is enacted.

In assessing the realization of deferred income taxes, management considers whether it is more likely than not that any deferred income tax assets will be realized. The ultimate realization of deferred income tax assets is dependent upon the generation of future taxable income during the period in which temporary differences become deductible. If it is more likely than not that some or all of the deferred income tax assets will not be realized a valuation allowance is recorded. As a result of the analysis of all available evidence as of September 30, 2011, the Company concluded that it

was not more likely than not that the deferred tax assets would be realized and accordingly, a full valuation allowance was established against the net deferred tax assets in the amount of \$32.2 million.

The Company has considered the following possible sources of taxable income when assessing the realization of the deferred tax assets: (1) future reversals of existing taxable temporary differences; (2) taxable income in prior carryback years; (3) tax planning strategies; and (4) future taxable income exclusive of reversing temporary differences and carryforwards. Reliance on future U.S. taxable income as an indicator that a valuation allowance is not required is difficult when there is negative evidence such as the Company's cumulative losses in recent years. In considering the evidence as to whether a valuation allowance is needed, the existence of cumulative losses in recent years is a factor that is accorded significant weight in the Company's assessment. As a result, a determination was made that there was not sufficient positive evidence to enable the Company to conclude that it was more likely than not that these deferred tax assets would be realized. Therefore, the Company has provided a full valuation allowance against the Company's net deferred tax assets. This assessment will continue to be undertaken in the future. The Company's results of operations may be impacted in the future by the Company's inability to realize a tax benefit for future tax losses or for items that will generate additional deferred tax assets. The Company's results of operations might be favorably impacted in the future by reversals of valuation allowances if the Company is able to demonstrate sufficient positive evidence that the Company's deferred tax assets will be realized. Furthermore, any income reported in future periods from the sale of assets or the operations of PICO Northstar Hallock, LLC ("Northstar"), an 88% owned subsidiary, which is constructing a canola seed crushing facility in Hallock, Minnesota would represent objective positive evidence and may result in a full or partial reversal of the valuation allowance.

The Company recognizes any uncertain income tax positions on income tax returns at the largest amount that is more-likely-than-not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained.

The Company recognizes any interest and penalties related to uncertain tax positions in income tax expense. For the nine months ended September 30, 2011 and 2010, the Company recorded approximately \$24,000 and \$116,000, respectively, in interest related to uncertain tax positions.

The Company reported an income tax expense of \$26.8 million and an income tax benefit of \$4.8 million for the nine months ended September 30, 2011 and 2010, respectively. The effective income tax rate for the three and nine months ended September 30, 2011, was a tax provision of 198%, and 213%, respectively, and a tax benefit of 59% and 38% for the three and nine months ended September 30, 2010, respectively. For the three and nine months ended September 30, 2011, the effective rate differs from the statutory rate of 35% primarily due to recording a full valuation allowance on the net deferred tax assets. The effective rate differs from the statutory rate in 2010 primarily due to foreign taxes, recording a tax benefit on the loss from unconsolidated affiliates in the tax provision, while the loss that creates that benefit is recorded below the tax provision on a separate line in the accompanying financial statements, offset by non-deductible compensation expense.

#### Debt:

During the nine months ended September 30, 2011, Northstar entered into a credit agreement with various lenders and ING Capital, LLC. Under the agreement, the lenders have committed to loan Northstar up to (i) \$89.5 million pursuant to senior secured, multi-draw term loans to fund construction of the project and (ii) \$10.5 million pursuant to a senior secured revolving credit facility to fund working capital upon project completion. Interest will accrue under the facility at a variable rate that is currently 5%. Repayment of interest on the term loans will be made quarterly and repayment of principal will be the earlier of the fifth anniversary of the project construction completion date and April 15, 2018. The revolving credit facility will be available until the earlier of either the fifth anniversary of project construction completion or April 15, 2018. Repayment of the loans may be accelerated by the lenders in the event certain covenants or conditions are not met. As of September 30, 2011, Northstar had drawn \$17 million under the loan (which includes \$2.8 million from PICO that is eliminated in consolidation).



The credit agreement contains the following significant financial covenants:

**Debt to Adjusted Capitalization Ratio:** Northstar will not permit its debt to adjusted capitalization ratio as of the last day of any Fiscal Quarter to be more than 0.60 to 1.00. Debt to adjusted capitalization ratio - as of any date, the ratio of (a) Total debt as of such date to (b) the sum of (i) total debt as of such date plus (ii) PICO Northstar, LLC's (parent company of Northstar) consolidated shareholders' equity as of such date plus (iii) an amount equal to the difference of (x) an amount equal to development expenses in an amount not to exceed \$8.4 million incurred in connection with the canola seed processing plant and integrated refinery but solely to the extent such development expenses are treated as current expenses (and are not capitalized) on the financial statements of Northstar in accordance with U.S. GAAP minus (y) the amount of development expenses referenced in clause (x) above that would have been amortized as of such date in accordance with U.S. GAAP had such development expenses been capitalized and not currently expensed.

**Debt Service Coverage Ratio:** Northstar will not permit its debt service coverage ratio to be less than 1.75 to 1.00 as of the last day of any fiscal quarter, beginning with the second full fiscal quarter ending after the project construction completion date, calculated for the four consecutive fiscal quarter period ending on each such date. Debt service coverage ratio - for any period, the ratio of (a) earnings before interest, taxes, depreciation and amortization (EBITDA) of Northstar and any of its subsidiaries for such period less (i) consolidated capital expenditures for such period (excluding that portion of consolidated capital expenditures that is financed by indebtedness (other than the obligations)) less (ii) permitted tax distributions with respect to such period less (iii) any other distributions made by the PICO Northstar, LLC to its members during such period to (b) debt service for such period.

**Minimum Net Worth of Borrower:** Northstar will not permit its net worth on any date to be less than \$60 million. Net worth - as of any date, is the amount by which Northstar's total assets exceed its total liabilities, determined on a consolidated basis in accordance with U.S. GAAP.

The Company was in compliance with all financial covenants related to the credit agreement at September 30, 2011.

In connection with the credit agreement, PICO entered into a standby purchase agreement with ING, under which ING has the right to cause PICO to become a lender under the credit agreement. Under the original terms of the credit facility underwriting, ING had the right to require PICO to purchase up to \$50 million if the facility was not fully syndicated by May 31, 2011. As of September 30, 2011, ING had syndicated \$83.3 million of the \$100 million resulting in a total commitment of up to \$16.7 million due from PICO. Subsequent to September 30, 2011, PICO assigned \$10 million of its \$16.7 million commitment to third parties. Pursuant to the terms of the credit agreement, the Company expects any term loans held by PICO will be refinanced into preferred membership units of Northstar.

PICO also entered into an agreement with ING under which it agreed to make further equity contributions to Northstar to cover any cost overruns in project construction. As of September 30, 2011, no cost overruns have been projected.

#### Recent Accounting Pronouncements

In September 2011, the FASB issued guidance on testing goodwill for impairment. The new guidance provides an entity the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity determines that this is the case, it is required to perform the currently prescribed two-step goodwill impairment test to identify potential goodwill impairment and measure the amount of goodwill impairment loss to be recognized for that reporting unit (if any). If an entity determines that the fair value of a reporting unit is greater than its carrying amount, the two-step goodwill impairment test is not required. The new guidance will be effective for the Company beginning July 1, 2012 but is not expected to have a material impact on the condensed consolidated financial statements.

In June 2011, the FASB issued guidance that requires the presentation of comprehensive income to report the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both cases, the Company is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. The revised guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, applied on a prospective basis. The Company will conform presentation when this guidance becomes effective and does not expect the change to have a material impact on the presentation of the condensed consolidated financial statements.

## 2. Net Loss Per Share

Basic earnings or loss per share is computed by dividing net earnings by the weighted average number of shares outstanding during the period. Diluted earnings or loss per share is computed similarly to basic earnings or loss per share except the weighted average shares outstanding are increased to include additional shares from the assumed exercise of any common stock equivalents using the treasury method, if dilutive. The Company's free-standing SAR and RSU are considered common stock equivalents for this purpose. The number of additional shares related to these common stock equivalents is calculated using the treasury stock method.

For the three and nine months ended September 30, 2011 and 2010, the Company's stock-settled SAR and RSU were excluded from the diluted per share calculation because their effect on the loss per share was anti-dilutive.

## 3. Comprehensive Loss

Comprehensive income or loss, net of income tax is comprised of the following (in thousands):

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Net income (loss)	\$ (42,739 )	\$ (2,082 )	\$ (44,611 )	\$ (10,185 )
Other comprehensive loss, net of tax:				
Unrealized depreciation on available-for-sale securities	(5,263 )	1,675	(12,746 )	(1,323 )
Foreign currency translation	(1,282 )	(41 )	(1,756 )	(400 )
Total other comprehensive loss, net of tax	(6,545 )	1,634	(14,502 )	(1,723 )
Comprehensive loss	(49,284 )	(448 )	(59,113 )	(11,908 )
Noncontrolling interest	(7,182 )	764	(5,330 )	2,305
Comprehensive loss attributable to PICO Holdings, Inc.	\$ (56,466 )	\$ 316	\$ (64,443 )	\$ (9,603 )

Total comprehensive loss is net of a deferred income tax charge of \$26 million and a benefit of \$1.5 million for the three months ended September 30, 2011 and 2010, respectively. For the nine months ended September 30, 2011 and 2010, total comprehensive loss is net of a deferred income tax charge of \$20 million and a benefit of \$4.5 million, respectively.

The components of accumulated other comprehensive income are as follows (in thousands):

	September 30, 2011	December 31, 2010
Net unrealized appreciation on available-for-sale investments	\$7,362	\$20,108
Foreign currency translation	(6,537 )	(4,781 )
Accumulated other comprehensive income	\$825	\$15,327

The accumulated balance is net of deferred income tax liability of \$407,000 at September 30, 2011 and \$8.4 million at December 31, 2010.

The following table reports the cost and carrying value of available-for-sale investments at September 30, 2011 and December 31, 2010 (in thousands):

September 30, 2011	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Carrying Value
Fixed maturities:				
U.S. Treasury securities	\$7,057	\$225	\$(2)	) \$7,280
Municipal bonds	3,126	266		3,392
Corporate bonds	25,972	629	(548)	) 26,053
Government sponsored enterprises	2,627	84		2,711
	38,782	1,204	(550)	) 39,436
Marketable equity securities	38,203	12,469	(1,816)	) 48,856
Total	\$76,985	\$13,673	\$(2,366)	) \$88,292
December 31, 2010	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Carrying Value
Fixed maturities:				
U.S. Treasury securities	\$4,911	\$56	\$(64)	) \$4,903
Municipal bonds	3,147	107		3,254
Corporate bonds	28,365	783	(675)	) 28,473
Government sponsored enterprises	4,193	187		4,380
	40,616	1,133	(739)	) 41,010
Marketable equity securities	80,664	30,687	(941)	) 110,410
Total	\$121,280	\$31,820	\$(1,680)	) \$151,420

The following table summarizes the market value of those investments in an unrealized loss position for periods less than or greater than 12 months (in thousands):

	2011		2010	
Less than 12 months	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
Fixed maturities:				
U.S. Treasury securities	\$552	\$2	\$3,494	\$64
Corporate bonds	8,444	161	11,286	196
	8,996	163	14,780	260
Marketable equity securities	11,247	1,057	5,907	459
Total	\$20,243	\$1,220	\$20,687	\$719
	2011		2010	
Greater than 12 months	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
Fixed maturities:				
Corporate bonds	\$7,043	\$387	\$7,053	\$479
Marketable equity securities	3,726	759	2,534	482
Total	\$10,769	\$1,146	\$9,587	\$961



**Marketable Equity Securities:** The Company's investments in marketable equity securities totaled \$48.9 million at September 30, 2011, and principally consist of common stock of publicly traded small-capitalization companies in the U.S. and selected foreign markets. At September 30, 2011, the Company reviewed all of its equity securities in an unrealized loss position and concluded certain securities were not other-than-temporarily impaired as the declines were not of sufficient duration and severity, and publicly-available financial information did not indicate impairment. The primary cause of the losses on those securities was normal market volatility. The securities that were other-than-temporarily were recorded as an impairment loss and amounted to \$988,000 and \$1 million, respectively, for the three and nine months ended September 30, 2011. During the three and nine months ended September 30, 2010, the Company recorded \$36,000 and \$347,000, respectively, of other-than-temporary impairment charges on marketable equity securities.

**Corporate Bonds and U.S. Treasury Obligations:** The Company owns various fixed maturity bonds in its portfolio. The U.S. Treasury, municipal, and government-sponsored enterprise bonds are typically held to meet state regulatory capital and deposit requirements for the insurance companies. The remainder of the bond portfolio consists of corporate bonds, which are purchased on a case by case basis depending on the maturity and yield-to-maturity of the bond and an analysis of the fundamental characteristics of the issuer. At September 30, 2011, there were unrealized losses on certain bonds in the portfolio. The Company does not consider those bonds to be other-than-temporarily impaired because the Company expects to hold, and will not be required to sell, these particular bonds, and it expects to recover the entire amortized cost basis at maturity. During the three and nine months ended September 30, 2011, and 2010, the Company did not record any impairment charges on investments in fixed maturity securities.

**Fair Value Measurements:**

The following table sets forth the Company's financial assets and liabilities that were measured at fair value on a recurring basis at September 30, 2011, and December 31, 2010, by level within the fair value hierarchy. Assets and liabilities measured at fair value are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the asset or liability.

The Company owns \$29.8 million of available-for-sale equity securities that trade on over-the-counter bulletin board markets. At September 30, 2011, the Company classified \$19.1 million of those securities as Level 2 due to the trading volumes being lower than normal, coupled with wide bid/ask spreads, lack of current publicly available information, or few or no recent transactions. A description of the levels follows the table below.

At September 30, 2011 (in thousands):

	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at September 30, 2011
Assets				
Available-for-sale securities (A)	\$69,158	\$19,134		\$88,292
Liabilities				
Deferred compensation (B)	\$35,794			\$35,794

At December 31, 2010 (in thousands):

	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at December 31, 2010
Assets				

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Available-for-sale securities (A)	\$132,677	\$18,743	\$151,420
Liabilities			
Deferred compensation (B)	\$37,879		\$37,879

(A) Where there are quoted market prices that are readily available in an active market, securities are classified as Level 1 of the valuation hierarchy. Level 1 available-for-sale investments are valued using quoted market prices multiplied by the number of shares owned and debt securities are valued using a market quote in an active market. All Level 2 available-for-sale securities are one class because they all contain similar risks and are valued using market prices and include securities where the markets are not active, that is where there are few transactions, or the prices are not current or the prices vary considerably over time. Inputs include directly or indirectly observable inputs such as quoted prices. Level 3 available-for-sale securities would include securities where valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets. This includes certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

(B) Deferred compensation plans are compensation plans directed by the Company and structured as a Rabbi Trust for certain executives and non-employee directors. The investment assets of the Rabbi Trust are valued using quoted market prices multiplied by the number of shares held in each trust account including the shares of PICO common stock held in the trusts. The related deferred compensation liability represents the fair value of the investment assets.

The following table sets forth the Company's non-financial assets that were measured at fair value on a non-recurring basis for the nine months ended September 30, 2011, by level within the fair value hierarchy. Assets and liabilities measured at fair value are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the asset (in thousands):

Assets	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Loss
(1) Intangible asset (exclusive right to use infrastructure)			\$84,900	\$16,224

(1) As of September 30, 2011, the Company had a non-recurring fair value measurement for an intangible asset with a carrying amount of \$101.1 million that was written down to its implied fair value of \$84.9 million, resulting in an impairment charge of \$16.2 million, which was included in earnings for 2011. The implied fair value was calculated using a discounted cash flow model that incorporated a wide range of assumptions including current asset pricing, price escalation, discount rates, absorption rates, and timing of sales, and costs. Given the continued dramatic and prolonged slow-down in housing starts and sales in the North Valleys of Reno, Nevada, and the recent decline in market prices for similar assets, the Company adjusted its assumptions and judgments in the model by reducing the price, lengthening the timing of absorption of water sales from the original projections.

#### Investment in Unconsolidated Affiliate (spigit inc.):

During the nine months ended September 30, 2011, spigit, inc. raised additional capital and as a result, the Company's ownership dropped from 37% to 32%. The Company's share of spigit's loss was \$1.6 million and \$5.3 million for the three and nine months ended September 30, 2011, respectively, and \$942,000, and \$2.4 million for the three and nine months ended September 30, 2010, respectively. The carrying value of the investment was zero and \$5.2 million at September 30, 2011 and December 31, 2010 respectively, and is reported in other investments in the accompanying balance sheets.

As the total losses recorded to date on the investment in spigit have reduced the carrying value to zero at September 30, 2011, the Company will not accrue any additional losses reported by spigit unless the Company decides to invest more capital into the operations. There are no plans or obligations to invest additional capital at this time.

The following is unaudited summarized financial information of spigit, inc. for the nine months ended September 30, 2011 and 2010 (in thousands):

	September 30, 2011	September 30, 2010
Revenues	\$6,093	\$3,035
Gross profit	\$3,746	\$2,671
Loss from continuing operations and net loss	\$(18,335)	\$(6,584)

#### 4. Disclosures About Fair Value of Financial Instruments:

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate such fair value:

— Cash and Cash Equivalents: Carrying amounts for these items approximate fair value because of the short maturity of these instruments. The majority of the Company's cash is held in the Federated Government Obligations Money Market Fund.

— Investments in fixed maturities and equity securities: Fair values are estimated based on quoted market prices, or dealer quotes for the actual or comparable securities. The Company regularly evaluates the carrying value of securities to determine whether there has been any diminution in value that is other-than-temporary.

— Debt: Carrying amounts for these items approximates fair value because they are based on current interest rates.

The table below presents the carrying values and estimated fair values for certain of the Company's financial instruments at September 30, 2011 (in thousands).

	September 30, 2011	
	Carrying Amount	Estimated Fair Value
Financial assets:		
Cash and cash equivalents	\$94,374	\$94,374
Fixed maturities	\$39,436	\$39,436
Equity securities	\$48,856	\$48,856
Notes and other receivables, net	\$9,924	\$9,924
Reinsurance receivable	\$13,446	\$13,446
Financial liabilities:		
Debt	\$63,059	\$63,059

#### 5. Segment Reporting

PICO is a diversified holding company engaged in five operating and reportable segments: Water Resource and Water Storage Operations, Real Estate Operations, Corporate, Insurance Operations in Run Off, and Agribusiness Operations.



The accounting policies of the reportable segments are the same as those described in the Company's 2010 Annual Report on Form 10-K filed with the SEC. During the nine months ended September 30, 2011, the insurance in run off segment paid a dividend to the corporate segment, consisting of cash, a publicly traded equity security, and a subsidiary holding various investments in publicly traded equity securities, changing the composition of both segments. As a result, all prior period segment results, including total assets, revenues, and income or loss before taxes for the insurance in run off segment and corporate segment have been restated to reflect the change in the segment composition as of the beginning of the earliest period presented in this report.

During the third quarter of 2011, the Company signed an agreement to sell Nevada Land and Resource Company, a wholly owned subsidiary of the Company, that is a component of the real estate segment.

Management analyzes segments using the following information:

Segment assets (in thousands):

	September 30, 2011	December 31, 2010
Total Assets:		
Water Resource and Water Storage Operations	\$204,315	\$226,496
Real Estate Operations	162,344	146,897
Corporate	108,507	125,789
Insurance Operations in Run Off	87,518	114,872
Agribusiness Operations	85,961	78,448
	\$648,645	\$692,502

Segment Assets:

During the nine months ended September 30, 2011, total assets of the water resource and water storage operations decreased \$22.2 million, primarily due to the \$16.2 million impairment charge recorded during the three months ended September 30, 2011. Total assets in the real estate operations increased \$15.4 million primarily due to acquisitions and development of real estate at UCP. Assets in the corporate segment decreased \$17.3 million primarily due to the recording of the valuation allowance on the net deferred tax assets offset by an increase in assets due to a dividend from the insurance operations in run off segment. Insurance operations in run-off decreased \$27.4 million primarily as a result of a dividend paid to the corporate segment.

Consolidated Assets:

On a consolidated basis, during the nine months ended September 30, 2011, total investments decreased \$68.3 million primarily due to the sale of equity securities, and property and equipment increased \$61.5 million primarily from construction costs for the canola plant being built in Hallock, MN. During the nine months ended September 30, 2011, the total deferred tax assets of the Company declined \$20 million due to the full valuation allowance recorded during the period.

Segment revenues and income or loss before taxes (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Revenues:				
Water Resource and Water Storage Operations	\$384	\$375	\$1,073	\$2,499
Real Estate Operations	14,585	611	22,928	4,336
Corporate	1,672	2,883	6,548	7,711
Insurance Operations in Run Off	4,898	3,628	14,614	6,376
Agribusiness Operations	1		8	
Total revenues	\$21,540	\$7,497	\$45,171	\$20,922
Income (Loss) Before Taxes:				
Water Resource and Water Storage Operations	\$(17,470)	\$(2,731)	\$(20,532)	\$(6,622)
Real Estate Operations	2,244	(792)	265	(2,462)
Corporate	(2,368)	(2,480)	(4,006)	(8,594)
Insurance Operations in Run Off	4,468	3,250	13,382	5,149
Agribusiness Operations	(695)		(1,668)	
Loss before income taxes	\$(13,821)	\$(2,753)	\$(12,559)	\$(12,529)

## 6. Commitments and Contingencies

The Company is subject to various other litigation matters that arise in the ordinary course of its business. Certain of our insurance subsidiaries are frequently a party in claims proceedings and actions regarding insurance coverage, all of which are considered routine and incidental to our business. Based upon information presently available, management is of the opinion that resolution of such litigation will not likely have a material adverse effect on the consolidated financial position, results of operations, or cash flows of the Company. Neither PICO nor its subsidiaries are parties to any potentially material pending legal proceedings other than the following.

On August 16, 2011 and August 26, 2011, Ronald Dennis and George Assad, respectively, each filed a shareholder derivative complaint, purportedly on behalf of the Company, against the Company's directors in the Superior Court of California, County of San Diego, (the "Derivative Actions"). The Derivative Actions allege a combination of claims for breach of fiduciary duty, gross mismanagement, contribution and indemnification, abuse of control, waste of corporate assets and unjust enrichment in connection with the May 13, 2011 shareholder advisory vote on the Company's 2010 executive compensation pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act and the 2010 executive compensation underlying the vote. On September 30, 2011, the Company removed each of the Derivative Actions to the United States District Court, Southern District of California. On October 7, 2011, the Company filed motions to dismiss each of the Derivative Actions. On October 13, 2011, the plaintiff in each of the Derivative Actions filed a motion to remand the Derivative Actions to the Superior Court of California, County of San Diego, and on October 24, 2011 the plaintiff in each of the Derivative Actions filed an opposition to the Company's motions to dismiss. On October 31, 2011, the Company filed an opposition to the plaintiffs' motions to remand and reply briefs in support of the Company's motions to dismiss. On November 7, 2011, the plaintiff in each of the Derivative Actions filed a reply brief in support of their motions to remand. Hearings on the motions to dismiss and motions to remand will be held upon request of the Court. We do not believe the results of this litigation will result in a material impact to the Company's financial statements.



Fish Springs Ranch, LLC:

The Company's settlement agreement with the Pyramid Lake Paiute Tribe of Indians relating to the exportation of water from the properties owned by Fish Springs Ranch, LLC is pending ratification by the United States Congress, but we cannot be certain as to when the United States Congress will act on this matter. No material developments occurred relating to this dispute or the settlement agreement during the first nine months of 2011.

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

The following discussion and analysis of financial condition and results of operations should be read together with the Unaudited Condensed Consolidated Financial Statements and accompanying Notes included elsewhere in this report, and the Consolidated Financial Statements and accompanying Notes included in our Annual Report on Form 10-K.

### Note About "Forward-Looking Statements"

This Quarterly Report on Form 10-Q (including the "Management's Discussion and Analysis of Financial Condition and Results of Operations" section) contains "forward-looking statements," as defined in Section 21E of the United States Securities Exchange Act of 1934, as amended, regarding our business, financial condition, results of operations, and prospects, including, without limitation, statements about our expectations, beliefs, intentions, anticipated developments, and other information concerning future matters. Words such as "may", "will", "could", "expects", "anticipates", "intends", "plans", "believes", "seeks", "estimates", "should", "target", "projects", "contemplates", "predicts", "potential", "co", similar expressions or variations of such words are intended to identify forward-looking statements, but are not the exclusive means of identifying forward-looking statements in this Quarterly Report on Form 10-Q. Although forward-looking statements in this Quarterly Report on Form 10-Q reflect the good faith judgment of our management, such statements can only be based on current expectations and assumptions. Consequently, forward-looking statements are inherently subject to risks and uncertainties, and the actual results and outcomes could differ from what is expressed or implied by the forward-looking statements. Factors that could cause or contribute to such differences in results and outcomes include, without limitation, those discussed under the headings "Item 1A. Risk Factors" in our 2010 Annual Report on Form 10-K and in other filings made from time to time with the United States Securities and Exchange Commission ("SEC") after the date of this Quarterly Report on Form 10-Q. Readers are urged not to place undue reliance on these forward-looking statements, which speak only as of the date of this Quarterly Report on Form 10-Q. We undertake no obligation to (and we expressly disclaim any obligation to) revise or update any forward-looking statement, whether as a result of new information, subsequent events, or otherwise (except as may be required by law), in order to reflect any event or circumstance which may arise after the date of this Quarterly Report on Form 10-Q. Readers are urged to carefully review and consider the various disclosures made in this Quarterly Report on Form 10-Q.

## INTRODUCTION

PICO Holdings, Inc. is a diversified holding company. In this Quarterly Report, PICO and its subsidiaries are collectively referred to as "PICO", "the Company", or by words such as "we" and "our". We seek to build and operate businesses where we believe significant value can be created from the development of unique assets, and to acquire businesses which we identify as undervalued and where our management participation in operations can aid in the recognition of the business's fair value, as well as create additional value.

Our objective is to maximize long-term shareholder value. Our goal is to manage our operations to achieve a superior return on net assets over the long term, as opposed to short-term earnings.

As of September 30, 2011 our business is separated into five operating segments:

- Water Resource and Water Storage Operations;
- Real Estate Operations;
- Corporate;
- Insurance Operations in "Run Off"; and
- Agribusiness Operations



As of September 30, 2011, our major consolidated subsidiaries are (wholly – owned unless noted):

- Vidler Water Company, Inc. (“Vidler”) which acquires and develops water resources and water storage operations in the southwestern United States, with assets and operations in Nevada, Arizona, Idaho, Colorado and New Mexico;
  - UCP, LLC (“UCP”), which acquires and develops partially-developed and finished residential housing lots in selected markets in California and Washington;
  - Nevada Land and Resource Company, LLC (“Nevada Land”), which sells property in northern Nevada and also sells or leases certain sub – surface rights (such as mineral rights, water rights and geothermal rights) associated with Nevada Land’s property;
  - Physicians Insurance Company of Ohio (“Physicians”), which is “running off” its medical professional liability insurance loss reserves; and
  - Citation Insurance Company (“Citation”), which is “running off” its property and casualty insurance and workers’ compensation loss reserves.
- PICO Northstar Hallock, LLC, an 88% owned subsidiary, doing business as Northstar Agri Industries (“Northstar”), which is constructing a canola seed crushing facility in Hallock, Minnesota. We anticipate the plant to be fully constructed and to commence operations in 2012.

## RESULTS OF OPERATIONS— THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2011 AND 2010

### Overview of Economic Conditions and Impact on Results of Operations:

The current economic environment and housing slow-down in the U.S. has significantly decreased the rate of growth in the Southwest and demand for our water and real estate assets in certain markets. Specific events occurred in those markets during the third quarter of 2011 that caused us to update our discounted cash flow models that calculate an estimated fair value for our Fish Springs Ranch water credits and pipeline rights and our Carson Lyon water assets. The changes in assumptions relate to the sales price of our water assets and the timing of future estimated sales. As a result of updating our discounted cash flow models, the estimated fair value of our Fish Springs water asset was calculated at \$84.9 million compared to its carrying value of \$101.1 million. Consequently, during the third quarter, we recorded the \$16.2 million difference as an impairment charge to reflect the decrease in the estimated fair value of the asset. Continued deterioration in the markets in which we operate has the potential to cause additional impairment charges on our real estate and water assets.

In addition, given the total cumulative losses reported by the Company over the past three years, we determined that it is not likely we will be able to realize our deferred income tax assets in the near future. The ultimate realization of deferred income tax assets is dependent upon the generation of future taxable income during the period in which temporary differences become deductible. We considered all the possible sources of taxable income when assessing the realization of the deferred tax assets and given the conditions currently existing in certain of the markets in which we operate, the near - term prospects for significant income sufficient to absorb our deferred tax assets are in doubt. As a result, we have recorded a \$32.2 million valuation allowance as part of our tax provision in our results of operations that reduced our net deferred tax asset to zero at September 30, 2011. We anticipate that the current weakness and lack of demand in certain of our markets will persist for several years and then be followed by a slow recovery. In this future recovery period, we expect demand to rebound and ultimately lead to an increase in sales activity in these markets. We also believe the operating results of the canola seed crushing plant we are constructing together with future sales from our real estate assets will lead to significant reported income. If and when we realize significant sales of real estate and water assets and / or the canola seed crushing plant generates sufficient income such that our total cumulative three year reported results is positive, we may then be able to reverse all or part of the valuation allowance on our deferred tax assets.

The focus of our operations is building long – term shareholder value. Our revenues and results of operations can and do fluctuate widely from period to period. For example, we recognize revenue from the sale of real estate and water assets when specific transactions close, and as a result, sales of real estate and water assets for any individual quarter are not necessarily indicative of revenues for future quarters or the full financial year.

## PICO Shareholders' Equity

At September 30, 2011, we reported shareholders' equity of \$507.1 million, or \$22.33 per share, compared to \$568.1 million, or \$25.03 per share at December 31, 2010. The \$61 million decrease in shareholders' equity for the first nine months of 2011 was primarily due to a \$64.4 million comprehensive loss. Comprehensive loss includes a net loss of \$49.9 million which reflects the \$16.2 million impairment charge on our Fish Springs water asset and a \$26.8 million provision for federal, foreign and state income tax that includes a \$32.2 million valuation allowance recorded on the net deferred tax assets. Book value per share decreased by \$2.70, or 11%, during the first nine months of 2011.

## Comprehensive Loss

We report comprehensive income or loss as well as net income or loss from the condensed consolidated statement of operations. Comprehensive income or loss measures changes in shareholders' equity, and includes unrealized items which are not recorded in the consolidated statement of operations, for example, foreign currency translation and the change in unrealized investment gains and losses on available-for-sale securities.

For the third quarter of 2011, we reported comprehensive loss of \$56.5 million which consisted primarily of a \$5.3 million net decrease in unrealized appreciation in investments and a net loss of \$49.9 million.

For the first nine months of 2011, we reported comprehensive loss of \$64.4 million. This comprehensive loss consisted of a net loss of \$49.9 million, a \$12.7 million net decrease in unrealized appreciation in investments, and a \$1.8 million loss on foreign currency translation.

## Segment Results of Operations

Our segment revenues and income or loss before taxes for the third quarter and first nine months of 2011 and 2010 were:

Thousands of dollars	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Revenues:				
Water Resource and Water Storage Operations	\$384	\$375	\$1,073	\$2,499
Real Estate Operations	14,585	611	22,928	4,336
Corporate	1,672	2,883	6,548	7,711
Insurance Operations in "Run Off"	4,898	3,628	14,614	6,376
Agribusiness Operations	1		8	
Total revenues	\$21,540	\$7,497	\$45,171	\$20,922
Income (loss) before income taxes:				
Water Resource and Water Storage Operations	\$(17,470)	\$(2,731)	\$(20,532)	\$(6,622)
Real Estate Operations	2,244	(792)	265	(2,462)
Corporate	(2,368)	(2,480)	(4,006)	(8,594)
Insurance Operations in "Run Off"	4,468	3,250	13,382	5,149
Agribusiness Operations	(695)		(1,668)	
Loss before income taxes	\$(13,821)	\$(2,753)	\$(12,559)	\$(12,529)

### Third Quarter Revenues

Our third quarter revenues were \$21.5 million in 2011, compared to \$7.5 million in 2010, an increase of \$14 million year-over-year. This increase was primarily due to a year-over-year increase in sales of real estate at UCP of \$14.2 million, and a \$1.7 million year-over-year increase in net realized gains reported in the insurance in run-off segment.

### Third Quarter Costs and Expenses

Third quarter costs and expenses were \$35.4 million in 2011, compared to \$10.3 million in 2010, an increase in year-over-year expenses of \$25.1 million. This increase in expenses is primarily due to an increase in cost of real estate sold of \$9.9 million from sales of real estate by UCP and an impairment charge in our water resource and water storage segment of \$16.2 million in 2011 with no corresponding charge in 2010.

### Third Quarter Net Loss Before Income Taxes

Our third quarter year-over-year net loss before income taxes increased by \$11.1 million. The primary components of this increased year-over-year loss was the impairment charge at Vidler of \$16.2 million partially offset by the increased year-over-year real estate gross margin at UCP of \$4.4 million.

### Third Quarter Income Taxes and Noncontrolling Interest in Subsidiaries

In the third quarter of 2011, we reported a net loss of \$49.9 million, or \$2.20 per share. We recorded a \$27.3 million tax provision and the noncontrolling interests reported a credit of \$7.2 million.

Our most significant subsidiary that is classified as noncontrolling interest is Fish Springs Ranch, LLC ("Fish Springs"). Due to the impairment charge recorded on the Fish Springs water asset we reassessed our previous method of attributing our 49% partner's share of the losses at Fish Springs. Accordingly, we have reversed these previously attributed losses amounting to \$7.4 million in the third quarter of 2011 such that our 49% partner's noncontrolling interest balance is now zero.

We reported a net loss of \$1.3 million, or \$0.06 per share for the third quarter of 2010 after a \$1.6 million tax benefit. During the three months ended September 30, 2010, the noncontrolling interests reported a loss of \$764,000.

Our effective tax rate for the third quarter of 2011 and 2010 was a tax provision of 198% compared to a tax benefit of 59% respectively, compared to the Federal corporate income tax rate of 35%. The difference is primarily due to the full valuation allowance recorded on our deferred tax assets recorded in the third quarter of 2011.

### First Nine Months Revenues

Our revenues during the first nine months were \$45.2 million in 2011, compared to \$20.9 million in 2010, an increase of \$24.3 million year-over-year. This increase is due primarily to an increase in the sale of real estate reported in the real estate segment of \$19.4 million and an increase of \$8.9 million in net realized gains on the sale of securities held in our insurance in run-off segment.

### First Nine Months Costs and Expenses

Our costs and expenses during the first nine months were \$57.7 million in 2011, compared to \$33.5 million in 2010, a year-over-year increase of \$24.3 million. This increase in costs and expenses is due primarily to an impairment charge

of \$16.2 million in the water resource and water storage segment in 2011, with no corresponding charge in 2010, an increase of \$14.1 million in the cost of sales of real estate recorded in the real estate segment which were partially offset by a year-over-year reduction in project expenses recorded in the water resource and water storage segment of \$3.2 million.

#### First Nine Months Net Loss Before Income Taxes

Our loss before income taxes decreased by \$30,000 in the first nine months of 2011 compared to the first nine months of 2010. This decreased loss was due primarily to an increase in the gross margin of real estate sales at UCP of \$5.2 million and an increase in year-over-year net realized gains of \$-8.9 million in the insurance in run-off segment, offset by an impairment charge of \$16.2 million recorded in the water resource and water storage segment with no corresponding charge in 2010.

#### First Nine Months Income Taxes and Noncontrolling Interest in Subsidiaries

In the first nine months of 2011, we reported a net loss of \$49.9 million, or \$2.20 per share, which included a \$26.8 million tax provision and the noncontrolling interests reported a credit of \$5.3 million.

Due to the impairment charge recorded on the Fish Springs water asset we reassessed our previous method of attributing our 49% partner's share of the losses at Fish Springs. Accordingly, we have reversed these previously attributed losses amounting to \$5.9 million in the first nine months of 2011 such that our 49% partner's noncontrolling interest balance is now zero.

We reported a net loss of \$7.9 million, or \$0.35 per share for the first nine months of 2010 after a \$4.8 million tax benefit. During the nine months ended September 30, 2010, the noncontrolling interests reported a loss of \$2.3 million.

Our effective tax rate for the first nine months of 2011 and 2010 was a tax provision of 213% and a tax benefit of 38% respectively, compared to the Federal corporate income tax rate of 35%. For the nine months ended September 30, 2011 the effective rate differs from the statutory rate of 35% primarily due to recording a full valuation allowance on our net deferred tax assets. The effective rate differs from the statutory rate in 2010 primarily due to foreign taxes, recording a tax benefit on the loss from unconsolidated affiliates in the tax provision, while the loss that creates that benefit is recorded below the tax provision on a separate line in the accompanying financial statements, and offset by non-deductible compensation expense.

## WATER RESOURCE AND WATER STORAGE OPERATIONS

Thousands of dollars	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Revenues:				
Sale of real estate and water assets	\$ 151	\$ 17	\$ 213	\$ 1,245
Net investment income	6	151	163	538
Other	227	207	697	716
Total revenues	384	375	1,073	2,499
Costs and expenses:				
Cost of real estate and water assets	(33	) (4	) (40	) (724
Impairment of water assets	(16,224	)	(16,224	)
Depreciation and amortization	(297	) (301	) (882	) (857
Overhead	(705	) (916	) (2,642	) (2,509
Project expenses	(595	) (1,885	) (1,789	) (5,031
Total costs and expenses	(17,854	) (3,106	) (21,577	) (9,121
Loss before income taxes	\$(17,470	) \$(2,731	) \$(20,504	) \$(6,622

Our water resource and water storage operations are conducted through Vidler Water Company, Inc. and its subsidiaries ("Vidler"). Over the past few years, several large sales of real estate and water assets have generated most of Vidler's revenues. Since the date of closing generally determines the accounting period in which revenues and cost of sales are recorded, Vidler's reported revenues and income fluctuate from quarter to quarter depending on the dates when specific transactions close. Consequently, sales of real estate and water assets for any individual quarter are not indicative of likely revenues for future quarters or the full financial year.

## Segment Revenues

There were no significant sales of real estate and water assets in the third quarter and first nine months of both 2011 and 2010. Revenues generated in the third quarter and first nine months of 2011 and 2010 consisted primarily of lease income from our ranch and farm properties and interest from the financing of certain water asset sales. In addition, in the first nine months of 2010, Vidler sold 149 acre-feet of water rights in Kane Springs, Lincoln County, Nevada which generated revenues of \$1.2 million.

## Impairment of Water Assets

The current economic environment and housing slow-down in the U.S. has significantly decreased the rate of growth in the Southwest and demand for our water and real estate assets in certain markets. Specific events occurred in those markets during the third quarter of 2011 that caused us to update our discounted cash flow models that calculate an estimated fair value for our Fish Springs Ranch water credits and pipeline rights and our Carson Lyon water assets. The changes in assumptions relate to the sales price of our water assets and the timing of future estimated sales. As a result of updating our discounted cash flow models, the fair value of our Fish Springs water asset was estimated at \$84.9 million compared to its carrying value of \$101.1 million. Consequently, during the third quarter, we recorded the \$16.2 million difference as an impairment charge to reflect the decrease in the estimated fair value of the asset. There were no other impairment charges during the quarter.

### Segment Expenses

Overhead expenses consist of costs which are not related to the development of specific water resources, such as salaries and benefits, rent, and audit fees.

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Overhead expenses were \$2.6 million for the first nine months of 2011 compared to \$2.5 million in the first nine months of 2010, an increase of \$133,000 year-over-year. This increase was largely due to increased salaries and benefits of Vidler employees' year-over-year.

Project expenses consist of costs related to the development of existing water resources, such as operating and maintenance costs and professional fees. Project expenses fluctuate from period to period depending on activity with Vidler's various water resource projects. Costs related to the development of water resources which meet the criteria to be recorded as an asset in our financial statements are capitalized and charged to cost of sales in the period that revenue is recognized. Project expenses principally relate to:

- the operation and maintenance of the Vidler Arizona Recharge Facility;
- the development of water rights in the Tule Desert groundwater basin and the Dry Lake Valley (both part of the Lincoln County, Nevada agreement);
- the utilization of water rights at Fish Springs Ranch as a future municipal water supply for the north valleys of the Reno, Nevada area;
- the operation of our farm properties in Idaho and maintenance of the associated water rights; and
- the exploration and drilling costs of Vidler's water resource development project in New Mexico.

Project expenses were \$595,000 in the third quarter of 2011, compared to \$1.9 million in the third quarter of 2010, and \$1.8 million in the first nine months of 2011 compared to \$5 million in the first nine months of 2010. The third quarter and first nine months year-over-year decrease in project expenses of \$1.3 million and \$3.2 million, respectively, is largely due to the reduction in expenses for exploration and drilling costs for the exploration phase of our water resource development project in New Mexico. These costs were expensed through the statement of operations as incurred in the first quarter and the first nine months of 2010. In the first nine months of 2011 approximately \$1.8 million of development costs were capitalized with respect to this project as, after the recent completion of our groundwater model, we now consider the project more likely than not to generate revenues from permitted water rights sufficient to recover our capitalized costs. In the future, we do not anticipate incurring any further significant development costs associated with this project and we expect to present our scientific evidence to support the award of up to 1,010 acre - feet of permitted water rights to the New Mexico's State Engineer's Office in 2012.

#### Net Recharge Credits in Arizona

During 2011, we acquired a further 6,000 acre-feet of water for storage (net recharge credits) in Arizona. As of September 30, 2011 we own over 402,000 net recharge credits (approximately 152,000 net recharge credits are held in the Phoenix Active Management Area and approximately 250,000 net recharge credits are held in our water storage facility in the Harquahala Valley).

## REAL ESTATE OPERATIONS

Thousands of dollars	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Revenues:				
Sale of real estate – Nevada Land	\$77	\$34	\$288	\$112
Sale of real estate UCP	14,216		21,655	2,434
Net investment income	93	192	373	536
Lease income and other	199	385	612	1,254
Total revenues	14,585	611	22,928	4,336
Costs and expenses:				
Cost of real estate – Nevada Land	(25	)	(44	) (7
Cost of real estate - UCP	(9,864	)	(15,761	) (1,722
Operating expenses	(2,452	) (1,403	) (6,858	) (5,069
Total costs and expenses	(12,341			

- (1) Interest income on loans includes fee income of \$662,000, \$633,000 and \$642,000 for the years ended December 31, 2011, 2010, and 2009, respectively.
- (2) Average loan balances include loans held for sale and nonperforming loans.
- (3) Includes taxable debt and equity securities and Federal Home Loan Bank Stock.
- (4) Stockholders' equity attributable to First Capital, Inc.

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**Rate/Volume Analysis.** The following table sets forth the effects of changing rates and volumes on net interest income and interest expense computed on a tax-equivalent basis. Information is provided with respect to (i) effects on interest income attributable to changes in volume (changes in volume multiplied by prior rate); (ii) effects attributable to changes in rate (changes in rate multiplied by prior volume); and (iii) effects attributable to changes in rate and volume (change in rate multiplied by changes in volume). Tax exempt income on loans and investment securities has been adjusted to a tax-equivalent basis using the federal marginal tax rate of 34%.

	2011 Compared to 2010 Increase (Decrease) Due to				2010 Compared to 2009 Increase (Decrease) Due to			
	Rate	Volume	Rate/ Volume	Net (In thousands)	Rate	Volume	Rate/ Volume	Net
<b>Interest-earning assets:</b>								
<b>Loans:</b>								
Taxable	\$ (303)	\$ (1,191)	\$ 20	\$ (1,474)	\$ (385)	\$ (545)	\$ 11	\$ (919)
Tax-exempt	(3)	94	(20)	71	70	(96)	(65)	(91)
Total investment securities	(306)	(1,097)	0	(1,403)	(315)	(641)	(54)	(1,010)
<b>Investment securities:</b>								
Taxable	(282)	193	(26)	(115)	(571)	461	(112)	(222)
Tax-exempt	(5)	(27)	0	(32)	(10)	96	(1)	85
Total investment securities	(287)	166	(26)	(147)	(581)	557	(113)	(137)
Federal funds sold and interest-bearing deposits with banks	9	(5)	(1)	3	13	(2)	(1)	10
Total net change in income on interest-earning assets	(584)	(936)	(27)	(1,547)	(883)	(86)	(168)	(1,137)
<b>Interest-bearing liabilities:</b>								
Interest-bearing deposits	(1,184)	(165)	46	(1,303)	(1,833)	226	(69)	(1,676)
Retail repurchase agreements	(20)	9	(3)	(14)	(2)	25	(1)	22
FHLB advances	(81)	(374)	30	(425)	(473)	(962)	203	(1,232)
Total net change in expense on interest-bearing liabilities	(1,285)	(530)	73	(1,742)	(2,308)	(711)	133	(2,886)
Net change in net interest income	\$ 701	\$ (406)	\$ (100)	\$ 195	\$ 1,425	\$ 625	\$ (301)	\$ 1,749

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### **Comparison of Financial Condition at December 31, 2011 and 2010**

Total assets decreased 3.0% from \$452.4 million at December 31, 2010 to \$438.9 million at December 31, 2011 primarily due to a decrease in net loans partially offset by an increase in securities available for sale.

Net loans decreased 6.3% from \$294.6 million at December 31, 2010 to \$276.0 million at December 31, 2011. The primary contributing factor to the decrease in net loans was a decrease of \$13.8 million in residential mortgage loans as the Bank continued to sell the majority of newly originated residential mortgage loans in the secondary market. The Bank originated \$31.6 million in new residential mortgages for sale in the secondary market during 2011 compared to \$43.1 million in 2010. These loans were originated and funded by the Bank and sold in the secondary market. Of this total, \$7.7 million paid off existing loans in the Bank's portfolio. Originating mortgage loans for sale in the secondary market allows the Bank to better manage its interest rate risk, while offering a full line of mortgage products to prospective customers. In addition to residential mortgage loans, consumer loans and commercial mortgage loans also decreased by \$3.8 million and \$2.2 million, respectively, during 2011 while construction loans increased by \$3.6 million during the year.

Securities available for sale, at fair value, consisting primarily of U. S. agency and privately-issued mortgage-backed obligations, U. S. agency notes and bonds, and municipal obligations, increased \$10.6 million, from \$100.9 million at December 31, 2010 to \$111.4 million at December 31, 2011. Purchases of securities available for sale totaled \$43.5 million in 2011. These purchases were offset by maturities of \$22.7 million, principal repayments of \$9.8 million and sales of \$1.4 million. The Bank invests excess cash in securities that provide safety, liquidity and yield. Accordingly, we purchase mortgage-backed securities to provide cash flow for loan demand and deposit changes, we purchase federal agency notes for short-term yield and low risk, and municipals are purchased to improve our tax equivalent yield focusing on longer term profitability.

The investment in securities held to maturity, consisting of federal agency mortgage-backed securities and municipal obligations, decreased from \$32,000 at December 31, 2010 to \$16,000 at December 31, 2011. During 2011, the Bank had maturities of \$14,000 and principal repayments of \$2,000.

Cash and cash equivalents decreased from \$21.6 million at December 31, 2010 to \$18.9 million at December 31, 2011. The decrease is due primarily to decreases in interest bearing deposits with banks and federal funds sold as excess liquidity was invested in higher yielding investment securities.

Total deposits decreased 3.6%, from \$378.0 million at December 31, 2010 to \$364.4 million at December 31, 2011. Interest-bearing demand deposits, money market and savings accounts decreased a total of \$7.0 million during 2011 while time deposits decreased \$13.2 million during the period. The decrease in interest-bearing demand deposits is primarily due to normal fluctuations in the balances of operating accounts of public entities, such as counties, cities and school corporations. Time deposits have decreased as some customers are unwilling to lock into long-term commitments while interest rates are at their current low levels. Noninterest-bearing demand deposits increased 16.0% to \$47.3 million at December 31, 2011.

Federal Home Loan Bank borrowings decreased \$3.4 million from \$15.7 million at December 31, 2010 to \$12.4 million at December 31, 2011. New advances totaling \$1.0 million were drawn during the year while principal payments on advances totaled \$4.4 million during 2011.

Retail repurchase agreements, which represent overnight borrowings from business and local municipal deposit customers, increased from \$8.7 million at December 31, 2010 to \$9.1 million at December 31, 2011, primarily due to normal balance fluctuations.

Total stockholders' equity attributable to the Company increased from \$47.9 million at December 31, 2010 to \$50.9 million at December 31, 2011. This increase is primarily the result of net income of \$4.0 million and an increase in the unrealized gain of available for sale securities of \$1.2 million, offset by dividends paid of \$2.1 million and repurchases of treasury stock of \$27,000. During 2011 the Company repurchased 1,608 shares of its stock at a weighted average price of \$16.80 per share. As of December 31, 2011, the Company had repurchased 50,193 shares of the 240,467 shares authorized by the Board of Directors under the current stock repurchase program which was announced in August 2008 and 378,727 shares since the original repurchase program began in 2001.

**Table of Contents****Off-Balance-Sheet Arrangements**

The Company is a party to financial instruments with off-balance-sheet risk including commitments to extend credit under existing lines of credit and commitments to originate loans. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated financial statements.

Off-balance-sheet financial instruments whose contract amounts represent credit and interest rate risk are summarized as follows:

	<b>At December 31,</b>	
	<b>2011</b>	<b>2010</b>
	<b>(In thousands)</b>	
Commitments to originate new loans	\$ 2,479	\$ 7,295
Undisbursed portion of construction loans	4,768	3,119
Unfunded commitments to extend credit under existing commercial and personal lines of credit	35,375	34,039
Standby letters of credit	1,685	1,689

The Company does not have any special purpose entities, derivative financial instruments or other forms of off-balance-sheet financing arrangements.

Commitments to originate new loans or to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Most equity line commitments are for a term of five to 10 years and commercial lines of credit are generally renewable on an annual basis. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amounts of collateral obtained, if deemed necessary by the Company upon extension of credit, are based on management's credit evaluation of the borrower.

**Contractual Obligations**

The following table summarizes information regarding the Company's contractual obligations as of December 31, 2011:

	<b>Total</b>	<b>Payments due by period</b>			
		<b>Less than 1 Year</b>	<b>1 3 Years</b>	<b>3 5 Years</b>	<b>More than 5 Years</b>
		<b>(In thousands)</b>			
Deposits	\$ 364,374	\$ 301,949	\$ 49,310	\$ 13,077	\$ 38
Federal Home Loan Bank advances	12,350	7,250	5,100	0	0
Retail repurchase agreements	9,125	9,125	0	0	0
Operating lease obligations	49	15	30	4	0
<b>Total contractual obligations</b>	<b>\$ 385,898</b>	<b>\$ 318,339</b>	<b>\$ 54,440</b>	<b>\$ 13,081</b>	<b>\$ 38</b>

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### **Liquidity and Capital Resources**

Liquidity refers to the ability of a financial institution to generate sufficient cash flow to fund current loan demand, meet deposit withdrawals and pay operating expenses. The Bank's primary sources of funds are new deposits, proceeds from loan repayments and prepayments and proceeds from the maturity of securities. The Bank may also borrow from the Federal Home Loan Bank of Indianapolis. While loan repayments and maturities of securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by market interest rates, general economic conditions and competition. At December 31, 2011, the Bank had cash and interest-bearing deposits with banks of \$18.9 million and securities available for sale with a fair value of \$111.4 million. If the Bank requires funds beyond its ability to generate them internally, it has additional borrowing capacity with the Federal Home Loan Bank of Indianapolis and collateral eligible for repurchase agreements.

The Bank must maintain an adequate level of liquidity to ensure the availability of sufficient funds to support loan growth and deposit withdrawals, to satisfy financial commitments and to take advantage of investment opportunities. At December 31, 2011, the Bank had total commitments to extend credit of \$42.6 million. See Note 16 in the accompanying Notes to Consolidated Financial Statements. At December 31, 2011, the Bank had certificates of deposit scheduled to mature within one year of \$50.1 million. Historically, the Bank has been able to retain a significant amount of its deposits as they mature.

The Company is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, the Company requires funds to pay any dividends to its shareholders and to repurchase any shares of its common stock. The Company's primary source of income is dividends received from the Bank. The amount of dividends the Bank may declare and pay to the Company in any calendar year, without the receipt of prior approval from the OCC but with prior notice to the OCC, cannot exceed net income for that year to date plus retained net income (as defined) for the preceding two calendar years. At December 31, 2011, the Company (on an unconsolidated basis) had liquid assets of \$278,000.

The Bank is required to maintain specific amounts of capital pursuant to OCC regulations. As of December 31, 2011 the Bank was in compliance with all regulatory capital requirements which were effective as of such date with tangible, core and risk-based capital ratios of 10.1%, 10.1% and 17.1%, respectively. See Note 19 in the accompanying Notes to Consolidated Financial Statements.

### **Effect of Inflation and Changing Prices**

The consolidated financial statements and related financial data presented in this report have been prepared in accordance with generally accepted accounting principles in the United States of America, which generally require the measurement of financial position and operating results in terms of historical dollars, without considering the changes in relative purchasing power of money over time due to inflation. The primary impact of inflation is reflected in the increased cost of the Bank's operations. Unlike most industrial companies, virtually all the assets and liabilities of the financial institution are monetary in nature. As a result, interest rates generally have a more significant impact on the financial institutions performance than do general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

### **Market Risk Analysis**

**Qualitative Aspects of Market Risk.** The Bank's principal financial objective is to achieve long-term profitability while reducing its exposure to fluctuating market interest rates. The Bank has sought to reduce the exposure of its earnings to changes in market interest rates by attempting to manage the mismatch between asset and liability maturities and interest rates. In order to reduce the exposure to interest rate fluctuations, the Bank has developed strategies to manage its liquidity, shorten its effective maturities of certain interest-earning assets and decrease the interest rate sensitivity of its asset base. Management has sought to decrease the average maturity of its assets by emphasizing the origination of short-term commercial and consumer loans, all of which are retained by the Bank for its portfolio. The Bank relies on retail deposits as its primary source of funds. Management believes retail deposits, compared to brokered deposits, reduce the effects of interest rate fluctuations because they generally represent a more stable source of funds.

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**Quantitative Aspects of Market Risk.** The Bank does not maintain a trading account for any class of financial instrument nor does the Bank engage in hedging activities or purchase high-risk derivative instruments. Furthermore, the Bank is not subject to foreign currency exchange rate risk or commodity price risk.

The Bank uses interest rate sensitivity analysis to measure its interest rate risk by computing changes in net portfolio value (NPV) of its cash flows from assets, liabilities and off-balance sheet items in the event of a range of assumed changes in market interest rates. NPV represents the market value of portfolio equity and is equal to the market value of assets minus the market value of liabilities, with adjustments made for off-balance sheet items. This analysis assesses the risk of loss in market risk sensitive instruments in the event of a sudden and sustained 100 basis point decrease to a 300 basis point increase in market interest rates with no effect given to any steps that management might take to counter the effect of that interest rate movement. Using data compiled by the OCC, the Bank receives a report that measures interest rate risk by modeling the change in NPV over a variety of interest rate scenarios.

The following table, which is based on information that the Bank provided to the OCC, sets forth the change in the Bank's NPV at December 31, 2011, based on OCC assumptions that would occur in the event of an immediate change in interest rates, with no effect given to any steps that management might take to counteract that change.

Change In Rates	At December 31, 2011				
	Dollar Amount	Net Portfolio Value Dollar Change	Percent Change	Net Portfolio Value as a Percent of Present Value of Assets NPV Ratio	Change
					(Dollars in thousands)
300bp	\$ 61,764	\$ 551	1%	13.75%	25bp
200bp	62,490	1,277	2	13.84	34bp
100bp	62,482	1,269	2	13.79	29bp
0bp	61,213	0	0	13.50	0bp
(100)bp	58,505	(2,708)	(4)	12.96	(54)bp

The preceding tables indicate that the Bank's NPV would be expected to increase in the event of a sudden and sustained increase in prevailing market interest rates and would be expected to decrease in the event of a sudden and sustained decrease in prevailing market interest rates. The expected increase in the Bank's NPV given an increase in rates is primarily attributable to management's efforts to reduce the Bank's concentration of fixed-rate loans and debt securities in the Bank's portfolio.

Certain assumptions utilized by the OCC in assessing the interest rate risk of savings associations within its region were utilized in preparing the preceding tables. These assumptions relate to interest rates, loan prepayments, deposit decay rates, and the market values of certain assets under differing interest rate scenarios, among others.

As with any method of measuring interest rate risk, certain shortcomings are inherent in the method of analysis presented in the foregoing tables. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets, such as adjustable-rate mortgage loans, have features that restrict changes in interest rates on a short-term basis and over the life of the asset. Further, in the event of a change in interest rates, expected rates of prepayments on loans and early withdrawals from certificates of deposit could deviate significantly from those assumed in calculating the tables.

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### **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The information required by this item is incorporated herein by reference to the section captioned *Management's Discussion and Analysis of Financial Condition and Results of Operations* in this Annual Report on Form 10-K.

### **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

The financial statements required by this item begin on page F-1.

### **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

### **ITEM 9A. CONTROLS AND PROCEDURES**

#### **Disclosure Controls and Procedures**

The Company's management, including the Company's principal executive officer and principal financial officer, have evaluated the effectiveness of the Company's disclosure controls and procedures, as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective for the purpose of ensuring that the information required to be disclosed in the reports that the Company files or submits under the Exchange Act with the Securities and Exchange Commission (the SEC): (1) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (2) is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

#### **Internal Control Over Financial Reporting**

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The internal control process has been designed under our supervision to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's financial statements for external reporting purposes in accordance with accounting principles generally accepted in the United States of America.

Management conducted an assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2011, utilizing the framework established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management has determined that the Company's internal control over financial reporting as of December 31, 2011 is effective.

Our internal control over financial reporting includes policies and procedures that pertain to the maintenance of records that accurately and fairly reflect, in reasonable detail, transactions and dispositions of assets; and provide reasonable assurances that: (1) transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States; (2) receipts and expenditures are being made only in accordance with authorizations of management and the directors of the Company; and (3) unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the Company's financial statements are prevented or timely detected.

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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. 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.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to rules of the SEC that permit the Company to provide only management's report in this annual report.

**Changes to Internal Control Over Financial Reporting**

There have been no changes in the Company's internal control over financial reporting during the quarter ended December 31, 2011 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**ITEM 9B. OTHER INFORMATION**

Not applicable.

**PART III****ITEM 10. DIRECTORS, EXECUTIVE OFFICERS, AND CORPORATE GOVERNANCE**

The information relating to the directors of the Company, information regarding compliance with Section 16(a) of the Exchange Act and information regarding the audit committee and audit committee financial expert is incorporated herein by reference to the sections captioned *Item 1 Election of Directors*, *Section 16(a) Beneficial Ownership Reporting Compliance*, and *Audit Committee* in the Company's Proxy Statement for the 2012 Annual Meeting of Stockholders.

**Executive Officers Who Are Not Directors**

<b>Name</b>	<b>Age<sup>(1)</sup></b>	<b>Position</b>
Jill Keinsley	44	Senior Vice President, Human Resources Director
M. Chris Frederick	44	Senior Vice President, Chief Financial Officer and Treasurer
Dennis L. Thomas	55	Senior Vice President- Lending

(1) As of December 31, 2011.

**Biographical Information**

*Jill Keinsley* has been affiliated with the Bank and served in her present position since August 2006.

*M. Chris Frederick* has been affiliated with the Bank since June 1990 and has served in his present position since 1997.

*Dennis L. Thomas* has been affiliated with the Bank since January 2000. He was employed by Harrison County Bank from 1981 until its merger with the Bank.

**Code of Ethics**

The Company maintains a Code of Ethics and Business Conduct that applies to all directors, officers and employees of the Company and its affiliates. The Code of Ethics and Business Conduct is posted on the Company's Internet website, [www.firstharrison.com](http://www.firstharrison.com).



**Table of Contents****ITEM 11. EXECUTIVE COMPENSATION**

The information regarding executive compensation, compensation committee interlocks and insider participation and compensation committee report is incorporated herein by reference to the sections captioned *Director Compensation* and *Executive Compensation* in the Company's Proxy Statement for the 2012 Annual Meeting of Stockholders.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS****(a) Security Ownership of Certain Beneficial Owners.**

Information required by this item is incorporated herein by reference to the section captioned *Stock Ownership* in the Company's Proxy Statement for the 2012 Annual Meeting of Stockholders.

**(b) Security Ownership of Management**

Information required by this item is incorporated herein by reference to the section captioned *Stock Ownership* in the Company's Proxy Statement for the 2012 Annual Meeting of Stockholders.

**(c) Changes in Control**

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

**(d) Equity Compensation Plan Information****Equity Compensation Plan Information as of December 31, 2011**

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	0	N/A	223,000
Equity compensation plans not approved by security holders	0	N/A	0
<b>Total</b>	<b>0</b>	<b>N/A</b>	<b>223,000</b>

The Company does not maintain any equity compensation plans that have not been approved by security holders.



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**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTORS INDEPENDENCE**

The information relating to certain relationships and related transactions and director independence is incorporated herein by reference to the sections captioned *Transactions with Related Persons* and *Director Independence* in the Company's Proxy Statement for the 2011 Annual Meeting of Stockholders.

**ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES**

The information relating to the principal accounting fees and expenses is incorporated herein by reference to the section captioned *Item 2 Ratification of Independent Registered Public Accounting Firm* in the Company's Proxy Statement for the 2012 Annual Meeting of Stockholders.

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**PART IV**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

- (1) The financial statements required in response to this item are incorporated by reference from Item 8 of this report.
- (2) All financial statement schedules are omitted as the required information either is not required or applicable, or the required information is contained in the financial statements or related notes.
- (3) Exhibits
  - 3.1 Articles of Incorporation of First Capital, Inc. (1)
  - 3.2 Fourth Amended and Restated Bylaws of First Capital, Inc. (2)
  - 10.1 \*Employment Agreement with Samuel E. Uhl (4)
  - 10.2 \*Employment Agreement with M. Chris Frederick (4)
  - 10.3 \*Employee Severance Compensation Plan (3)
  - 10.4 \*First Capital, Inc. 2009 Equity Incentive Plan (5)
  - 10.5 \*Employment Agreement with William W. Harrod (4)
  - 10.6 \*Director Deferred Compensation Agreement between First Federal Savings & Loan Association and James Pendleton (6)
  - 10.7 \*Director Deferred Compensation Agreement between First Federal Savings & Loan Association and Gerald Uhl (6)
  - 10.8 \*Director Deferred Compensation Agreement between First Federal Savings & Loan Association and Mark Shireman (6)
  - 10.9 \*Director Deferred Compensation Agreement between First Federal Savings & Loan Association and John Buschemeyer (6)
  - 11.0 Statement Re: Computation of Per Share Earnings (incorporated by reference to Item 8, *Financial Statements and Supplementary Data* of this Form 10-K)
  - 21.0 Subsidiaries of the Registrant (incorporated by reference to Part I, *Business Subsidiary Activities* of this Form 10-K)
  - 23.0 Consent of Monroe Shine and Co., Inc.
  - 31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
  - 31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
  - 32.0 Section 1350 Certification of Chief Executive Officer & Chief Financial Officer
  - 101.0 The following materials from the Company's Annual Report on Form 10-K for the year ended December 31, 2011, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statement of Changes in Stockholders' Equity, (iv) the Consolidated Statements of Cash Flows and (v) the Notes to the Consolidated Financial Statements, tagged as blocks of text. \*\*

\* Management contract or compensatory plan, contract or arrangement.

\*\* Furnished, not filed.

- (1) Incorporated by reference from the Exhibits filed with the Registration Statement on Form SB-2, and any amendments thereto, Registration No. 333-63515.
- (2) Incorporated by reference to the Current Report on Form 8-K filed with the Securities and Exchange Commission on August 22, 2007.
- (3) Incorporated by reference to the Quarterly Report on Form 10-QSB for the quarter ended December 31, 1998.
- (4) Incorporated by reference to the Annual Report on Form 10-KSB for the year ended December 31, 1999.
- (5) Incorporated by reference to the appendix to the Definitive Proxy Statement on Schedule 14A filed with the Securities and Exchange Commission on April 9, 2010.
- (6) Incorporated by reference to the Exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2008.



**Table of Contents****SIGNATURES**

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

**FIRST CAPITAL, INC.**

Date: March 22, 2012

/s/ William W. Harrod

William W. Harrod

President, Chief Executive Officer and a Director

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

Name	Title	Date
/s/ William W. Harrod William W. Harrod	President, Chief Executive Officer and Director  (principal executive officer)	March 22, 2012
/s/ Gerald L. Uhl Gerald L. Uhl	Chairman	March 22, 2012
/s/ Michael C. Frederick Michael C. Frederick	Senior Vice President, Chief Financial Officer and Treasurer  (principal accounting and financial officer)	March 22, 2012
/s/ Samuel E. Uhl Samuel E. Uhl	Chief Operating Officer and Director	March 22, 2012
/s/ Mark D. Shireman Mark D. Shireman	Director	March 22, 2012
/s/ Dennis L. Huber Dennis L. Huber	Director	March 22, 2012
/s/ Kenneth R. Saulman Kenneth R. Saulman	Director	March 22, 2012

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/s/ John W. Buschemeyer John W. Buschemeyer	Director	March 22, 2012
/s/ Michael L. Shireman Michael L. Shireman	Director	March 22, 2012
/s/ Kathryn W. Ernstberger Kathryn W. Ernstberger	Director	March 22, 2012
/s/ William I. Orwick, Sr. William I. Orwick, Sr.	Director	March 22, 2012
/s/ Carolyn E. Wallace Carolyn E. Wallace	Director	March 22, 2012
/s/ Pamela G. Kraft Pamela G. Kraft	Director	March 22, 2012
/s/ Christopher L. Byrd Christopher L. Byrd	Director	March 22, 2012

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**Report of Independent Registered Public Accounting Firm**

Board of Directors and Stockholders

**First Capital, Inc.**

Corydon, Indiana

We have audited the accompanying consolidated balance sheets of **First Capital, Inc. and Subsidiaries** as of December 31, 2011 and 2010, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the years then ended. The Company's management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of **First Capital, Inc. and Subsidiaries** as of December 31, 2011 and 2010, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

/s/ Monroe Shine

New Albany, Indiana

March 22, 2012

MONROE SHINE & CO., INC. ® CERTIFIED PUBLIC ACCOUNTANTS AND BUSINESS CONSULTANTS

**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****DECEMBER 31, 2011 AND 2010***(In thousands, except share and per share data)*

	2011	2010
<b>ASSETS</b>		
Cash and due from banks	\$ 10,794	\$ 10,463
Interest bearing deposits with banks	525	2,496
Federal funds sold	7,604	8,616
Total cash and cash equivalents	18,923	21,575
Securities available for sale, at fair value	111,440	100,851
Securities-held to maturity	16	32
Loans, net	276,047	294,550
Loans held for sale	2,909	4,375
Federal Home Loan Bank stock, at cost	2,820	3,194
Foreclosed real estate	661	591
Premises and equipment	10,721	10,992
Accrued interest receivable	1,801	1,894
Cash value of life insurance	5,991	5,789
Goodwill	5,386	5,386
Core deposit intangibles	32	98
Other assets	2,139	3,051
<b>Total Assets</b>	<b>\$ 438,886</b>	<b>\$ 452,378</b>
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing	\$ 47,313	\$ 40,774
Interest-bearing	317,061	337,229
Total deposits	364,374	378,003
Retail repurchase agreements	9,125	8,669
Advances from Federal Home Loan Bank	12,350	15,729
Accrued interest payable	413	649
Accrued expenses and other liabilities	1,571	1,324
Total liabilities	387,833	404,374
<b>Commitments and Contingencies</b>		
<b>EQUITY</b>		
Preferred stock of \$.01 par value per share Authorized 1,000,000 shares; none issued	0	0
Common stock of \$.01 par value per share Authorized 5,000,000 shares; issued 3,164,420 shares	32	32
Additional paid-in capital	24,313	24,313
Retained earnings-substantially restricted	32,297	30,442
Accumulated other comprehensive income	1,612	391
Less treasury stock, at cost - 378,727 shares (377,119 shares in 2010)	(7,312)	(7,285)
Total First Capital, Inc. stockholders' equity	50,942	47,893

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Noncontrolling interest in subsidiary	111	111
<b>Total equity</b>	<b>51,053</b>	<b>48,004</b>
<b>Total Liabilities and Equity</b>	<b>\$ 438,886</b>	<b>\$ 452,378</b>

See notes to consolidated financial statements.

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**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**  
**YEARS ENDED DECEMBER 31, 2011 AND 2010**

<i>(In thousands, except per share data)</i>	<b>2011</b>	<b>2010</b>
<b>INTEREST INCOME</b>		
Loans, including fees	\$ 17,179	\$ 18,607
Securities:		
Taxable	1,936	2,068
Tax-exempt	1,039	1,060
Federal Home Loan Bank dividends	81	64
Federal funds sold and interest-bearing deposits in banks	38	35
Total interest income	20,273	21,834
<b>INTEREST EXPENSE</b>		
Deposits	3,116	4,419
Retail repurchase agreements	59	73
Advances from Federal Home Loan Bank	585	1,010
Total interest expense	3,760	5,502
Net interest income	16,513	16,332
Provision for loan losses	1,825	2,037
Net interest income after provision for loan losses	14,688	14,295
<b>NONINTEREST INCOME</b>		
Service charges on deposit accounts	2,884	2,726
Commission and fee income	176	132
Loss on sale of securities	(8)	0
Other than temporary impairment loss on securities	(36)	0
Gain on sale of mortgage loans	690	739
Mortgage brokerage fee income	50	0
Increase in cash surrender value of life insurance	202	217
Other income	93	92
Total noninterest income	4,051	3,906
<b>NONINTEREST EXPENSE</b>		
Compensation and benefits	7,446	7,019
Occupancy and equipment	1,261	1,373
Data processing	1,202	810
Professional fees	599	654
Advertising	275	208
Other expenses	2,428	2,698
Total noninterest expense	13,211	12,762
Income before income taxes	5,528	5,439

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Income tax expense	1,543	1,561
<b>Net Income</b>	<b>3,985</b>	<b>3,878</b>
Less net income attributable to the noncontrolling interest in subsidiary	13	13
<b>Net Income Attributable to First Capital, Inc.</b>	<b>\$ 3,972</b>	<b>\$ 3,865</b>
Earnings per common share attributable to First Capital, Inc.		
<b>Basic</b>	<b>\$ 1.43</b>	<b>\$ 1.39</b>
<b>Diluted</b>	<b>\$ 1.43</b>	<b>\$ 1.39</b>
<b>Dividends per share on common shares</b>	<b>\$ 0.76</b>	<b>\$ 0.74</b>

See notes to consolidated financial statements.

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**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
**YEARS ENDED DECEMBER 31, 2011 AND 2010**

<i>(In thousands)</i>	<b>2011</b>	<b>2010</b>
<b>Net Income</b>	<b>\$ 3,985</b>	<b>\$ 3,878</b>
<b>OTHER COMPREHENSIVE INCOME</b>		
Unrealized gains (losses) on securities available for sale:		
Unrealized holding gains (losses) arising during the period	1,978	(164)
Income tax (expense) benefit	(784)	65
Net of tax amount	1,194	(99)
Less: reclassification adjustment for realized losses included in net income	8	0
Income tax benefit	(3)	0
Net of tax amount	5	0
Less: reclassification adjustment for other-than-temporary impairment losses included in net income	36	0
Income tax benefit	(14)	0
Net of tax amount	22	0
<b>Other Comprehensive Income, net of tax</b>	<b>1,221</b>	<b>(99)</b>
<b>Comprehensive Income</b>	<b>\$ 5,206</b>	<b>\$ 3,779</b>

See notes to consolidated financial statements.

**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY****YEARS ENDED DECEMBER 31, 2011 AND 2010**

<i>(In thousands, except share and per share data)</i>	<b>Common Stock</b>	<b>Additional Paid-in Capital</b>	<b>Retained Earnings</b>	<b>Accumulated Other Comprehensive Income</b>	<b>Treasury Stock</b>	<b>Noncontrolling Interest</b>	<b>Total</b>
Balances at January 1, 2010	\$ 31	\$ 24,025	\$ 28,640	\$ 490	\$ (7,242)	\$ 112	\$ 46,056
Net income	0	0	3,865	0	0	13	3,878
Change in unrealized gain on securities available for sale, net of reclassification adjustments and tax effect	0	0	0	(99)	0	0	(99)
Cash dividends	0	0	(2,063)	0	0	(14)	(2,077)
Stock options exercised	1	288	0	0	0	0	289
Purchase of 2,827 treasury shares	0	0	0	0	(43)	0	(43)
Balances at December 31, 2010	32	24,313	30,442	391	(7,285)	111	48,004
Net income	0	0	3,972	0	0	13	3,985
Change in unrealized gain on securities available for sale, net of reclassification adjustments and tax effect	0	0	0	1,221	0	0	1,221
Cash dividends	0	0	(2,117)	0	0	(13)	(2,130)
Purchase of 1,608 treasury shares	0	0	0	0	(27)	0	(27)
Balances at December 31, 2011	\$ 32	\$ 24,313	\$ 32,297	\$ 1,612	\$ (7,312)	\$ 111	\$ 51,053

See notes to consolidated financial statements.

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**FIRST CAPITAL, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**YEARS ENDED DECEMBER 31, 2011 AND 2010**

<i>(In thousands)</i>	<b>2011</b>	<b>2010</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 3,985	\$ 3,878
Adjustments to reconcile net income to net cash and cash equivalents provided by operating activities:		
Amortization of premium and accretion of discount on securities, net	935	908
Depreciation and amortization expense	916	899
Deferred income taxes	273	149
Increase in cash value of life insurance	(202)	(217)
Provision for loan losses	1,825	2,037
Loss on sale of securities	8	0
Other than temporary impairment loss on securities	36	0
Proceeds from sale of mortgage loans	33,781	40,962
Mortgage loans originated for sale	(31,625)	(43,135)
Net gain on sale of mortgage loans	(690)	(739)
Decrease in accrued interest receivable	93	160
Decrease in accrued interest payable	(236)	(331)
Net change in other assets/liabilities	193	1,036
<b>Net Cash Provided By Operating Activities</b>	<b>9,292</b>	<b>5,607</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchase of securities available for sale	(43,486)	(57,770)
Proceeds from maturities of securities available for sale	22,660	36,866
Proceeds from maturities of securities held to maturity	14	21
Proceeds from sales of securities available for sale	1,399	0
Principal collected on mortgage-backed obligations	9,776	12,711
Net decrease in loans receivable	15,793	13,221
Proceeds from sale of foreclosed real estate	815	1,570
Proceeds from redemption of Federal Home Loan Bank stock	374	357
Purchase of premises and equipment	(580)	(227)
<b>Net Cash Provided By Investing Activities</b>	<b>6,765</b>	<b>6,749</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase (decrease) in deposits	(13,629)	3,527
Net increase in retail repurchase agreements	456	720
Advances from Federal Home Loan Bank	1,000	9,500
Repayment of advances from Federal Home Loan Bank	(4,379)	(18,547)
Exercise of stock options	0	282
Purchase of treasury stock	(27)	(43)
Dividends paid	(2,130)	(2,077)
<b>Net Cash Used In Financing Activities</b>	<b>(18,709)</b>	<b>(6,638)</b>
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	<b>(2,652)</b>	<b>5,718</b>
Cash and cash equivalents at beginning of year	21,575	15,857

**Cash and Cash Equivalents at End of Year**

\$ 18,923      \$ 21,575

See notes to consolidated financial statements.

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**FIRST CAPITAL, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Nature of Operations**

First Capital, Inc. (the Company) is the thrift holding company of First Harrison Bank (the Bank), a wholly-owned subsidiary. The Bank is a federally-chartered savings bank which provides a variety of banking services to individuals and business customers through thirteen locations in southern Indiana. The Bank's primary source of revenue is real estate mortgage loans. The Bank originates mortgage loans for sale in the secondary market and also sells non-deposit investment products through a financial services division. First Harrison Investments, Inc. and First Harrison Holdings, Inc. are wholly-owned Nevada corporate subsidiaries of the Bank that jointly own First Harrison, LLC, a Nevada limited liability company that holds and manages an investment securities portfolio. First Harrison REIT, Inc. is a wholly-owned subsidiary of First Harrison Holdings, Inc. which holds a portion of the Bank's real estate mortgage loan portfolio.

The Company has evaluated subsequent events for potential recognition and disclosure through the date the consolidated financial statements were issued.

**Basis of Consolidation and Reclassifications**

The consolidated financial statements include the accounts of the Company and its subsidiaries and have been prepared in accordance with generally accepted accounting principles in the United States of America and conform to general practices in the banking industry. Intercompany balances and transactions have been eliminated. Certain prior year amounts have been reclassified to conform to the current year presentation.

**Statements of Cash Flows**

For purposes of the statements of cash flows, the Company considers all cash, amounts due from depository institutions and federal funds sold to be cash and cash equivalents.

**Use of Estimates**

The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and 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 relate to the determination of the allowance for loan losses and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans. In connection with the determination of the allowance for loan losses and foreclosed real estate, management obtains independent appraisals for significant properties.

A majority of the Bank's loan portfolio consists of single-family residential and commercial real estate loans in the southern Indiana area. Accordingly, the ultimate collectability of a substantial portion of the Bank's loan portfolio and the recovery of the carrying amount of foreclosed real estate are susceptible to changes in local market conditions.

While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the estimated losses on loans. Such agencies may require the Bank to recognize additional losses based on their judgments about information available to them at the time of their examination. Because of these factors, it is reasonably possible that the estimated losses on loans may change materially in the near term. However, the amount of the change that is reasonably possible cannot be estimated.

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**FIRST CAPITAL, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(1 - continued)

**Investment Securities**

*Securities Available for Sale:* Securities available for sale consist primarily of mortgage-backed and other debt securities and are stated at fair value. The Company holds mortgage-backed securities and other debt securities issued by the Government National Mortgage Association (GNMA), a U.S. government agency, and the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), and the Federal Home Loan Bank (FHLB), government-sponsored enterprises (collectively referred to as government agencies), as well as privately-issued collateralized mortgage obligations (CMOs) and other mortgage-backed securities. Mortgage-backed securities represent participating interests in pools of long-term first mortgage loans originated and serviced by issuers of the securities. CMOs are complex mortgage-backed securities that restructure the cash flows and risks of the underlying mortgage collateral. The Company also holds debt securities issued by municipalities and political subdivisions of state and local governments. Amortization of premiums and accretion of discounts are recognized in interest income using methods approximating the interest method over the period to maturity, adjusted for anticipated prepayments. Unrealized gains and losses, net of tax, on securities available for sale are included in other comprehensive income and the accumulated unrealized holding gains and losses are reported as a separate component of equity until realized. Realized gains and losses on the sale of securities available for sale are determined using the specific identification method and are included in other noninterest income and, when applicable, are reported as a reclassification adjustment, net of tax, in other comprehensive income.

*Securities Held to Maturity:* Debt securities for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts that are recognized in interest income using methods approximating the interest method over the period to maturity, adjusted for anticipated prepayments. The Company classifies certain mortgage-backed securities and municipal obligations as held to maturity.

Declines in the fair value of individual available for sale and held to maturity securities below their amortized cost that are other than temporary result in write-downs of the individual securities to their fair value. The related write-downs 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 amortized 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 for a period of time sufficient to allow for any anticipated recovery in fair value.

Investments in non-marketable equity securities such as Federal Home Loan Bank stock are carried at cost. Impairment testing on these investments is based on applicable accounting guidance and the cost basis is reduced when impairment is deemed to be other-than-temporary.

**Loans and Allowance for Loan Losses**

*Loans Held for Investment*

Loans are stated at unpaid principal balances, less net deferred loan fees and the allowance for loan losses. The Bank grants real estate mortgage, commercial business and consumer loans. A substantial portion of the loan portfolio is represented by mortgage loans to customers in southern Indiana. The ability of the Bank's customers to honor their contracts is dependent upon the real estate and general economic conditions in this area.

Loan origination and commitment fees, as well as certain direct costs of underwriting and closing loans, are deferred and amortized as a yield adjustment to interest income over the lives of the related loans using the interest method. Amortization of net deferred loan fees is discontinued when a loan is placed on nonaccrual status.



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**FIRST CAPITAL, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(1 - continued)

**Loans and Allowance for Loan Losses continued**

*Nonaccrual Loans*

The recognition of income on a loan is discontinued and previously accrued interest is reversed, when interest or principal payments become 90 days past due unless, in the opinion of management, the outstanding interest remains collectible. Past due status is determined based on contractual terms. Generally, by applying the cash receipts method, interest income is subsequently recognized only as received until the loan is returned to accrual status. The cash receipts method is used when the likelihood of further loss on the loan is remote. Otherwise, the Company applies the cost recovery method and applies all payments as a reduction of the unpaid principal balance until the loan qualifies for return to accrual status. Interest income on impaired loans is recognized using the cost recovery method, unless the likelihood of further loss on the loan is remote.

A loan is restored to accrual status when all principal and interest payments are brought current and the borrower has demonstrated the ability to make future payments of principal and interest as scheduled, which generally requires that the borrower demonstrate a period of performance of at least six consecutive months.

*Impaired Loans*

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due 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. Impairment is measured on a loan-by-loan basis 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.

Values for collateral dependent loans are generally based on appraisals obtained from independent licensed real estate appraisers, with adjustments applied for estimated costs to sell the property, costs to complete unfinished or repair damaged property and other known defects. New appraisals are generally obtained for all significant properties when a loan is identified as impaired, and a property is considered significant if the value of the property is estimated to exceed \$200,000. Subsequent appraisals are obtained as needed or if management believes there has been a significant change in the market value of the property. In instances where it is not deemed necessary to obtain a new appraisal, management bases its impairment and allowance for loan loss analysis on the original appraisal with adjustments for current conditions based on management's assessment of market factors and management's inspection of the property.

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**FIRST CAPITAL, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(1 - continued)

**Loans and Allowance for Loan Losses continued**

*Restructured Loans*

Modification of a loan is considered to be a troubled debt restructuring (TDR) if the debtor is experiencing financial difficulties and the Company grants a concession to the debtor that it would not otherwise consider. By granting the concession, the Company expects to obtain more cash or other value from the debtor, or to increase the probability of receipt, than would be expected by not granting the concession. The concession may include, but is not limited to, reduction of the stated interest rate of the loan, reduction of accrued interest, extension of the maturity date or reduction of the face amount of the debt. A concession will be granted when, as a result of the restructuring, the Company does not expect to collect all amounts due, including interest at the original stated rate. A concession may also be granted if the debtor is not able to access funds elsewhere at a market rate for debt with similar risk characteristics as the restructured debt. The Company's determination of whether a loan modification is a TDR considers the individual facts and circumstances surrounding each modification.

Restructured loans can involve loans remaining on nonaccrual, moving to nonaccrual, or continuing on accrual status, depending on the individual facts and circumstances of the borrower. Generally, a nonaccrual loan that is restructured in a TDR remains on nonaccrual status for a period of at least six months following the restructuring to ensure that the borrower performs in accordance with the restructured terms including consistent and timely payments.

*Allowance for Loan Losses*

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on at least a quarterly basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific and general components. The specific component relates to loans that are individually evaluated for impairment or loans otherwise classified as doubtful, substandard, or special mention. For such loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan.

The general component covers non-classified loans and classified loans that are not individually evaluated for impairment, and is based on historical loss experience adjusted for qualitative factors. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by the Company over the most recent eight calendar quarters unless the historical loss experience is not considered indicative of the level of risk in the remaining balance of a particular portfolio segment, in which case an adjustment is determined by management. The Company's actual loss experience is then adjusted by an overall loss factor weighting adjustment based on a qualitative analysis prepared by management and reviewed on a quarterly basis. The overall loss factor considers changes in underwriting standards, economic conditions, changes and trends in past due and classified loans and other internal and external factors. Management also applies additional loss factor multiples to loans classified as watch, special mention and substandard that are not individually evaluated for impairment. The loss factor multiples for classified loans are based on management's assessment of historical trends regarding losses experienced on classified loans in prior periods. See Note 4 for additional discussion of the overall loss factor and loss factor multiples for classified loans as of December 31, 2011 and 2010.

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**FIRST CAPITAL, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(1 - continued)

**Loans and Allowance for Loan Losses continued**

The following portfolio segments are considered in the allowance for loan loss analysis: residential real estate, land, construction, commercial real estate, commercial business, home equity and second mortgage, and other consumer loans.

Residential real estate loans primarily consist of loans to individuals for the purchase or refinance of their primary residence, with a smaller portion of the segment secured by multi-family residential properties. The risks associated with residential real estate loans are closely correlated to the local housing market and general economic conditions.

Land loans primarily consist of loans secured by farmland and vacant land held for investment purposes. The risks associated with land loans are related to the market value of the property taken as collateral and the underlying cash flows for loans secured by farmland, and general economic conditions.

The Company's construction loan portfolio consists of single-family residential properties, multi-family properties and commercial projects, and includes both owner-occupied and speculative investment properties. Risks inherent in construction lending are related to the market value of the property held as collateral, the cost and timing of constructing or improving a property, the borrower's ability to use funds generated by a project to service a loan until a project is completed, movements in interest rates and the real estate market during the construction phase, and the ability of the borrower to obtain permanent financing.

Commercial real estate loans are comprised of loans secured by various types of collateral including office buildings, warehouses, retail space and mixed use buildings located in the Company's primary lending area. Risks related to commercial real estate lending are related to the market value of the property taken as collateral, the underlying cash flows and general economic condition of the local real estate market. Repayment of these loans is generally dependent on the ability of the borrower to attract tenants at lease rates that provide for adequate debt service and can be impacted by local economic conditions which impact vacancy rates. The Company generally obtains loan guarantees from financially capable parties for commercial real estate loans.

Commercial business loans includes lines of credit to businesses, term loans and letters of credit secured by business assets such as equipment, accounts receivable, inventory, or other assets excluding real estate and are generally made to finance capital expenditures or fund operations. Commercial loans contain risks related to the value of the collateral securing the loan and the repayment is primarily dependent upon the financial success and viability of the borrower. As with commercial real estate loans, the Company generally obtains loan guarantees from financially capable parties for commercial business loans.

Home equity and second mortgage loans and other consumer loans consist primarily of home equity lines of credit and other loans secured by junior liens on the borrower's personal residence, home improvement loans, automobile and truck loans, boat loans, mobile home loans, loans secured by savings deposits, credit cards and other personal loans. The risks associated with these loans is related to the local housing market and local economic conditions including the unemployment level.

There were no significant changes to the Company's accounting policies or methodology used to estimate the allowance for loan losses from the prior period.

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**FIRST CAPITAL, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(1 - continued)

**Loans and Allowance for Loan Losses continued**

*Loan Charge-Offs*

For portfolio segments other than consumer loans, the Company's practice is to charge-off any loan or portion of a loan when the loan is determined by management to be uncollectible due to the borrower's failure to meet repayment terms, the borrower's deteriorating or deteriorated financial condition, the depreciation of the underlying collateral, the loan's classification as a loss by regulatory examiners, or for other reasons. A partial charge-off is recorded on a loan when the uncollectibility of a portion of the loan has been confirmed, such as when a loan is discharged in bankruptcy, the collateral is liquidated, a loan is restructured at a reduced principal balance, or other identifiable events that lead management to determine the full principal balance of the loan will not be repaid. A specific reserve is recognized as a component of the allowance for estimated losses on loans individually evaluated for impairment. Partial charge-offs on nonperforming and impaired loans are included in the Company's historical loss experience used to estimate the general component of the allowance for loan losses as discussed above. Specific reserves are not considered charge-offs in management's evaluation of the general component of the allowance for loan losses because they are estimates and the outcome of the loan relationship is undetermined. At December 31, 2011, the Company had 11 loans on which partial charge-offs of \$501,000 had been recorded. At December 31, 2010, the Company had no loans outstanding on which a partial charge-off had been recorded.

Consumer loans not secured by real estate are typically charged off at 90 days past due, or earlier if deemed uncollectible, unless the loans are in the process of collection. Overdrafts are charged off after 45 days past due. Charge-offs are typically recorded on loans secured by real estate when the property is foreclosed upon.

**Foreclosed Real Estate**

Foreclosed real estate includes both formally foreclosed property and in-substance foreclosed property held for sale. In-substance foreclosed properties are those properties for which the institution has taken physical possession, regardless of whether formal foreclosure proceedings have taken place.

At the time of foreclosure, foreclosed real estate is recorded at fair value less estimated costs to sell, which becomes the property's new basis. Any write-downs based on the property's fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, valuations are periodically performed by management and property held for sale is carried at the lower of the new cost basis or fair value less cost to sell. Costs incurred in maintaining foreclosed real estate and subsequent impairment adjustments to the carrying amount of a property, if any, are included in other noninterest expense.

**Premises and Equipment**

Premises and equipment are stated at cost less accumulated depreciation. The Company uses the straight line method of computing depreciation at rates adequate to amortize the cost of the applicable assets over their estimated useful lives. Maintenance and repairs are expensed as incurred. The cost and related accumulated depreciation of assets sold, or otherwise disposed of, are removed from the related accounts and any gain or loss is included in earnings.

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**FIRST CAPITAL, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(1 - continued)

**Goodwill and Other Intangibles**

Goodwill recognized in a business combination represents the excess of the cost of the acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed. Goodwill is carried at its implied fair value and is evaluated for possible impairment at least annually or more frequently upon the occurrence of an event or change in circumstances that would more likely than not reduce the fair value of the reporting unit below its carrying amount. Such circumstances could include, but are not limited to: (1) a significant adverse change in legal factors or in business climate, (2) unanticipated competition, or (3) an adverse action or assessment by a regulator. If the carrying amount of the goodwill exceeds its implied fair value, an impairment loss is recognized in earnings equal to that excess amount. The loss recognized cannot exceed the carrying amount of goodwill. After a goodwill impairment loss is recognized, the adjusted carrying amount of goodwill is its new accounting basis.

Other intangible assets consist of acquired core deposit intangibles. Core deposit intangibles are amortized over the estimated economic lives of the acquired core deposits. The carrying amount of core deposit intangibles and the remaining estimated economic life are evaluated annually or whenever events or circumstances indicate the carrying amount may not be recoverable or the remaining period of amortization requires revision. After an impairment loss is recognized, the adjusted carrying amount of the intangible asset is its new accounting basis.

**Mortgage Banking Activities**

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or market value. Aggregate market value is determined based on the quoted prices under a best efforts sales agreement with a third party. Net unrealized losses are recognized through a valuation allowance by charges to income. Realized gains on sales of mortgage loans are included in noninterest income. Mortgage loans are sold with servicing released.

Commitments to originate mortgage loans held for sale are considered derivative financial instruments to be accounted for at fair value. The Bank's mortgage loan commitments subject to derivative accounting are fixed-rate mortgage loan commitments at market rates when initiated. At December 31, 2011, the Bank had commitments to originate \$1.2 million in fixed-rate mortgage loans intended for sale in the secondary market after the loans are closed. Fair value is estimated based on fees that would be charged on commitments with similar terms.

**Cash Surrender Value of Life Insurance**

The Bank has purchased life insurance policies on certain directors, officers and key employees to offset costs associated with the Bank's compensation and benefit programs. Bank-owned life insurance is recorded at the amount that can be realized under the insurance contracts at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

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**FIRST CAPITAL, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(1 - continued)

**Income Taxes**

When income tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while other positions are subject to some degree of uncertainty regarding the merits of the position taken or the amount of the position that would be sustained. The Company recognizes the benefits of a tax position in the consolidated financial statements of the period during which, based on all available evidence, management believes it is more-likely-than-not (more than 50 percent probable) that the tax position would be sustained upon examination. Income tax positions that meet the more-likely-than-not threshold are measured as the largest amount of income tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with the income tax positions claimed on income tax returns that exceeds the amount measured as described above is reflected as a liability for unrecognized income tax benefits in the consolidated balance sheet, along with any associated interest and penalties that would be payable to the taxing authorities, if there were an examination. Interest and penalties associated with unrecognized income tax benefits are classified as additional income taxes in the statement of income.

Income taxes are provided for the tax effects of the transactions reported in the financial statements and consist of taxes currently due plus deferred income taxes. Income tax reporting and financial statement reporting rules differ in many respects. As a result, there will often be a difference between the carrying amount of an asset or liability as presented in the accompanying consolidated balance sheets and the amount that would be recognized as the tax basis of the same asset or liability computed based on the effects of tax positions recognized, as described in the preceding paragraph. These differences are referred to as temporary differences because they are expected to reverse in future years. Deferred income tax assets are recognized for temporary differences where their future reversal will result in future tax benefits. Deferred income tax assets are also recognized for the future tax benefits expected to be realized from net operating loss or tax credit carryforwards. Deferred income tax liabilities are recognized for temporary differences where their future reversal will result in the payment of future income taxes. Deferred income tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred income tax assets will not be realized. Deferred tax assets and liabilities are reflected at income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

**Stock-Based Compensation**

The Company has adopted the fair value based method of accounting for stock-based compensation prescribed in Accounting Standards Codification (ASC) Topic 718 for its stock plans.

**Advertising Costs**

Advertising costs are charged to operations when incurred.

**Comprehensive Income**

Comprehensive income consists of reported net income and other comprehensive income. Other comprehensive income refers to revenue, expenses, gains and losses that are recorded as an element of equity but are excluded from reported net income. Other comprehensive income includes changes in the unrealized gains and losses on securities available for sale.

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**FIRST CAPITAL, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(1 - continued)

**Earnings per Common Share**

Basic earnings per common share is computed by dividing net income available to common shareholders by the weighted average number of shares of common stock outstanding during the periods presented. Diluted earnings per common share include the dilutive effect of additional potential common shares issuable under stock options, restricted stock and other potentially dilutive securities outstanding. Earnings and dividends per share are restated for stock splits and dividends through the date of issuance of the financial statements.

**Loss Contingencies**

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated.

**Recent Accounting Pronouncements**

The following are summaries of recently issued or adopted accounting pronouncements that impact the accounting and reporting practices of the Company:

In April 2011, the FASB issued ASU No. 2011-02, *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*. The new guidance is intended to assist creditors in determining when a loan modification or restructuring is considered a TDR, in order to address current diversity in practice and lead to more consistent application of accounting principles. In evaluating whether a restructuring constitutes a TDR, a creditor must separately conclude that the restructuring constitutes a concession and the debtor is experiencing financial difficulties. The amendments in the update are effective for the first interim period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. The adoption of this ASU did not have a material impact on the Company's consolidated financial position or results of operations.

In April 2011, the FASB issued ASU No. 2011-03, *Reconsideration of Effective Control for Repurchase Agreements*. The update removes from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (2) the collateral maintenance implementation guidance related to that criterion. Other criteria applicable to the assessment of effective control are not changed by the amendments in the update. The guidance in the update is effective for the first interim or annual period beginning on or after December 15, 2011, and should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. The adoption of this ASU is not expected to have a material impact on the Company's consolidated financial position or results of operations.

In May 2011, the FASB issued ASU No. 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements by U.S. GAAP and IFRSs*. The amendments in this ASU generally represent clarifications of FASB ASC Topic 820, but also include some instances where a particular principle or requirement for measuring fair value or disclosing information about fair value measurements has changed. This ASU results in common principles and requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. GAAP and IFRSs. The amendments in this ASU are to be applied prospectively. For public entities, the amendments are effective for interim and annual periods beginning after December 15, 2011. Early application by public entities is not permitted. The adoption of this ASU is not expected to have any impact on the Company's consolidated financial position or results of operations.

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**FIRST CAPITAL, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(1 - continued)

**Recent Accounting Pronouncements continued**

In June 2011, the FASB issued ASU No. 2011-05, *Amendments to Topic 220, Comprehensive Income*. Under the amendments in this ASU, an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. This ASU eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments in this ASU do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. The amendments in this ASU should be applied retrospectively. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted, because compliance with the amendments is already permitted. The amendments do not require any transition disclosures. The adoption of this ASU did not have a material impact on the Company's consolidated financial position or results of operations. ASU No. 2011-12 issued in December 2011 deferred the effective date of ASU No. 2011-05 related to the presentation of reclassifications of items out of accumulated other comprehensive income. All other requirements of ASU No. 2011-05 were not affected by ASU No. 2011-12.

In September 2011, the FASB issued ASU No. 2011-08, *Intangibles-Goodwill and Other (Topic 350): Testing Goodwill for Impairment*. The update provides entities with the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, then the entity is required to perform the second step of the goodwill impairment test to measure the amount of the impairment loss, if any. Under the amendments in ASU No. 2011-08, an entity has the option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to performing the first step of the two-step goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period. The amendments enacted by ASU No. 2011-08 are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted, including for annual and interim goodwill impairment tests performed as of a date before September 15, 2011, if an entity's financial statements for the most recent annual or interim period have not yet been issued or, for nonpublic entities, have not yet been made available for issuance. The adoption of this update is not expected to have a material impact on the Company's consolidated financial position or results of operations.

In December 2011, the FASB issued ASU No. 2011-11, *Balance Sheet (Topic 210)*. The update requires an entity to disclose information about offsetting and related arrangements to enable users of the financial statements to understand the effect of netting arrangements on the entity's financial position. The scope includes derivatives, sale and repurchase agreements and reverse sale and repurchase agreements, and securities borrowing and securities lending arrangements. The amendments in the update are effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods, with disclosures required by the amendments provided retrospectively for all comparative periods presented. The adoption of this update is not expected to have any impact on the Company's consolidated financial position or results of operations.

**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED****(2) RESTRICTION ON CASH AND DUE FROM BANKS**

The Bank is required to maintain reserve balances on hand and with the Federal Reserve Bank which are noninterest bearing and unavailable for investment. The average amount of those reserve balances for the years ended December 31, 2011 and 2010 was approximately \$1.4 million and \$1.3 million, respectively.

**(3) INVESTMENT SECURITIES**

Debt and equity securities have been classified in the balance sheets according to management's intent. Investment securities at December 31, 2011 and 2010 are summarized as follows:

<i>(In thousands)</i>	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Fair Value</b>
<b>December 31, 2011:</b>				
Securities available for sale:				
Agency mortgage-backed securities	\$ 11,689	\$ 542	\$ 11	\$ 12,220
Agency CMO	23,196	152	60	23,288
Privately-issued CMO	896	16	32	880
Other debt securities:				
Agency notes and bonds	41,971	395	3	42,363
Municipal obligations	25,800	1,501	0	27,301
<b>Subtotal debt securities</b>	<b>103,552</b>	<b>2,606</b>	<b>106</b>	<b>106,052</b>
Mutual funds	5,369	52	33	5,388
<b>Total securities available for sale</b>	<b>\$ 108,921</b>	<b>\$ 2,658</b>	<b>\$ 139</b>	<b>\$ 111,440</b>
Securities held to maturity:				
Agency mortgage-backed securities	\$ 16	\$ 0	\$ 0	\$ 16
<b>Total securities held to maturity</b>	<b>\$ 16</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 16</b>
<b>December 31, 2010:</b>				
Securities available for sale:				
Agency mortgage-backed securities	\$ 12,101	\$ 580	\$ 0	\$ 12,681
Agency CMO	11,987	46	65	11,968
Privately-issued CMO	1,688	10	46	1,652
Other debt securities:				
Agency notes and bonds	42,400	297	317	42,380
Municipal obligations	29,366	371	281	29,456
<b>Subtotal debt securities</b>	<b>97,542</b>	<b>1,304</b>	<b>709</b>	<b>98,137</b>
Mutual funds	2,705	36	27	2,714

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Total securities available for sale	\$ 100,247	\$ 1,340	\$ 736	\$ 100,851
Securities held to maturity:				
Agency mortgage-backed securities	\$ 18	\$ 0	\$ 0	\$ 18
Municipal obligations	14	0	0	14
Total securities held to maturity	\$ 32	\$ 0	\$ 0	\$ 32

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**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(3 - continued)

The amortized cost and fair value of debt securities as of December 31, 2011, by contractual maturity, are shown below. Expected maturities of mortgage-backed securities may differ from contractual maturities because the mortgages underlying the obligations may be prepaid without penalty.

	<b>Securities Available for Sale</b>		<b>Securities Held to Maturity</b>	
	<b>Amortized Cost</b>	<b>Fair Value</b>	<b>Amortized Cost</b>	<b>Fair Value</b>
<i>(In thousands)</i>				
Due in one year or less	\$ 2,299	\$ 2,313	\$ 0	\$ 0
Due after one year through five years	10,495	10,607	0	0
Due after five years through ten years	17,025	17,577	0	0
Due after ten years	37,952	39,167	0	0
	67,771	69,664	0	0
Mortgage-backed securities and CMO	35,781	36,388	16	16
	\$ 103,552	\$ 106,052	\$ 16	\$ 16

At December 31, 2011, certain investment securities were pledged under retail repurchase agreements and to secure Federal Home Loan Bank advances at December 31, 2011. (See Notes 9 and 10)

Information pertaining to investment securities available for sale with gross unrealized losses at December 31, 2011, aggregated by investment category and the length of time that individual investment securities have been in a continuous loss position, follows:

	<b>Number of Investment Positions</b>	<b>Fair Value</b>	<b>Gross Unrealized Losses</b>
<i>(Dollars in thousands)</i>			
Continuous loss position less than twelve months:			
Agency mortgage-backed securities	2	\$ 2,067	\$ 11
Agency CMO	9	7,402	60
Agency notes and bonds	2	2,061	3
Total less than twelve months	13	11,530	74
Continuous loss position more than twelve months:			
Privately-issued CMO	1	237	32
Mutual fund	1	346	33
Total more than twelve months	2	583	65
Total securities available for sale	15	\$ 12,113	\$ 139

At December 31, 2011, the Company did not have any securities held to maturity with an unrealized loss. Management evaluates securities for other-than-temporary impairment at least quarterly, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (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 Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

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**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(3 - continued)

At December 31, 2011, the 13 U.S. government agency debt securities, including agency mortgage-backed securities, agency CMOs and agency notes and bonds in a loss position had depreciated approximately 0.6% from the amortized cost basis. All of the U.S. government agency securities are issued by U.S. government agencies or government-sponsored enterprises, or are secured by first mortgage loans. These unrealized losses related principally to current interest rates for similar types of securities. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government, its agencies or other governments, whether downgrades by bond rating agencies have occurred, and the results of reviews of the issuer's financial condition. As the Company has the ability to hold the U.S. government agency debt securities until maturity, or for the foreseeable future if classified as available for sale, no declines are deemed to be other-than-temporary.

At December 31, 2010, the privately-issued CMO in a loss position had depreciated approximately 11.8% from the amortized cost basis. The Company evaluates the existence of a potential credit loss component related to the decline in fair value of the privately-issued CMO portfolio each quarter using an independent third party analysis. At December 31, 2011, the privately-issued CMO in a loss position had an amortized cost of \$269,000 and a fair value of \$237,000, and had been downgraded to a substandard regulatory classification in 2009 due to a downgrade of the security's credit quality rating by various rating agencies. Based on the independent third party analysis performed in December 2011, the Company recognized an other-than-temporary impairment loss of \$36,000 representing the credit loss component of the unrealized loss. While management does not anticipate further credit-related impairment losses at December 31, 2011, additional deterioration in market and economic conditions may have an adverse impact on the credit quality in the future.

During the year ended December 31, 2011, the Company realized gross gains on sales of available for sale U.S. government agency mortgage-backed securities of \$16,000 and gross losses on sales of available for sale municipal obligations of \$24,000.

**(4) LOANS AND ALLOWANCE FOR LOAN LOSSES**

Loans at December 31, 2011 and 2010 consisted of the following:

<i>(In thousands)</i>	<b>2011</b>	<b>2010</b>
<b>Real estate mortgage loans:</b>		
Residential	\$ 116,338	\$ 130,143
Land	9,910	9,534
Residential construction	10,988	8,151
Commercial real estate	57,680	59,901
Commercial real estate construction	743	0
Commercial business loans	20,722	21,911
<b>Consumer loans:</b>		
Home equity and second mortgage loans	38,641	43,046
Automobile loans	20,627	19,384
Loans secured by savings accounts	767	1,042
Unsecured loans	3,126	3,076
Other consumer loans	5,312	5,732
<b>Gross loans</b>	<b>284,854</b>	<b>301,920</b>

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Deferred loan origination fees, net	143	222
Undisbursed portion of loans in process	(4,768)	(3,119)
Allowance for loan losses	(4,182)	(4,473)
Loans, net	\$ 276,047	\$ 294,550

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**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(4 - continued)

At December 31, 2011, residential mortgage loans secured by residential properties without private mortgage insurance or government guarantee and with loan-to-value ratios exceeding 90% amounted to approximately \$4.6 million.

Mortgage loans serviced for the benefit of others amounted to \$269,000 and \$279,000 at December 31, 2011 and 2010, respectively.

The Bank has entered into loan transactions with certain directors, officers and their affiliates (i.e., related parties). In the opinion of management, such indebtedness was incurred in the ordinary course of business on substantially the same terms, including interest rate and collateral, as those prevailing at the time for comparable transactions with unrelated persons.

The following table represents the aggregate activity for related party loans during the year ended December 31, 2011. The beginning balance has been adjusted to reflect new directors and officers, as well as directors and officers that are no longer with the Company.

*(In thousands)*

Beginning balance, as adjusted	\$6,441
New loans	8,728
Payments	(9,309)
Ending balance	\$5,860

A director of the Bank is a shareholder of a farm implement dealership that contracts with the Bank to provide sales financing to the dealership's customers. In the opinion of management, these transactions were made in the ordinary course of business on substantially the same terms, including interest rate and collateral, as those prevailing at the time for comparable transactions with unrelated parties. During the year ended December 31, 2011, the Bank purchased approximately \$444,000 of loans to customers of the corporation and the aggregate outstanding balance of all loans purchased from the corporation was approximately \$1.2 million and \$1.4 million at December 31, 2011 and 2010, respectively.

**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(4 - continued)

The following table provides the components of the Company's recorded investment in loans for each portfolio segment at December 31, 2011 and 2010:

	<b>Residential</b>			<b>Commercial Real Estate</b>	<b>Commercial Business</b>	<b>Home Equity and Second Mortgage</b>	<b>Other Consumer</b>	<b>Total</b>
	<b>Real Estate</b>	<b>Land</b>	<b>Construction</b>	<b>Real Estate</b>	<b>Business</b>	<b>Mortgage</b>	<b>Consumer</b>	
	<i>(In thousands)</i>							
<b><u>December 31, 2011:</u></b>								
Principal loan balance	\$ 116,338	\$ 9,910	\$ 6,963	\$ 57,680	\$ 20,722	\$ 38,641	\$ 29,832	\$ 280,086
Accrued interest receivable	463	60	16	160	64	162	202	1,127
Net deferred loan origination fees and costs	67	2	0	0	(10)	84	0	143
Recorded investment in loans	\$ 116,868	\$ 9,972	\$ 6,979	\$ 57,840	\$ 20,776	\$ 38,887	\$ 30,034	\$ 281,356
<b><u>December 31, 2010:</u></b>								
Principal loan balance	\$ 130,143	\$ 9,534	\$ 5,032	\$ 59,901	\$ 21,911	\$ 43,046	\$ 29,234	\$ 298,801
Accrued interest receivable	480	54	16	174	68	171	199	1,162
Net deferred loan origination fees and costs	91	1		10		120		222
Recorded investment in loans	\$ 130,714	\$ 9,589	\$ 5,048	\$ 60,085	\$ 21,979	\$ 43,337	\$ 29,433	\$ 300,185

**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(4 - continued)

An analysis of the allowance for loan losses and recorded investment in loans as of and for the year ended December 31, 2011 is as follows:

	<b>Residential</b>			<b>Commercial Real Estate</b>	<b>Commercial Business</b>	<b>Home Equity and Second Mortgage</b>	<b>Other Consumer</b>	<b>Total</b>
	<b>Real Estate</b>	<b>Land</b>	<b>Construction</b>	<b>Estate</b>				
	<i>(In thousands)</i>							
<b><u>Allowance for Loan Losses:</u></b>								
Beginning balance	\$ 1,024	\$ 55	\$ 21	\$ 1,051	\$ 1,251	\$ 606	\$ 465	\$ 4,473
Provisions	609	38	8	614	197	322	37	1,825
Charge-offs	(819)	0	0	(396)	(333)	(577)	(302)	(2,427)
Recoveries	14	0	4	0	45	49	199	311
Ending balance	\$ 828	\$ 93	\$ 33	\$ 1,269	\$ 1,160	\$ 400	\$ 399	\$ 4,182
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	\$ 183	\$ 0	\$ 0	\$ 539	\$ 936	\$ 0	\$ 0	\$ 1,658
Collectively evaluated for impairment	645	93	33	730	224	400	399	2,524
Acquired with deteriorated credit quality	0	0	0	0	0	0	0	0
Ending balance	\$ 828	\$ 93	\$ 33	\$ 1,269	\$ 1,160	\$ 400	\$ 399	\$ 4,182
<b><u>Recorded Investment in Loans:</u></b>								
Individually evaluated for impairment	\$ 2,281	\$ 5	\$ 247	\$ 2,853	\$ 1,928	\$ 87	\$ 0	\$ 7,401
Collectively evaluated for impairment	114,587	9,967	6,732	54,987	18,848	38,800	30,034	273,955
Acquired with deteriorated credit quality	0	0	0	0	0	0	0	0
Ending balance	\$ 116,868	\$ 9,972	\$ 6,979	\$ 57,840	\$ 20,776	\$ 38,887	\$ 30,034	\$ 281,356

**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(4 - continued)

An analysis of the allowance for loan losses and recorded investment in loans as of and for the year ended December 31, 2010 is as follows:

	Residential			Commercial		Home Equity and Second Mortgage		Other Consumer	Total
	Real Estate	Land	Construction	Real Estate	Commercial Business				
(In thousands)									
<b><u>Allowance for Loan Losses:</u></b>									
Beginning balance	\$ 1,208	\$ 121	\$ 107	\$ 1,633	\$ 1,264	\$ 217	\$ 381	\$ 4,931	
Provisions	427	(6)	(86)	680	7	648	367	2,037	
Charge-offs	(620)	(61)	0	(1,265)	(29)	(299)	(457)	(2,731)	
Recoveries	9	1	0	3	9	40	174	236	
Ending balance	\$ 1,024	\$ 55	\$ 21	\$ 1,051	\$ 1,251	\$ 606	\$ 465	\$ 4,473	
Ending allowance balance attributable to loans:									
Individually evaluated for impairment	\$ 458	\$ 0	\$ 0	\$ 607	\$ 1,089	\$ 338	\$ 0	\$ 2,492	
Collectively evaluated for impairment	566	55	21	444	162	268	465	1,981	
Acquired with deteriorated credit quality	0	0	0	0	0	0	0	0	
Ending balance	\$ 1,024	\$ 55	\$ 21	\$ 1,051	\$ 1,251	\$ 606	\$ 465	\$ 4,473	
<b><u>Recorded Investment in Loans:</u></b>									
Individually evaluated for impairment	\$ 2,951	\$ 0	\$ 279	\$ 1,780	\$ 2,148	\$ 390	\$ 0	\$ 7,548	
Collectively evaluated for impairment	127,763	9,589	4,769	58,305	19,831	42,947	29,433	292,637	
Acquired with deteriorated credit quality	0	0	0	0	0	0	0	0	
Ending balance	\$ 130,714	\$ 9,589	\$ 5,048	\$ 60,085	\$ 21,979	\$ 43,337	\$ 29,433	\$ 300,185	

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**FIRST CAPITAL, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(4 - continued)

At December 31, 2011 and 2010, for each loan portfolio segment management applied an overall qualitative factor of 1.15 to the Company's historical loss factors based on the most eight recent calendar quarters. The overall qualitative factor is derived from management's analysis of changes and trends in the following qualitative factors:

**Underwriting Standards** Management reviews the findings of periodic internal audit loan reviews, independent outsourced loan reviews and loan reviews performed by the banking regulators to evaluate the risk associated with changes in underwriting standards. At December 31, 2011 and 2010, management assessed the risk associated with this component as neutral, requiring no adjustment to the historical loss factors.

**Economic Conditions** Management analyzes trends in housing and unemployment data in the Harrison, Floyd and Clark counties of Indiana, the Company's primary market area, to evaluate the risk associated with economic conditions. Due to a decrease in new home construction and an increase in unemployment in the Company's primary market area, management assigned a risk factor of 1.20 for the component at December 31, 2011 and 2010.

**Past Due Loans** Management analyzes trends in past due loans for the Company to evaluate the risk associated with delinquent loans. In general, past due loan ratios have remained at elevated levels compared to historical amounts since 2007, and management assigned a risk factor of 1.20 for the component at December 31, 2011 and 2010.

**Other Internal and External Factors** This component includes management's consideration of other qualitative factors such as loan portfolio composition. The Company has focused on the origination of commercial business and real estate loans in an effort to convert the Company's balance sheet from that of a traditional thrift institution to a commercial bank. In addition, the Company has increased its investment in mortgage loans in which it does not hold a first lien position. Commercial loans and second mortgage loans generally entail greater credit risk than residential mortgage loans secured by a first lien. As a result of changes in the loan portfolio composition, management assigned a risk factor of 1.20 for this component at December 31, 2011 and 2010.

Each of the four factors above was assigned an equal weight to arrive at an average for the overall qualitative factor of 1.15 at December 31, 2011 and 2010. The effect of the overall qualitative factor was to increase the estimated allowance for loan losses by \$317,000 and \$258,000 at December 31, 2011 and 2010, respectively.

Management also applies additional loss factor multiples to loans classified as watch, special mention and substandard that are not individually evaluated for impairment. The multiples consider the increased likelihood of loss on classified loans based on the Company's historical experience. The multiples remained unchanged from December 31, 2010 to December 31, 2011, and the effect of the loss factor multiples for classified loans was to increase the estimated allowance for loan losses by \$172,000 and \$248,000 at December 31, 2011 and 2010, respectively.

**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(4 - continued)

The following table summarizes the Company's impaired loans by class of loans as of and for the year ended December 31, 2011:

	<b>Recorded Investment</b>	<b>Unpaid Principal Balance</b>	<b>Related Allowance</b>	<b>Average Recorded Investment</b>	<b>Interest Income Recognized</b>	<b>Interest Recognized Cash Method</b>
<i>(In thousands)</i>						
<b><u>Loans with no related allowance recorded:</u></b>						
Residential real estate	\$ 1,149	\$ 1,507	\$ 0	\$ 978	\$ 0	\$ 29
Land	5	6	0	5	0	0
Construction	247	249	0	261	0	0
Commercial real estate	1,215	1,280	0	514	0	9
Commercial business	0	0	0	14	0	0
Home equity and second mortgage	87	94	0	32	0	1
Other consumer	0	0	0	4	0	0
	2,703	3,136	0	1,808	0	39
<b><u>Loans with an allowance recorded:</u></b>						
Residential real estate	1,132	1,233	183	2,035	0	9
Land	0	0	0	0	0	0
Construction	0	0	0	56	0	0
Commercial real estate	1,638	1,933	539	1,208	0	0
Commercial business	1,928	2,023	936	2,036	0	0
Home equity and second mortgage	0	0	0	282	0	0
Other consumer	0	0	0	5	0	0
	4,698	5,189	1,658	5,622	0	9
<b><u>Total:</u></b>						
Residential real estate	2,281	2,740	183	3,013	0	38
Land	5	6	0	5	0	0
Construction	247	249	0	317	0	0
Commercial real estate	2,853	3,213	539	1,722	0	9
Commercial business	1,928	2,023	936	2,050	0	0
Home equity and second mortgage	87	94	0	314	0	1
Other consumer	0	0	0	9	0	0
	\$ 7,401	\$ 8,325	\$ 1,658	\$ 7,430	\$ 0	\$ 48

**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(4 - continued)

The following table summarizes the Company's impaired loans by class of loans as of and for the year ended December 31, 2010:

	<b>Recorded Investment</b>	<b>Unpaid Principal Balance</b>	<b>Related Allowance</b>	<b>Average Recorded Investment</b>	<b>Interest Income Recognized</b>	<b>Interest Recognized Cash Method</b>
<i>(In thousands)</i>						
<b><u>Loans with no related allowance recorded:</u></b>						
Residential real estate	\$ 703	\$ 822	\$ 0	\$ 1,082	\$ 0	\$ 1
Land	0	0	0	68	0	0
Construction	0	0	0	0	0	0
Commercial real estate	398	412	0	1,107	0	0
Commercial business	0	0	0	0	0	0
Home equity and second mortgage	17	18	0	140	0	0
Other consumer	0	0	0	25	0	0
	1,118	1,252	0	2,422	0	1
<b><u>Loans with an allowance recorded:</u></b>						
Residential real estate	2,248	2,358	458	1,532	0	4
Land	0	0	0	0	0	0
Construction	279	281	0	140	0	0
Commercial real estate	1,382	1,424	607	963	0	0
Commercial business	2,148	2,175	1,089	2,190	0	0
Home equity and second mortgage	373	379	338	347	0	2
Other consumer	0	0	0	0	0	0
	6,430	6,617	2,492	5,172	0	6
<b><u>Total:</u></b>						
Residential real estate	2,951	3,180	458	2,614	0	5
Land	0	0	0	68	0	0
Construction	279	281	0	140	0	0
Commercial real estate	1,780	1,836	607	2,070	0	0
Commercial business	2,148	2,175	1,089	2,190	0	0
Home equity and second mortgage	390	397	338	487	0	2
Other consumer	0	0	0	25	0	0
	\$ 7,548	\$ 7,869	\$ 2,492	\$ 7,594	\$ 0	\$ 7

**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(4 - continued)

Nonperforming loans consists of nonaccrual loans and loans over 90 days past due and still accruing interest. The following table presents the recorded investment in nonperforming loans by class of loans at December 31, 2011 and 2010:

	December 31, 2011			December 31, 2010		
	Loans 90+ Days			Loans 90+ Days		
	Nonaccrual	Past Due	Total	Nonaccrual	Past Due	Total
	Loans	Still Accruing	Nonperforming Loans	Loans	Still Accruing	Nonperforming Loans
	<i>(In thousands)</i>					
Residential real estate	\$ 2,281	\$ 143	\$ 2,424	\$ 2,951	\$ 334	\$ 3,285
Land	5	38	43	0	0	0
Construction	247	0	247	279	0	279
Commercial real estate	2,853	0	2,853	1,780	0	1,780
Commercial business	1,928	0	1,928	2,148	20	2,168
Home equity and second mortgage	87	159	246	390	8	398
Other consumer	0	23	23	0	17	17
Total	\$ 7,401	\$ 363	\$ 7,764	\$ 7,548	\$ 379	\$ 7,927

The following table presents the aging of the recorded investment loans by class of loans at December 31, 2011:

	30-59 Days	60-89 Days	Over 90 Days	Total	Total	
	Past Due	Past Due	Past Due	Past Due	Current	Loans
	<i>(In thousands)</i>					
Residential real estate	\$ 5,205	\$ 1,068	\$ 1,035	\$ 7,308	\$ 109,560	\$ 116,868
Land	442	43	43	528	9,444	9,972
Construction	0	0	247	247	6,732	6,979
Commercial real estate	676	0	1,258	1,934	55,906	57,840
Commercial business	256	0	0	256	20,520	20,776
Home equity and second mortgage	558	72	246	876	38,011	38,887
Other consumer	306	37	23	366	29,668	30,034
Total	\$ 7,443	\$ 1,220	\$ 2,852	\$ 11,515	\$ 269,841	\$ 281,356

**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(4 - continued)

The following table presents the aging of the recorded investment in loans by class of loans at December 31, 2010:

	30-59 Days	60-89 Days	Over 90 Days	Total		Total
	Past Due	Past Due	Past Due	Past Due	Current	Loans
	<i>(In thousands)</i>					
Residential real estate	\$ 5,652	\$ 581	\$ 1,590	\$ 7,823	\$ 122,891	\$ 130,714
Land	143	6	0	149	9,440	9,589
Construction	135	0	279	414	4,634	5,048
Commercial real estate	788	337	678	1,803	58,282	60,085
Commercial business	143	0	2,001	2,144	19,835	21,979
Home equity and second mortgage	596	352	298	1,246	42,091	43,337
Other consumer	362	93	17	472	28,961	29,433
Total	\$ 7,819	\$ 1,369	\$ 4,863	\$ 14,051	\$ 286,134	\$ 300,185

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, public information, historical payment experience, credit documentation, and current economic trends, among other factors. The Company classifies loans based on credit risk at least quarterly. The Company uses the following regulatory definitions for risk ratings:

*Special Mention:* Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the Company's credit position at some future date.

*Substandard:* Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

*Doubtful:* Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

*Loss:* Loans classified as loss are considered uncollectible and of such little value that their continuance on the Company's books as an asset, without establishment of a specific valuation allowance or charge-off, is not warranted.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans.

**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(4 - continued)

The following table presents the recorded investment in loans by risk category and class of loans as of the date indicated:

	<b>Residential</b>			<b>Commercial Real Estate</b>	<b>Commercial Business</b>	<b>Home Equity and Second Mortgage</b>	<b>Other Consumer</b>	<b>Total</b>
	<b>Real Estate</b>	<b>Land</b>	<b>Construction</b>					
	<i>(In thousands)</i>							
<b><u>December 31, 2011:</u></b>								
Pass	\$ 113,037	\$ 7,578	\$ 6,217	\$ 46,544	\$ 16,961	\$ 38,513	\$ 29,976	\$ 225,826
Special mention	862	255	307	5,392	1,462	63	44	8,385
Substandard	688	2,134	208	3,051	425	224	14	6,744
Doubtful	2,281	5	247	2,853	1,928	87	0	7,401
Loss	0	0	0	0	0	0	0	
<b>Total</b>	<b>\$ 116,868</b>	<b>\$ 9,972</b>	<b>\$ 6,979</b>	<b>\$ 57,840</b>	<b>\$ 20,776</b>	<b>\$ 38,887</b>	<b>\$ 30,034</b>	<b>\$ 281,356</b>
<b><u>December 31, 2010:</u></b>								
Pass	\$ 121,604	\$ 9,172	\$ 4,588	\$ 50,742	\$ 18,568	\$ 42,014	\$ 29,275	\$ 275,963
Special mention	2,691	308	0	4,937	765	695	158	9,554
Substandard	3,468	109	181	2,626	498	238	0	7,120
Doubtful	2,951	0	279	1,780	2,148	390	0	7,548
Loss	0	0	0	0	0	0	0	0
<b>Total</b>	<b>\$ 130,714</b>	<b>\$ 9,589</b>	<b>\$ 5,048</b>	<b>\$ 60,085</b>	<b>\$ 21,979</b>	<b>\$ 43,337</b>	<b>\$ 29,433</b>	<b>\$ 300,185</b>

**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(4 - continued)

The following table summarizes the Company's TDRs by class of loan and accrual status as of December 31, 2011 and 2010:

	December 31, 2011					December 31, 2010		
	Accruing	Nonaccrual	Total	Related Allowance for Loan Losses	Accruing	Nonaccrual	Total	Related Allowance for Loan Losses
	(In thousands)							
Residential real estate	\$ 112	\$ 516	\$ 628	\$ 11	\$ 0	\$ 623	\$ 623	\$ 71
Land	135	0	135	0	0	0	0	0
Construction	207	247	454	0	0	279	279	0
Commercial real estate	0	1,603	1,603	211	0	1,057	1,057	444
Commercial business	0	1,843	1,843	914	0	1,909	1,909	914
Home equity and second mortgage	8	0	8	0	0	0	0	0
Other consumer	0	0	0	0	0	75	75	75
Total	\$ 462	\$ 4,209	\$ 4,671	\$ 1,136	\$ 0	\$ 3,943	\$ 3,943	\$ 1,504

At December 31, 2011 and 2010, commitments to lend additional funds to debtors whose loan terms have been modified in a TDR (both accruing and nonaccruing) totaled \$192,000 and \$61,000, respectively. These commitments represent the undisbursed portion of construction loans to borrowers that have outstanding loans classified as TDRs.

**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(4 - continued)

The following table summarizes information in regard to TDRs that were restructured during the year ended December 31, 2011:

	Number of Contracts	Pre- Modification Outstanding Balance (In thousands)	Post- Modification Outstanding Balance
Residential real estate	4	\$ 331	\$ 331
Land	1	135	135
Construction	2	454	454
Commercial real estate	2	1,139	1,139
Home equity and second mortgage	1	8	8
Total	10	\$ 2,067	\$ 2,067

For the TDRs listed above, the terms of modification included temporary interest-only payment periods, reduction of the stated interest rate and the deferral of past due principal and interest until maturity, or the consolidation of outstanding loans at a reduced interest rate. There were no principal charge-offs recorded as a result of TDRs during 2011.

There were no TDRs modified within the previous 12 months for which there was a subsequent payment default (defined as the loan becoming more than 90 days past due, being moved to nonaccrual status, or the collateral being foreclosed upon) during the year ended December 31, 2011. In the event that a TDR subsequently defaults, the Company evaluates the restructuring for possible impairment. As a result, the related allowance for loan losses may be increased or charge-offs may be taken to reduce the carrying amount of the loan.

**(5) PREMISES AND EQUIPMENT**

Premises and equipment as of December 31 consisted of the following:

(In thousands)	2011	2010
Land and land improvements	\$ 3,256	\$ 3,256
Leasehold improvements	56	50
Office buildings	10,044	9,967
Furniture, fixtures and equipment	4,870	4,702
	18,226	17,975
Less accumulated depreciation	7,505	6,983
Totals	\$ 10,721	\$ 10,992

Depreciation expense was \$751,000 and \$826,000 for the years ended December 31, 2011 and 2010, respectively.

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**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED****(6) FORECLOSED REAL ESTATE**

At December 31, 2011 and 2010, the Bank had foreclosed real estate held for sale of \$661,000 and \$591,000, respectively. During the years ended December 31, 2011 and 2010, foreclosure losses in the amount of \$650,000 and \$1.7 million, respectively, were charged off to the allowance for loan losses. Losses on subsequent write downs of foreclosed real estate of \$2,000 for 2010 are aggregated with realized gains and losses from the sale of foreclosed real estate. There were no losses on subsequent write-downs of foreclosed real estate for 2011. Net realized losses from the sale of foreclosed real estate amounted to \$128,000 and \$79,000 for the years ended December 31, 2011 and 2010, respectively. The net gain or loss on foreclosed real estate is reported in other noninterest expense. Real estate taxes and other expenses of holding foreclosed real estate are included in other noninterest expenses and amounted to \$84,000 and \$133,000 in 2011 and 2010, respectively. Realized gains from the sale of foreclosed real estate totaling \$35,000 and \$12,000 were deferred for 2011 and 2010, respectively, because the sales were financed by the Bank and did not qualify for recognition under generally accepted accounting principles. At December 31, 2011 and 2010, deferred gains on the sale of foreclosed real estate financed by the Bank amounted to \$52,000 and \$17,000, respectively.

**(7) GOODWILL AND OTHER INTANGIBLES**

The Company acquired goodwill in the acquisition of Hometown Bancshares, Inc. during 2003. Goodwill is evaluated for impairment at least annually or more frequently upon the occurrence of an event or when circumstances indicate that the carrying amount is greater than its fair value. No impairment of goodwill was recognized during 2011 or 2010.

The following is a summary of other intangible assets subject to amortization as of December 31, 2011 and 2010:

<i>(In thousands)</i>	<b>2011</b>	<b>2010</b>
<b>Core deposit intangibles:</b>		
Acquired in branch acquisition	\$ 181	\$ 181
Acquired in Hometown merger	566	566
Gross carrying amount	747	747
Accumulated amortization	(715)	(649)
	\$ 32	\$ 98

Amortization expense was \$66,000 for 2011 and \$73,000 for 2010. The remaining \$32,000 of amortization expense on the core deposit intangibles will be recognized during the year ending December 31, 2012.

**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED****(8) DEPOSITS**

The aggregate amount of time deposit accounts with balances of \$100,000 or more was approximately \$31.1 million and \$34.5 million at December 31, 2011 and 2010, respectively.

At December 31, 2011, scheduled maturities of time deposits were as follows:

	<i>(In thousands)</i>
Year ending December 31:	
2012	\$ 50,097
2013	31,712
2014	17,598
2015	12,220
2016 and thereafter	895
<b>Total</b>	<b>\$ 112,522</b>

The Bank held deposits of approximately \$8.7 million and \$8.0 million for related parties at December 31, 2011 and 2010, respectively.

**(9) RETAIL REPURCHASE AGREEMENTS**

Retail repurchase agreements represent overnight borrowings from deposit customers and the debt securities sold under the repurchase agreements are under the control of the Bank. Information concerning borrowings under repurchase agreements is summarized as follows:

<i>(Dollars in thousands)</i>	<b>2011</b>	<b>2010</b>
Weighted average interest rate at year end	0.51%	0.76%
Weighted average interest rate during the year	0.64%	0.90%
Average daily balance	\$ 9,174	\$ 8,142
Maximum month-end balance during the year	\$ 9,608	\$ 9,223
<b>Debt securities underlying the agreements at December 31:</b>		
Amortized cost	\$ 12,043	\$ 11,178
Fair value	\$ 12,108	\$ 11,322

**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED****(10) ADVANCES FROM FEDERAL HOME LOAN BANK**

At December 31, 2011 and 2010, advances from the Federal Home Loan Bank were as follows:

<i>(Dollars in thousands)</i>	<b>2011</b>		<b>2010</b>	
	<b>Weighted Average Rate</b>	<b>Amount</b>	<b>Weighted Average Rate</b>	<b>Amount</b>
Fixed rate advances	3.78%	\$ 12,350	4.05%	\$ 15,729

At December 31, 2011, advances from the Federal Home Loan Bank totaling \$10.0 million carried a put option whereby the Federal Home Loan Bank will automatically convert the fixed rate advance to a variable rate should the market interest rate exceed a pre-determined strike rate.

The following is a schedule of maturities for advances outstanding as of December 31, 2011:

<i>(In thousands)</i>	
Due in:	
2012	\$ 7,250
2013	5,100
2014	0
2015	0
2016	0
Thereafter	0
Total	\$ 12,350

The advances are secured under a blanket collateral agreement. At December 31, 2011, the carrying value of residential mortgage loans and a mutual fund investment pledged as security for the advances was \$84.0 million and \$1.5 million, respectively.

**(11) LEASE COMMITMENTS**

During 2010, the Bank extended a noncancelable lease agreement for branch office space which expires in 2015. The Bank also had a noncancelable sub-lease agreement for branch office space which expired in 2010. The Bank let that lease expire because it developed a new office nearby which opened in 2009.

The Bank's subsidiary companies headquartered in Nevada lease office space under sublease agreements that automatically renew for one year periods each October.

The future minimum rental payments under noncancelable operating leases having remaining terms in excess of one year as of December 31, 2011 for each of the next five years and in the aggregate are as follows:

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	<i>(In thousands)</i>	
Year ending December 31:		
2012	\$	15
2013		15
2014		15
2015		4
2016 and thereafter		0
Total	\$	49

Total rental expense for all operating leases for the years ended December 31, 2011 and 2010 was \$25,000 and \$48,000, respectively.

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The components of income tax expense were as follows:

<i>(In thousands)</i>	<b>2011</b>	<b>2010</b>
Current	\$ 1,270	\$ 1,412
Deferred	273	149
<b>Totals</b>	<b>\$ 1,543</b>	<b>\$ 1,561</b>

The reconciliation of income tax expense with the amount which would have been provided at the federal statutory rate of 34% follows:

<i>(In thousands)</i>	<b>2011</b>	<b>2010</b>
Provision at federal statutory tax rate	\$ 1,880	\$ 1,849
State income tax-net of federal tax benefit	114	123
Tax-exempt interest income	(364)	(342)
Increase in cash value of life insurance	(69)	(74)
Other	(18)	5
<b>Totals</b>	<b>\$ 1,543</b>	<b>\$ 1,561</b>
<b>Effective tax rate</b>	<b>27.9%</b>	<b>28.7%</b>

Significant components of the deferred tax assets and liabilities as of December 31, 2011 and 2010 were as follows:

<i>(In thousands)</i>	<b>2011</b>	<b>2010</b>
Deferred tax assets (liabilities):		
Deferred compensation plans	\$ 123	\$ 141
Allowance for loan losses	1,493	1,760
State net operating loss carryforward	0	26
Other	33	20
<b>Deferred tax assets</b>	<b>1,649</b>	<b>1,947</b>
Depreciation	(637)	(589)
Deferred loan fees and costs	(75)	(111)
Federal Home Loan Bank stock dividends	(101)	(114)
Unrealized gain on securities available for sale	(906)	(214)
Acquisition purchase accounting adjustments	(11)	(35)
<b>Deferred tax liabilities</b>	<b>(1,730)</b>	<b>(1,063)</b>
<b>Net deferred tax asset (liability)</b>	<b>\$ (81)</b>	<b>\$ 884</b>

At December 31, 2011 and 2010, the Company had no liability for unrecognized income tax benefits related to uncertain tax positions and does not anticipate any increase in the liability for unrecognized tax benefits during the next twelve months. The Company believes that its income tax positions would be sustained upon examination and does not anticipate any adjustments that would result in a material change to its financial position or results of operations. The Company files U.S. federal income tax returns and Indiana state income tax returns. Returns filed in these jurisdictions for tax years ended on or after December 31, 2008 are subject to examination by the relevant taxing authorities. Each entity included in the consolidated federal and Indiana state income tax returns filed by the Company are charged or given credit for the applicable tax as though separate returns were filed.

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**FIRST CAPITAL, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(12 - continued)

Prior to July 1, 1996, the Bank was permitted by the Internal Revenue Code to deduct from taxable income an annual addition to a statutory bad debt reserve subject to certain limitations. Retained earnings at December 31, 2011 and 2010 include approximately \$1.0 million of cumulative deductions for which no deferred federal income tax liability has been recorded. Reduction of these reserves for purposes other than tax bad debt losses or adjustments arising from carryback of net operating losses would create income for tax purposes subject to the then current corporate income tax rate. The unrecorded deferred liability on these amounts was approximately \$354,000 at December 31, 2011 and 2010.

Federal legislation enacted in 1996 repealed the use of the qualified thrift reserve method of accounting for bad debts for tax years beginning after December 31, 1995. As a result, the Bank discontinued the calculation of the annual addition to the statutory bad debt reserve using the percentage-of-taxable-income method and adopted the experience reserve method for banks. Under this method, the Bank computes its federal tax bad debt deduction based on actual loss experience over a period of years. The legislation also provided that the Bank will not be required to recapture its pre-1988 statutory bad debt reserves if it ceases to meet the qualifying thrift definitional tests as provided under prior law and if the Bank continues to qualify as a bank under existing provisions of the Internal Revenue Code.

**(13) EMPLOYEE BENEFIT PLANS**

**Defined Contribution Plan:**

The Bank has a qualified contributory defined contribution plan available to all eligible employees. The plan allows participating employees to make tax-deferred contributions under Internal Revenue Code Section 401(k). The Bank contributed \$336,000 and \$321,000 to the plan for the years ended December 31, 2011 and 2010, respectively.

**Employee Stock Ownership Plan:**

On December 31, 1998, the Bank established a leveraged employee stock ownership plan (ESOP) covering substantially all employees. The Bank accounts for the ESOP in accordance with FASB ASC 718-40, *Employee Stock Ownership Plans*. The ESOP trust acquired 61,501 shares of Company common stock financed by a loan with the Company with a ten year term. The employer loan and the related interest income are not recognized in the consolidated financial statements as the debt is serviced from Bank contributions. Dividends payable on allocated shares are charged to retained earnings and are satisfied by the allocation of cash dividends to participant accounts. Dividends payable on unallocated shares are not considered dividends for financial reporting purposes. Shares held by the ESOP trust are allocated to participant accounts based on the ratio of the current year principal and interest payments to the total of the current year and future years principal and interest to be paid on the employer loan. The employer loan was fully paid in 2008 and all shares of the Company common stock have been allocated to participant accounts.

Compensation expense is recognized based on the average fair value of shares released for allocation to participant accounts during the year with a corresponding credit to stockholders' equity. No compensation expense was recognized for the years ended December 31, 2011 and 2010 as all shares were allocated during 2008.

At December 31, 2011, the ESOP trust holds 64,007 shares of Company stock, including shares acquired on the open market, all of which have been allocated to participant accounts.

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**FIRST CAPITAL, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**(14) DEFERRED COMPENSATION PLANS**

The Bank has a deferred compensation plan whereby certain officers will be provided specific amounts of income for a period of fifteen years following normal retirement. The benefits under the agreements become fully vested after four years of service beginning with the effective date of the agreements. The Bank accrues the present value of the benefits so the amounts required will be provided at the normal retirement dates and thereafter.

Assuming normal retirement, the benefits under the plan are paid in varying amounts between 1999 and 2022. The Bank is the owner and beneficiary of insurance policies on the lives of these officers which may provide funds for a portion of the required payments. The agreements also provide for payment of benefits in the event of disability, early retirement, termination of employment or death. Deferred compensation expense for this plan was \$17,000 and \$21,000 for the years ended December 31, 2011 and 2010, respectively.

The Bank also has a directors' deferred compensation plan whereby a director defers into a retirement account a portion of his monthly director fees for a specified period to provide a specified amount of income for a period of fifteen years following normal retirement. The Bank also accrues the interest cost on the deferred obligation so the amounts required will be provided at the normal retirement dates and thereafter.

Assuming normal retirement, the benefits under the plan are paid in varying amounts between 1995 and 2037. The agreements also provide for payment of benefits in the event of disability, early retirement, termination of service or death. Deferred compensation expense for this plan was \$18,000 and \$17,000 for the years ended December 31, 2011 and 2010, respectively.

**(15) STOCK-BASED COMPENSATION PLANS**

The Company's stock-based compensation plans are described below. No compensation cost was charged against income for those plans for 2011 or 2010. No income tax benefit was realized in 2011 for stock options exercised. The total income tax benefit for stock options exercised was \$6,000 for 2010.

**Stock Option Plans**

The Company's stock option plans adopted prior to 2000 provided for issuance of up to 209,192 shares of the Company's authorized but unissued common stock to all employees, including any officer or employee-director. Under the plans, the Company could grant both non-statutory and statutory (i.e., incentive) stock options. In the case of incentive stock options, the aggregate fair value of the stock (determined at the time the incentive stock option is granted) for which any optionee may be granted incentive options which are first exercisable during any calendar year shall not exceed \$100,000. Option prices may not be less than the fair market value of the underlying stock at the date of the grant. Options granted generally vest ratably over five years and are exercisable in whole or in part for a period up to ten years from the date of the grant. Certain stock options provide for accelerated vesting if there is a change in control (as defined in the plan).

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**FIRST CAPITAL, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

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The fair market value of stock options granted was estimated at the date of grant using the Black-Scholes-Merton option pricing model. Expected volatilities are based on historical volatility of the Company's stock. The expected term of options granted represents the period of time that options are expected to be outstanding and is based on historical trends. The risk free rate for the expected life of the options is based on the U.S. Treasury yield curve in effect at the time of grant. No options were granted during the years ended December 31, 2011 and 2010.

There were no stock options outstanding at December 31, 2011 or 2010. During 2010 stock options for 28,215 shares with a weighted average exercise price of \$10.00 were exercised and stock options for 4,400 shares with a weighted average exercise price of \$10.00 were forfeited. The total intrinsic value of options exercised during 2010 was \$135,000.

No compensation expense was recognized for the years ended December 31, 2011 and 2010, respectively, related to the stock option plans. At December 31, 2011, there was no remaining unrecognized compensation expense related to nonvested stock options.

**2009 Equity Incentive Plan**

On May 20, 2009, the Company adopted the 2009 Equity Incentive Plan (the Plan). The Plan provides for the award of stock options, restricted stock, performance shares and stock appreciation rights. The aggregate number of shares of the Company's common stock available for issuance under the Plan may not exceed 223,000 shares. The Company may grant both non-statutory and statutory stock options which may not have a term exceeding ten years. An award of a performance share is a grant of a right to receive shares of the Company's common stock which is contingent upon the achievement of specific performance criteria or other objectives set at the grant date. Stock appreciation rights are equity or cash settled share-based compensation arrangements whereby the number of shares that will ultimately be issued or the cash payment is based upon the appreciation of the Company's common stock. Awards granted under the Plan may be granted either alone or in addition to or, in tandem with, any other award granted under the Plan. As of December 31, 2011, no awards had been granted under the Plan.

**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED****(16) COMMITMENTS AND CONTINGENCIES**

In the normal course of business, there are outstanding various commitments and contingent liabilities, such as commitments to extend credit and legal claims, which are not reflected in the financial statements.

Commitments under outstanding standby letters of credit totaled \$1.7 million at December 31, 2011.

The following is a summary of the commitments to extend credit at December 31, 2011 and 2010:

<i>(In thousands)</i>	<b>2011</b>	<b>2010</b>
<b>Loan commitments:</b>		
Fixed rate	\$ 1,113	\$ 1,138
Adjustable rate	1,366	6,157
Unused lines of credit on credit cards	2,942	2,861
Undisbursed commercial and personal lines of credit	15,748	15,335
Undisbursed portion of construction loans in process	4,768	3,119
Undisbursed portion of home equity lines of credit	16,685	15,843
Total commitments to extend credit	\$ 42,622	\$ 44,453

**(17) FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK**

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. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the balance sheet.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments (see Note 16). The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount and type of collateral obtained, if deemed necessary by the Bank upon extension of credit, varies and is based on management's credit evaluation of the counterparty.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Standby letters of credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank's policy for obtaining collateral, and the nature of such collateral, is essentially the same as that involved in making commitments to extend credit.

The Bank has not been required to perform on any financial guarantees and did not incur any losses on its commitments in 2011 or 2010.

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**FIRST CAPITAL, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

**(18) DIVIDEND RESTRICTION**

As an Indiana corporation, the Company is subject to Indiana law with respect to the payment of dividends. Under Indiana law, the Company may pay dividends so long as it is able to pay its debts as they become due in the usual course of business and its assets exceed the sum of its total liabilities, plus the amount that would be needed, if the Company were to be dissolved at the time of the dividend, to satisfy any rights that are preferential to the rights of the persons receiving the dividend. The ability of the Company to pay dividends depends primarily on the ability of the Bank to pay dividends to the Company.

The payment of dividends by the Bank is subject to regulation by the Office of the Comptroller of the Currency (OCC). The Bank may not declare or pay a cash dividend or repurchase any of its capital stock if the effect thereof would cause the regulatory capital of the Bank to be reduced below regulatory capital requirements imposed by the OCC or below the amount of the liquidation account established upon completion of the conversion of the Bank's former mutual holding company (First Capital, Inc., MHC) from mutual to stock form on December 31, 1998.

**(19) REGULATORY MATTERS**

The Bank is subject to various regulatory capital requirements administered by the OCC. Failure to meet minimum capital requirements can initiate certain mandatory-and possibly additional discretionary-actions by regulators, that if undertaken, could have a direct material effect on the Bank and the consolidated financial statements. Under the regulatory capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines involving quantitative measures of the Bank's assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification under the prompt corrective action guidelines are 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 Bank to maintain minimum amounts and ratios (set forth in the table below) of total risk-based capital and Tier I capital to risk-weighted assets (as defined in the regulations), Tier I capital to adjusted total assets (as defined) and tangible capital to adjusted total assets (as defined). Management believes, as of December 31, 2011, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2011, the most recent notification from the OCC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table below. There are no conditions or events since that notification that management believes have changed the institution's category.

The actual capital amounts and ratios are also presented in the following table. No amounts were deducted from capital for interest-rate risk in either year.

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	<b>Actual</b>		<b>Minimum For Capital Adequacy Purposes:</b>		<b>Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions:</b>	
<i>(Dollars in thousands)</i>	<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>
<b><u>As of December 31, 2011:</u></b>						
Total capital (to risk weighted assets)	\$ 46,018	17.05%	\$ 21,597	8.00%	\$ 26,996	10.00%
Tier I capital (to risk weighted assets)	\$ 43,494	16.11%	N/A		\$ 16,197	6.00%
Tier I capital (to adjusted total assets)	\$ 43,494	10.06%	\$ 17,302	4.00%	\$ 21,627	5.00%
Tangible capital (to adjusted total assets)	\$ 43,494	10.06%	\$ 6,488	1.50%	N/A	
<b><u>As of December 31, 2010:</u></b>						
Total capital (to risk weighted assets)	\$ 43,607	15.54%	\$ 22,448	8.00%	\$ 28,060	10.00%
Tier I capital (to risk weighted assets)	\$ 41,626	14.83%	N/A		\$ 16,836	6.00%
Tier I capital (to adjusted total assets)	\$ 41,626	9.32%	\$ 17,866	4.00%	\$ 22,332	5.00%
Tangible capital (to adjusted total assets)	\$ 41,626	9.32%	\$ 6,700	1.50%	N/A	

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**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED****(20) DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS**

The following table summarizes the carrying value and estimated fair value of financial instruments at December 31, 2011 and 2010:

	<b>2011</b>		<b>2010</b>	
<i>(In thousands)</i>	<b>Carrying Value</b>	<b>Fair Value</b>	<b>Carrying Value</b>	<b>Fair Value</b>
<b>Financial assets:</b>				
Cash and cash equivalents	\$ 18,923	\$ 18,923	\$ 21,575	\$ 21,575
Securities available for sale	111,440	111,440	100,851	100,851
Securities held to maturity	16	16	32	32
Loans held for sale	2,909	2,966	4,375	4,453
Loans, net of allowance for loan losses	276,047	287,624	294,550	307,083
Federal Home Loan Bank stock	2,820	2,820	3,194	3,194
Accrued interest receivable	1,801	1,801	1,894	1,894
<b>Financial liabilities:</b>				
Deposits	364,374	367,359	378,003	380,713
Retail repurchase agreements	9,125	9,125	8,669	8,669
Advances from Federal Home Loan Bank	12,350	12,840	15,729	16,483
Accrued interest payable	413	413	649	649
<b>Off-balance-sheet financial instruments:</b>				
Asset related to commitments to extend credit	0	48	0	49

The carrying amounts in the preceding table are included in the consolidated balance sheets under the applicable captions. The contractual or notional amounts of financial instruments with off-balance-sheet risk are disclosed in Note 16.

The following methods and assumptions were used to estimate the fair value of each class of financial instrument for which it is practicable to estimate that value:

**Cash and Cash Equivalents**

For cash and cash equivalents, including cash and due from banks, interest-bearing deposits with banks, and federal funds sold, the carrying amount is a reasonable estimate of fair value.

**Debt and Equity Securities**

For marketable equity securities, the fair values are based on quoted market prices. For debt securities, the Company obtains fair value measurements from an independent pricing service and the fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, U.S. government and agency yield curves, live trading levels, trade execution data, market consensus prepayment speeds, credit information, and the security's terms and conditions, among other factors. For Federal Home Loan Bank stock, a restricted equity security, the carrying amount is a reasonable estimate of fair value because it is not marketable.

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**FIRST CAPITAL, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

(20 - continued)

**Loans**

The fair value of loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. The carrying amount of accrued interest receivable approximates its fair value. The fair value of loans held for sale is based on specific prices of underlying contracts for sale to investors.

**Deposits**

The fair value of demand deposits, savings accounts, money market deposit accounts and other transaction accounts is the amount payable on demand at the balance sheet date. The fair value of fixed-maturity certificates of deposit is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities. The carrying amount of accrued interest payable approximates its fair value.

**Borrowed Funds**

The carrying amount of retail repurchase agreements approximates its fair value. The fair value of advances from Federal Home Loan Bank is estimated by discounting the future cash flows using the current rates at which similar loans with the same remaining maturities could be obtained.

**Commitments to Extend Credit**

The majority of commitments to extend credit would result in loans with a market rate of interest if funded. The fair value of these commitments are the fees that would be charged to customers to enter into similar agreements. For fixed rate loan commitments, the fair value also considers the difference between current levels of interest rates and the committed rates.

**(21) FAIR VALUE MEASUREMENTS**

FASB ASC Topic 820, *Fair Value Measurements*, provides the framework for measuring fair value. That framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under FASB ASC Topic 820 are described as follows:

- Level 1: Inputs to the valuation methodology are quoted prices, unadjusted, for identical assets or liabilities in active markets. A quoted market price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.
- Level 2: Inputs to the valuation methodology include quoted market prices for similar assets or liabilities in active markets; inputs to the valuation methodology include quoted market prices for identical or similar assets or liabilities in markets that are not active; or inputs to the valuation methodology that are derived principally from or can be corroborated by observable market data by correlation or other means.
- Level 3:

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Inputs to the valuation methodology are unobservable and significant to the fair value measurement. Level 3 assets and liabilities include financial instruments whose value is determined using discounted cash flow methodologies, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

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**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

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A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below. These valuation methodologies were applied to all of the Company's financial and nonfinancial assets carried at fair value or the lower of cost or fair value. The table below presents the balances of assets measured at fair value on a recurring and nonrecurring basis as of December 31, 2011 and 2010. The Company had no liabilities measured at fair value as of December 31, 2011 and 2010.

	Level 1	Carrying Value		Total
		Level 2	Level 3	
		(In thousands)		
<b>December 31, 2011:</b>				
<b>Assets Measured on a Recurring Basis</b>				
Securities available for sale:				
Agency mortgage-backed securities	\$ 0	\$ 12,220	\$ 0	\$ 12,220
Agency CMO	0	23,288	0	23,288
Privately-issued CMO	0	880	0	880
Agency notes and bonds	0	42,363	0	42,363
Municipal obligations	0	27,301	0	27,301
Mutual funds	5,388	0	0	5,388
Total securities available for sale	\$ 5,388	\$ 106,052	\$ 0	\$ 111,440
<b>Assets Measured on a Nonrecurring Basis</b>				
Impaired loans	\$ 0	\$ 0	\$ 6,107	\$ 6,107
Loans held for sale	0	2,909	0	2,909
Foreclosed real estate	0	0	661	661
<b>December 31, 2010:</b>				
<b>Assets Measured on a Recurring Basis</b>				
Securities available for sale:				
Agency mortgage-backed securities	\$ 0	\$ 12,681	\$ 0	\$ 12,681
Agency CMO	0	11,968	0	11,968
Privately-issued CMO	0	1,652	0	1,652
Agency notes and bonds	0	42,380	0	42,380
Municipal obligations	0	29,456	0	29,456
Mutual funds	2,714	0	0	2,714
Total securities available for sale	\$ 2,714	\$ 98,137	\$ 0	\$ 100,851
<b>Assets Measured on a Nonrecurring Basis</b>				
Impaired loans	\$ 0	\$ 0	\$ 5,435	\$ 5,435
Loans held for sale	0	4,375	0	4,375
Foreclosed real estate	0	0	591	591

**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED**

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Fair value is based upon quoted market prices, where available. If quoted market prices are not available, fair value is based on internally developed models or obtained from third parties that primarily use, as inputs, observable market-based parameters or a matrix pricing model that employs the Bond Market Association's standard calculations for cash flow and price/yield analysis and observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value, or the lower of cost or fair value. These adjustments may include unobservable parameters. Any such valuation adjustments have been applied consistently over time. The Company's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

***Securities Available for Sale.*** Securities classified as available for sale are reported at fair value on a recurring basis. These securities are classified as Level 1 of the valuation hierarchy where quoted market prices from reputable third-party brokers are available in an active market. If quoted market prices are not available, the Company obtains fair value measurements from an independent pricing service. These securities are reported using Level 2 inputs and the fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, U.S. government and agency yield curves, live trading levels, trade execution data, market consensus prepayment speeds, credit information, and the security's terms and conditions, among other factors. Changes in fair value of securities available for sale are recorded in other comprehensive income, net of income tax effect.

***Impaired Loans.*** Impaired loans are carried at the present value of estimated future cash flows using the loan's existing rate or the fair value of collateral if the loan is collateral dependent. Impaired loans are evaluated and valued at the time the loan is identified as impaired at the lower of cost or market value. For collateral dependent impaired loans, market value is measured based on the value of the collateral securing these loans. Collateral may be real estate and/or business assets, including equipment, inventory and/or accounts receivable, and its fair value is generally determined based on real estate appraisals or other independent evaluations by qualified professionals. The appraisals are then discounted to reflect management's estimate of the fair value of the collateral given the current market conditions and the condition of the collateral. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above. Fair value of impaired loans is classified as Level 3 in the fair value hierarchy.

***Loans Held for Sale.*** Loans held for sale are carried at the lower of cost or market value. The portfolio comprised of residential real estate loans and fair value is based on specific prices of underlying contracts for sales to investors. These measurements are carried at Level 2.

***Foreclosed Real Estate Held for Sale.*** Foreclosed real estate held for sale is reported at fair value less estimated costs to dispose of the property. The fair values are determined by real estate appraisals which are then discounted to reflect management's estimate of the fair value of the property given current market conditions. Fair value of foreclosed real estate held for sale is classified as Level 3 in the fair value hierarchy.

There have been no changes in the valuation techniques and related inputs used for assets measured at fair value on a recurring and nonrecurring basis during the years ended December 31, 2011 and 2010. There were no transfers in or out of the Company's Level 3 financial assets for the years ended December 31, 2011 and 2010. In addition, there were no transfers into or out of Levels 1 and 2 of the fair value hierarchy during the years ended December 31, 2011 and 2010.

**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED****(22) PARENT COMPANY CONDENSED FINANCIAL INFORMATION *(In thousands)***

Condensed financial information for the Company (parent company only) follows:

**Balance Sheets**

	<b>As of December 31,</b>	
	<b>2011</b>	<b>2010</b>
<b>Assets:</b>		
Cash and cash equivalents	\$ 278	\$ 369
Other assets	139	139
Investment in subsidiaries	50,525	47,389
	<b>\$ 50,942</b>	<b>\$ 47,897</b>
<b>Liabilities and Equity:</b>		
Accrued expenses	\$ 0	\$ 4
Stockholders' equity	50,942	47,893
	<b>\$ 50,942</b>	<b>\$ 47,897</b>

**Statements of Income**

	<b>Years Ended December 31,</b>	
	<b>2011</b>	<b>2010</b>
Interest income	\$ 1	\$ 2
Dividend income	2,207	1,356
Other operating expenses	(222)	(196)
Income before income taxes and equity in undistributed net income of subsidiaries	1,986	1,162
Income tax benefit	71	81
Income before equity in undistributed net income of subsidiaries	2,057	1,243
Equity in undistributed net income of subsidiaries	1,915	2,622
Net income	\$ 3,972	\$ 3,865

**Statements of Cash Flows**

	<b>Years Ended December 31,</b>	
	<b>2011</b>	<b>2010</b>
<b>Operating Activities:</b>		
Net income	\$ 3,972	\$ 3,865

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Adjustments to reconcile net income to cash and cash equivalents provided by operating activities:		
Equity in undistributed net income of subsidiaries	(1,915)	(2,622)
Net change in other assets and liabilities	(4)	(2)
Net cash provided by operating activities	2,054	1,241
Financing Activities:		
Exercise of stock options	0	282
Purchase of treasury stock	(27)	(43)
Cash dividends paid	(2,117)	(2,063)
Net cash used in financing activities	(2,144)	(1,824)
Net decrease in cash and cash equivalents	(91)	(583)
Cash and cash equivalents at beginning of year	369	952
Cash and cash equivalents at end of year	\$ 278	\$ 369

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**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED****(23) SUPPLEMENTAL DISCLOSURE FOR EARNINGS PER SHARE**

	<b>Years Ended December 31,</b>	
	<b>2011</b>	<b>2010</b>
<i>(In thousands, except for share and per share data)</i>		
<b>Basic:</b>		
Earnings:		
Net income attributable to First Capital, Inc.	\$ 3,972	\$ 3,865
Shares:		
Weighted average common shares outstanding	2,786,410	2,785,168
Net income per common share attributable to First Capital, Inc., basic	\$ 1.43	\$ 1.39
<b>Diluted:</b>		
Earnings:		
Net income attributable to First Capital, Inc.	\$ 3,972	\$ 3,865
Shares:		
Weighted average common shares outstanding	2,786,410	2,785,168
Add: Dilutive effect of outstanding options	0	1,059
Weighted average common shares outstanding, as adjusted	2,786,410	2,786,227
Net income per common share attributable to First Capital, Inc., diluted	\$ 1.43	\$ 1.39

**(24) SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION**

	<b>Years Ended December 31,</b>	
	<b>2011</b>	<b>2010</b>
<i>(In thousands)</i>		
<b>Cash payments for:</b>		
Interest	\$ 3,995	\$ 5,834
Income taxes	1,601	1,153
<b>Noncash investing activities:</b>		
Transfers from loans to real estate acquired through foreclosure	\$ 1,256	\$ 1,765
Proceeds from sales of foreclosed real estate financed through loans	267	438

**Table of Contents****FIRST CAPITAL, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED****(25) SELECTED QUARTERLY FINANCIAL INFORMATION (UNAUDITED)**

	<b>First Quarter</b>	<b>Second Quarter</b>	<b>Third Quarter</b>	<b>Fourth Quarter</b>
	<i>(In thousands, except per share data)</i>			
<b><u>2011</u></b>				
Interest income	\$ 5,099	\$ 5,150	\$ 5,101	\$ 4,923
Interest expense	1,052	1,066	897	805
Net interest income	4,047	4,144	4,204	4,118
Provision for loan losses	500	425	400	500
Net interest income after provision for loan losses	3,547	3,719	3,804	3,618
Noninterest income	923	955	1,074	1,099
Noninterest expenses	3,252	3,371	3,331	3,257
Income before income taxes	1,218	1,303	1,547	1,460
Income tax expense	319	358	451	415
Net income	899	945	1,096	1,045
Less: net income attributable to noncontrolling interest in subsidiary	3	4	3	3
Net income attributable to First Capital, Inc.	\$ 896	\$ 941	\$ 1,093	\$ 1,045
Earnings per common share attributable to First Capital, Inc.:				
Basic	\$ 0.32	\$ 0.34	\$ 0.39	\$ 0.38
Diluted	\$ 0.32	\$ 0.34	\$ 0.39	\$ 0.38
<b><u>2010</u></b>				
Interest income	\$ 5,479	\$ 5,583	\$ 5,483	\$ 5,289
Interest expense	1,509	1,433	1,326	1,234
Net interest income	3,970	4,150	4,157	4,055
Provision for loan losses	460	420	590	567
Net interest income after provision for loan losses	3,510	3,730	3,567	3,488
Noninterest income	823	1,003	1,020	1,060
Noninterest expenses	2,890	3,395	3,315	3,162
Income before income taxes	1,443	1,338	1,272	1,386
Income tax expense	439	346	359	417
Net income	1,004	992	913	969
Less: net income attributable to noncontrolling interest in subsidiary	3	4	3	3
Net income attributable to First Capital, Inc.	\$ 1,001	\$ 988	\$ 910	\$ 966

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Earnings per common share attributable to First Capital, Inc.:

Basic	\$ 0.36	\$ 0.35	\$ 0.33	\$ 0.35
Diluted	\$ 0.36	\$ 0.35	\$ 0.33	\$ 0.35

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