4525 Harding Road, Suite 300
Nashville, TN 37205

NASHVILLE BANK & TRUST®

Phone (615) 515-1700
Fax (615) 515-1717
wwwnashvillebankandtrust.com

March 1, 2012

Dear Shareholder:

Nashville Bank and Trust enjoyed another year of growth and increased profitability in 2011. The National and local economies improved modestly, and our team continued to cultivate mutually beneficial relationships. Net interest income after provision for loan losses grew to $7.7 million, up 21.0% from 2011. Non interest income increased 14.5% to $3.9 million. Net Income rose by more than 50%, reaching $2.0 million. Fully diluted earnings per share climbed to $0.89 from $0.61 a year ago.

Total assets increased by 17.0% in 2011 to $242 million. Deposits grew by 18.2% during 2011, while the bank's loans increased by 12.0% to $169.7 million.

In 2011, our Trust and Wealth Management business continued its strong and steady growth. Revenue in this business increased by 17.2% to $3.5 million and once again comprised the bulk of the bank's non interest income. We continue to win new wealth management business from people who need quality asset management and the comprehensive services we offer.

We ended the year with a solid capital position. Our Tier 1 leverage ratio in the bank was 10.02%, double the FDIC's minimum threshold for a "well-capitalized bank". We returned 8.3% on average equity capital for the year after earning 6% in 2010. Continuing to grow our returns on equity capital is among our highest priorities for the coming years. As we reach our goals in terms of the level and stability of profits, our board will consider all potential uses of capital with the intention of increasing shareholder return.

Looking ahead, we see both opportunities and risks for our firm and our customers. The economy, we believe, will grow moderately in 2012, and business confidence will improve thus increasing the demand for credit. However, we expect that our competition will begin relaxing underwriting standards and reduce the pricing offered which will further increase the competitive environment. Bank investors often learn with sorrow in bad times the dubious choices management has made in good times. Our team will endeavor to safeguard your capital by striving to resist these pressures and focusing on credit quality and outstanding customer service.

Our wealth management business will grow as it always has -- one relationship at a time. But we will also seek to expand the reach and breadth of our services by carefully considering new service offerings and potential acquisitions.

Our bank is blessed above all with outstanding people. Our clients can choose among many banks – but they won't find people like ours elsewhere – experienced, knowledgeable, friendly and eager to serve. This staff has built a solid business with the base of capital the shareholders provided. We are poised for continued, careful growth.

We thank you again for your continued support.

Charles W. Cook, Jr.

Charles W. Cook , Jr.

Chairman of the Board

Thomas S. Stumb

President and Chief Executive Officer

# NBT HOLDINGS INC. AND SUBSIDIARY

## CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2011 and 2010

**NBT HOLDINGS INC. AND SUBSIDIARY**
**Nashville, Tennessee**

**CONSOLIDATED FINANCIAL STATEMENTS**
**December 31, 2011 and 2010**

CONTENTS

# REPORT OF INDEPENDENT AUDITORS

The Board of Directors
NBT Holdings Inc. and Subsidiary
Nashville, Tennessee

We have audited the consolidated balance sheets of NBT Holdings Inc. and Subsidiary as of December 31, 2011 and 2010 and the related consolidated statements of income, changes in shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of NBT Holdings Inc. and Subsidiary 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.

Crowe Horwath LLP

Crowe Horwath LLP

Brentwood, Tennessee
February 17, 2012

**NBT HOLDINGS INC. AND SUBSIDIARY**
**CONSOLIDATED BALANCE SHEETS**
**December 31, 2011 and 2010**

| | 2011 | 2010 |
|---|---|---|
| **ASSETS** | | |
| Cash and due from financial institutions | $ 5,687,987 | $ 6,434,356 |
| Interest bearing deposits in other financial institutions | 9,630,940 | 4,226,639 |
| Federal funds sold | 3,360,810 | 7,450,943 |
| Cash and cash equivalents | 18,679,737 | 18,111,938 |
| | | |
| Time deposits in other financial institutions | 12,368,000 | 17,805,000 |
| Securities available for sale | 39,859,082 | 17,823,583 |
| | | |
| Gross loans | 169,663,316 | 151,517,591 |
| Allowance for loan losses | (2,546,333) | (2,191,049) |
| Net loans | 167,116,983 | 149,326,542 |
| | | |
| Restricted equity securities | 1,866,350 | 1,360,350 |
| Premises and equipment, net | 212,117 | 232,188 |
| Accrued interest receivable | 718,984 | 513,535 |
| Prepaid long-term compensation | 192,416 | 346,388 |
| Prepaid FDIC insurance assessments | 286,779 | 448,219 |
| Deferred tax asset, net | 375,204 | 323,589 |
| Other assets | 284,586 | 214,094 |
| | | |
| Total assets | $ 241,960,238 | $ 206,505,426 |
| | | |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Deposits | | |
| Non-interest bearing | $ 41,934,771 | $ 30,969,585 |
| Interest bearing | 155,591,055 | 136,090,258 |
| Total deposits | 197,525,826 | 167,059,843 |
| | | |
| Federal Home Loan Bank advances | 17,343,000 | 15,250,000 |
| Accrued interest payable | 25,216 | 56,284 |
| Other liabilities | 1,469,458 | 1,145,206 |
| Total liabilities | 216,363,500 | 183,511,333 |
| | | |
| Shareholders' equity | | |
| Preferred stock, $0.10 par value; 5,000,000 shares authorized; no shares issued in 2011 and 2010 | - | - |
| Common stock, $0.10 par value; 40,000,000 shares authorized; 2,227,198 shares issued in 2011 and 2,201,645 in 2010 | 222,720 | 220,165 |
| Additional paid-in capital | 21,706,088 | 21,540,037 |
| Retained earnings | 3,250,289 | 1,234,903 |
| Accumulated other comprehensive income (loss) | 417,641 | (1,012) |
| | | |
| Total shareholders' equity | 25,596,738 | 22,994,093 |
| | | |
| Total liabilities and shareholders' equity | $ 241,960,238 | $ 206,505,426 |

See accompanying notes to consolidated financial statements.

## NBT HOLDINGS INC. AND SUBSIDIARY
## CONSOLIDATED STATEMENTS OF INCOME
### Years ended December 31, 2011 and 2010

| | 2011 | 2010 |
|---|---|---|
| Non-interest income | | |
| Wealth management services | $ 3,500,790 | $ 2,986,996 |
| Service charges on deposit accounts | 156,711 | 154,048 |
| Gain on securities | - | 82,545 |
| Other | 204,795 | 148,841 |
| Total non-interest income | 3,862,296 | 3,372,430 |
| Interest income | | |
| Loans, including fees | 8,741,446 | 7,896,676 |
| Taxable securities | 455,716 | 292,130 |
| Tax-exempt securities | 185,829 | 11,159 |
| Interest bearing deposits | 249,766 | 494,196 |
| Federal funds sold | 14,104 | 20,065 |
| Total interest income | 9,646,861 | 8,714,226 |
| Interest expense | | |
| Deposits | 1,395,623 | 1,761,325 |
| Short-term borrowings | 1,091 | 1,847 |
| Long-term borrowings | 235,839 | 214,689 |
| Total interest expense | 1,632,553 | 1,977,861 |
| Net interest income | 8,014,308 | 6,736,365 |
| Provision for loan losses | 355,284 | 407,240 |
| Net interest income after provision for loan losses | 7,659,024 | 6,329,125 |
| **Total revenue, net** | 11,521,320 | 9,701,555 |
| Non-interest expense | | |
| Salaries and employee benefits | 6,035,788 | 5,227,438 |
| Occupancy | 364,779 | 308,203 |
| Furniture and equipment | 39,829 | 36,258 |
| Data processing | 523,478 | 520,966 |
| Wealth management processing fees | 351,885 | 290,039 |
| Advertising and public relations | 92,776 | 98,804 |
| Professional services | 295,971 | 369,068 |
| FDIC insurance assessments | 176,432 | 192,191 |
| Other | 467,525 | 516,267 |
| Total non-interest expense | 8,348,463 | 7,559,234 |
| **Income before income taxes** | 3,172,857 | 2,142,321 |
| Income tax expense | 1,157,471 | 820,490 |
| **Net income** | $ 2,015,386 | $ 1,321,831 |
| Earnings per share: | | |
| Basic | $ 0.91 | $ 0.61 |
| Diluted | $ 0.89 | $ 0.61 |

See accompanying notes to consolidated financial statements.

**NBT HOLDINGS INC. AND SUBSIDIARY**
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**
**Years Ended December 31, 2011 and 2010**

| | Shares | Common Stock | Additional Paid-In Capital | Retained Earnings (Accumulated Deficit) | Accumulated Other Comprehensive Income (Loss) | Total Shareholders' Equity |
|---|---|---|---|---|---|---|
| Balance at January 1, 2010 | 2,151,645 | $ 215,165 | $21,125,195 | $ (86,928) | $ (23,419) | $21,230,013 |
| Proceeds from issuance of common stock | 30,000 | 3,000 | 297,000 | - | - | 300,000 |
| Issuance of restricted shares of common stock, net | 20,000 | 2,000 | (2,000) | - | - | - |
| Stock based compensation expense | - | - | 119,842 | - | - | 119,842 |
| Comprehensive income: | | | | | | |
| Net income | - | - | - | 1,321,831 | - | 1,321,831 |
| Change in unrealized gain (loss) on securities available for sale, net of tax $13,903 in taxes | - | - | - | - | 22,407 | 22,407 |
| Total comprehensive income | | | | | | 1,344,238 |
| Balance at December 31, 2010 | 2,201,645 | 220,165 | 21,540,037 | 1,234,903 | (1,012) | 22,994,093 |
| Exercise of stock options | 772 | 77 | (77) | - | - | - |
| Issuance of restricted shares of common stock, net | 24,781 | 2,478 | (2,478) | - | - | - |
| Stock based compensation expense | - | - | 168,606 | - | - | 168,606 |
| Comprehensive income: | | | | | | |
| Net income | - | - | - | 2,015,386 | - | 2,015,386 |
| Change in unrealized gain (loss) on securities available for sale, net of $259,767 in taxes | - | - | - | - | 418,653 | 418,653 |
| Total comprehensive income | | | | | | 2,434,039 |
| Balance at December 31, 2011 | 2,227,198 | $ 222,720 | $21,706,088 | $ 3,250,289 | $ 417,641 | $25,596,738 |

See accompanying notes to consolidated financial statements.

**NBT HOLDINGS INC. AND SUBSIDIARY**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**Years Ended December 31, 2011 and 2010**

| | 2011 | 2010 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Net income | $ 2,015,386 | $ 1,321,831 |
| Adjustments to reconcile net income to net cash from operating activities | | |
| Depreciation and amortization | 84,013 | 100,859 |
| Net amortization of securities | 156,324 | 36,925 |
| Deferred income tax expense (benefit) | (311,382) | 52,179 |
| Provision for loan losses | 355,284 | 407,240 |
| Gain on securities | - | (82,545) |
| Stock based compensation expense | 168,606 | 119,842 |
| Net change in: | | |
| Accrued interest receivable | (205,449) | (57,290) |
| Accrued interest payable | (31,068) | (19,917) |
| Prepaid long-term compensation | 153,972 | 152,333 |
| Prepaid FDIC insurance assessments | 161,440 | 165,268 |
| Other assets | (70,492) | (31,957) |
| Other liabilities | 324,252 | 419,262 |
| Net cash from operating activities | 2,800,886 | 2,584,030 |
| **Cash flows from investing activities** | | |
| Net decrease in time deposits in other financial institutions | 5,437,000 | 6,154,000 |
| Proceeds from Reserve Primary Fund investment | - | 273,159 |
| Available for sale securities: | | |
| Purchases | (28,851,536) | (9,088,463) |
| Maturities, calls and paydowns | 7,338,133 | 432,969 |
| Sales | - | 121,656 |
| Net increase in loans | (18,145,725) | (15,025,130) |
| Purchase of restricted equity securities | (506,000) | (317,650) |
| Additions of premises and equipment, net | (63,942) | (153,834) |
| Net cash from investing activities | (34,792,070) | (17,603,293) |
| **Cash flows from financing activities** | | |
| Proceeds from Federal Home Loan Bank advances | 3,843,000 | 10,000,000 |
| Repayments of Federal Home Loan Bank advances | (1,750,000) | (978,687) |
| Net increase in deposits | 30,465,983 | 11,826,640 |
| Proceeds from issuance of common stock | - | 300,000 |
| Net cash from financing activities | 32,558,983 | 21,147,953 |
| Net change in cash and cash equivalents | 567,799 | 6,128,690 |
| Cash and cash equivalents at beginning of year | 18,111,938 | 11,983,248 |
| Cash and cash equivalents at end of year | $ 18,679,737 | $ 18,111,938 |
| Supplemental cash flow information: | | |
| Cash paid during year for interest | $ 1,663,621 | $ 1,997,779 |
| Cash paid during year for income taxes | 1,381,133 | 689,375 |

See accompanying notes to consolidated financial statements.

## NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations and Principals of Consolidation: The consolidated financial statements include NBT Holdings Inc. and its wholly owned subsidiary, Nashville Bank and Trust Company "the "Bank", together referred to as "the Corporation." Intercompany transactions and balances are eliminated in consolidation.

The Bank received its charter as a state bank with trust powers and began operating on August 30, 2004. During July 2009, NBT Holdings Inc. was formed and the existing shares of common stock for Nashville Bank and Trust Company were acquired and exchanged for common shares in NBT Holdings Inc. The Bank represents substantially all the operations in the consolidated financial statements and it provides a variety of banking, investment management and trust administration services to individuals, businesses and charitable institutions. Its primary deposit products are demand, money market and certificates of deposit and its primary lending products are residential and commercial real estate mortgages, commercial loans and loans to individuals.

Subsequent Events: The Corporation has evaluated subsequent events for recognition and disclosure through February 17, 2012 which is the date the financial statements were available to be issued.

Use of Estimates: To prepare financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided and future results could differ. The allowance for loan losses and fair values of financial instruments are particularly subject to change.

Cash Flows: Cash and cash equivalents include cash, deposits with other financial institutions with maturities under 90 days, and federal funds sold. Net cash flows are reported for customer loan and deposit transactions, and time deposits in other financial institutions.

Time Deposits in Other Financial Institutions: Time deposits in other financial institutions are carried at cost. These accounts are maintained at several financial institutions and are all within the insurance limits provided by the Federal Deposit Insurance Corporation.

Securities: Debt securities are classified as available for sale when they might be sold before maturity. Securities available for sale are carried at fair value with unrealized holding gains and losses reported in accumulated other comprehensive income (loss), net of tax.

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

Management evaluates securities for other-than-temporary impairment "OTTI" on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement, and 2) OTTI related to other factors, which is recognized in other comprehensive income(loss). The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

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

Loans: Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of deferred loan fees and costs. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income using the level-yield method without anticipating prepayments.

Interest income is reported on the interest method and includes amortization of net deferred loan fees and costs over the loan term. Interest income on all loans is discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in process of collection. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. Nonaccrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

All interest accrued, but not received, for loans placed on nonaccrual are reversed against interest income. Interest received on such loans is accounted for on the cash-basis or cost-recovery method until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Concentration of Credit Risk: Most of the Corporation's business activity is with customers located within Nashville, Tennessee. Therefore, the Corporation's exposure to credit risk is significantly affected by changes in the economy in the Nashville, Tennessee metropolitan area.

Allowance for Loan Losses: The allowance for loan losses is a valuation allowance for probable incurred credit losses, increased by the provision for loan losses and decreased by charge-offs less recoveries. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed.

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

A loan is impaired when, based on current information and events, it is probable that the Corporation will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loans, for which the terms have been modified resulting in a concession, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

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.

Commercial and commercial real estate loans are individually evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans are collectively evaluated for impairment and accordingly, they are not separately identified for impairment disclosures.

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

Troubled debt restructurings are measured at the present value of estimated future cash flows using the loan's effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral. For troubled debt restructurings that subsequently default, the Corporation determines the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

The historical loss experience used in management's analysis of the general component for the allowance for loan losses is determined by portfolio segment and is based on the average loss history experienced by the banking industry over the most recent 10 years. The Corporation used the loss history of its peers, as it has not experienced any losses on its own during the entire history of the Corporation. Management used a 10 year period of peer losses in order to align with what management expects normalized probable incurred losses to be for the Corporation. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. The following portfolio segments have been identified:

Commercial and Industrial loans include loans for commercial, industrial or agricultural purposes to business enterprises that are not secured by real estate. These loans are typically made on the basis of the borrower's ability to repay from the cash flow of the borrower's business and are generally secured by accounts receivable, inventory and equipment. The collateral securing loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business.

Commercial Real Estate loans include loans secured by non-residential real estate and improvements thereon. Often these loans are made to single borrowers or groups of related borrowers, and the repayment of these loans largely depends on the results of operations and management of these properties. Adverse economic conditions may affect the repayment ability of these loans.

Residential Real Estate loans include loans secured by residential real estate, including single-family and multi-family dwellings. Adverse economic conditions in the Corporation's market area may reduce borrowers' ability to repay these loans and may reduce the collateral securing these loans.

Construction and Land Development loans include loans to finance the process of improving properties preparatory to erecting new structures or the on-site construction of industrial, commercial, residential or farm buildings. Construction and land development loans also include loans secured by vacant land, except land known to be used or usable for agricultural purposes. Construction loans generally are made for relatively short terms. They generally are more vulnerable to changes in economic conditions. Further, the nature of these loans is such that they are more difficult to evaluate and monitor. The risk of loss on a construction loan is dependent largely upon the accuracy of the initial estimate of the property's value upon completion of the project and the estimated cost (including interest) of the project. Periodic site inspections are made on construction loans.

Consumer loans include loans to individuals for household, family and other personal expenditures that are not secured by real estate.

Foreclosed Assets: Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. If fair value declines subsequent to foreclosure, a valuation allowance is recorded through expense. Costs after acquisition are expensed.

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

Transfers of Financial Assets: Transfers of financial assets are accounted for as sales, when control over the assets has been relinquished. Control over transferred assets is deemed to be surrendered when the assets have been isolated from the Corporation, the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and the Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Premises and Equipment: Premises and equipment are stated at cost less accumulated depreciation. Leasehold improvements are depreciated using the straight-line method over the shorter of the lease terms and the useful lives of the fixed assets. Furniture, fixtures and equipment are depreciated using the straight-line method with useful lives ranging from three to five years.

Restricted Equity Securities: The Corporation is a member of the Federal Home Loan Bank “FHLB” and Federal Reserve Bank “FRB” systems. Members are required to own a certain amount of stock based on the level of borrowings and on their level of equity and may invest in additional amounts. FHLB and FRB stock are carried at cost, classified as restricted equity securities and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

Prepaid Long-term Compensation: The Corporation paid retention bonuses in cash to certain key employees. These cash bonuses are considered long-term compensation to be earned over a 36 to 60 month requisite service period. The amount of the contracts is earned prorata by the employees and expensed prorata by the Corporation over the contractual term of the agreements. In the event that the employee leaves during the life of the contract, the employee is obligated to repay the unearned amount.

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

Assets Under Management: Assets held in fiduciary or agency capacities are not included in the consolidated balance sheets, since such items are not assets of the Corporation.

Wealth Management Services Income Recognition: Income from Wealth Management Services is calculated by multiplying each investment management account’s market value, determined on a specific date each month, by a static or tiered percentage, according to the investment management agreement. The income resulting from Wealth Management Services accounts is recognized monthly.

Stock-Based Compensation: Compensation cost is recognized for stock options and restricted stock awards issued to employees and directors, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options, while the market price of the Corporation’s common stock at the date of grant is used for restricted stock awards. Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award.

Retirement Plans: Employee 401(k) benefit plan expense is the amount of matching contributions for the period.

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

Income Taxes: Income tax expense or benefit is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded.

The Corporation recognizes interest and/or penalties related to income tax matters in income tax expense.

Earnings Per Share: Basic earnings per share available to common shareholders is computed by dividing net income adjusted for income allocated to participating securities by the weighted average number of common shares outstanding during the period. All outstanding unvested share-based payment awards that contain rights to nonforfeitable dividends are considered participating securities for this calculation. Diluted earnings per share includes the dilutive effect of additional potential common shares issuable under stock options.

Comprehensive Income: Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains and losses on securities available for sale which are also recognized as separate components of shareholders' equity.

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. Management does not believe that there now are such matters that will have a material effect on the financial statements.

Restrictions on Cash: Cash on hand or on deposit with the Federal Reserve Bank was required to meet regulatory reserve and clearing requirements.

Dividend Restriction: Banking regulations require maintaining certain capital levels and may limit the dividends paid by the Bank to the Corporation or by the Corporation to shareholders.

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

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

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

**NOTE 2 - SECURITIES**

The following table summarizes the amortized cost and fair value of the available for sale securities portfolio at December 31, 2011 and 2010 and the corresponding amounts of gross unrealized gains and losses recognized in accumulated other comprehensive income (loss):

| 2011 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Available for sale | | | | |
| U.S. government sponsored entities and agencies | $ 4,156,323 | $ 53,887 | $ - | $ 4,210,210 |
| Corporate bonds | 5,270,969 | 156,827 | (133,037) | 5,294,759 |
| State and political subdivisions | 10,447,181 | 509,161 | (3,961) | 10,952,381 |
| Collateralized mortgage obligations | 1,622,661 | 1,934 | (24,169) | 1,600,426 |
| Mortgage-backed securities: residential | 10,673,623 | 126,010 | (2,535) | 10,797,098 |
| Mortgage backed securities: commercial | 7,011,546 | 75 | (7,413) | 7,004,208 |
| Total available for sale | $ 39,182,303 | $ 847,894 | $ (171,115) | $ 39,859,082 |
| 2010 | | | | |
| Available for sale | | | | |
| U.S. government sponsored entities and agencies | $ 6,919,274 | $ 102,437 | $ (19,404) | $ 7,002,307 |
| Corporate bonds | 3,527,321 | 72,212 | (17,418) | 3,582,115 |
| State and political subdivisions | 3,431,825 | 36 | (106,338) | 3,325,523 |
| Collateralized mortgage obligations | 121,353 | 6,001 | - | 127,354 |
| Mortgage-backed securities: residential | 3,825,450 | 31,054 | (70,220) | 3,786,284 |
| Total available for sale | $ 17,825,223 | $ 211,740 | $ (213,380) | $ 17,823,583 |

Sales of available for sale securities were as follows:

| | 2011 | 2010 |
|---|---|---|
| Proceeds | $ - | $ 121,656 |
| Gross gains | - | 4,548 |
| Gross losses | - | - |

The Corporation had an investment in a money market fund "Primary Liquidity Class I" with a company called The Reserve, which invested a portion of the assets in Lehman Brothers commercial paper. In connection with the bankruptcy of Lehman Brothers, the Corporation recognized an impairment loss of $114,972 in 2008 due to the defaulted commercial paper held in the fund. During 2010, the Corporation recovered $273,159 resulting in a gain of $77,997 related to the previously recognized impairment loss.

There were no securities pledged at year end 2011 and 2010 and no holdings of securities of any one issuer, other than the U.S. government sponsored entities and agencies, in an amount greater than 10% of shareholders' equity.

**NOTE 2 – SECURITIES** (Continued)

The amortized cost and fair value of the investment securities portfolio are shown by contractual maturity. Expected maturities may differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately.

| | December 31, 2011 | | December 31, 2010 | |
|---|---|---|---|---|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| One to five years | $ 5,059,214 | $ 5,239,638 | $ 4,277,509 | $ 4,369,126 |
| Five to ten years | 9,346,881 | 9,504,718 | 7,491,394 | 7,496,573 |
| Beyond ten years | 5,468,378 | 5,712,994 | 2,109,517 | 2,044,246 |
| Collateralized mortgage obligations | 1,622,661 | 1,600,426 | 121,353 | 127,354 |
| Mortgage-backed securities: Residential | 10,673,623 | 10,797,098 | 3,825,450 | 3,786,284 |
| Mortgage-backed securities: Commercial | 7,011,546 | 7,004,208 | - | - |
| Total | $ 39,182,303 | $ 39,859,082 | $ 17,825,223 | $ 17,823,583 |

The following table summarizes the investment securities with unrealized losses at December 31, 2011 and 2010 aggregated by major security type and length of time in a continuous unrealized loss position:

| | Less than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| December 31, 2011 | | | | | | |
| Available for sale | | | | | | |
| Corporate bonds | $ 1,150,189 | $ (99,811) | $ 466,774 | $ (33,226) | $ 1,616,963 | $(133,037) |
| State and political subdivisions | 857,055 | (3,448) | 123,167 | (513) | 980,222 | (3,961) |
| Collateralized mortgage obligations | 1,533,970 | (24,169) | - | - | 1,533,970 | (24,169) |
| Mortgage back securities: residential | 1,192,090 | (2,535) | - | - | 1,192,090 | (2,535) |
| Mortgage back securities: commercial | 2,526,390 | (7,413) | - | - | 2,526,390 | (7,413) |
| Total available for sale | $ 7,259,694 | $(137,376) | $ 589,941 | $ (33,739) | $ 7,849,635 | $(171,115) |
| December 31, 2010 | | | | | | |
| Available for sale | | | | | | |
| U.S. government sponsored entities and agencies | $ 480,596 | $ (19,404) | $ - | $ - | $ 480,596 | $ (19,404) |
| Corporate bonds | 982,582 | (17,418) | - | - | 982,582 | (17,418) |
| State and political subdivisions | 3,117,028 | (106,338) | - | - | 3,117,028 | (106,338) |
| Mortgage back securities: residential | 3,354,083 | (70,220) | - | - | 3,354,083 | (70,220) |
| Total available for sale | $ 7,934,289 | $(213,380) | $ - | $ - | $ 7,934,289 | $(213,380) |

**NOTE 2 – SECURITIES** (Continued)

Unrealized losses on securities have not been recognized into income because the issuer(s) are of high credit quality, management does not intend to sell and it is more likely than not that management will not be required to sell the securities prior to their anticipated recovery, and the decline in fair value is largely due to changes in market interest rates and illiquidity instead of credit quality. The fair value is expected to recover as the securities approach their maturity dates and/or market rates change. As a result, the Corporation does not consider these securities to be other-than-temporarily impaired at December 31, 2011.

Restricted equity securities consist of securities which are restricted as to transferability. These securities are recorded at cost. Restricted equity securities consist of the following at December 31, 2011 and 2010:

| | 2011 | 2010 |
|---|---|---|
| Federal Home Loan Bank stock | $ 1,221,800 | $ 720,900 |
| Federal Reserve Bank stock | 644,550 | 639,450 |
| | $ 1,866,350 | $ 1,360,350 |

**NOTE 3 - LOANS**

Loans at year end were as follows:

| | 2011 | 2010 |
|---|---|---|
| Commercial | $ 36,010,693 | $ 28,348,063 |
| Commercial real estate | 29,527,521 | 19,982,147 |
| Residential real estate: | | |
| Closed-end | 54,134,103 | 49,694,696 |
| Open-end | 32,854,498 | 36,448,679 |
| Construction and land development | | |
| Owner occupied | 2,344,330 | 2,015,088 |
| Development | 3,253,145 | 5,652,009 |
| Consumer | 11,600,604 | 9,344,924 |
| Subtotal | 169,724,894 | 151,485,606 |
| Net deferred loan (fees) costs | (61,578) | 31,985 |
| Gross loans | $ 169,663,316 | $ 151,517,591 |

As of December 31, 2011 and 2010, the Corporation did not have any significant loans classified as impaired, non performing, past due 90 days or more, or troubled debt restructurings. The amount of interest income recognized for the time loans were impaired during 2011 was nominal.

**NOTE 3 - LOANS** (Continued)

The following tables present the activity in the allowance for loan losses by portfolio segment for the year ending December 31, 2011:

| December 31, 2011 | Commercial | Commercial Real Estate | Residential Real Estate | Construction and Land Development | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|
| Allowance for loan losses: | | | | | | | |
| Beginning balance | $ 654,839 | $ 337,696 | $ 775,296 | $ 169,551 | $ 115,386 | $ 138,281 | $ 2,191,049 |
| Provision for loan losses | 27,188 | 181,977 | 226,322 | (67,188) | 242 | (13,257) | 355,284 |
| Loans charged-off | - | - | - | - | - | - | - |
| Recoveries | - | - | - | - | - | - | - |
| Total ending allowance balance | $ 682,027 | $ 519,673 | $ 1,001,618 | $ 102,363 | $ 115,628 | $ 125,024 | $ 2,546,333 |

Activity in the allowance for loan losses was as follows:

| | 2011 | 2010 |
|---|---|---|
| Beginning balance | $ 2,191,049 | 1,783,809 |
| Provision for loan losses | 355,284 | 407,240 |
| Loans charged-off | - | - |
| Recoveries | - | - |
| Ending balance | $ 2,546,333 | $ 2,191,049 |

**NOTE 3 - LOANS** (Continued)

The following tables present the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2011 and 2010. The recorded investment amounts do not include accrued and unpaid interest or any net deferred loan fees or costs due to immateriality.

| December 31, 2011 | Commercial | Commercial Real Estate | Residential Real Estate | Construction and Land Development | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|
| Ending allowance balance attributable to loans: | | | | | | | |
| Individually evaluated for impairment | $ - | $ - | $ 119,933 | $ - | $ - | $ - | $ 119,933 |
| Collectively evaluated for impairment | 682,027 | 519,673 | 881,685 | 102,363 | 115,628 | 125,024 | 2,426,400 |
| Total ending allowance balance | $ 682,027 | $ 519,673 | $ 1,001,618 | $ 102,363 | $ 115,628 | $ 125,024 | $ 2,546,333 |
| Loans: | | | | | | | |
| Individually evaluated for impairment | $ - | $ - | $ 119,933 | $ - | $ - | $ - | $ 119,933 |
| Collectively evaluated for impairment | 36,010,693 | 29,527,521 | 86,868,668 | 5,597,475 | 11,600,604 | - | 169,604,961 |
| Total ending loans balance | $ 36,010,693 | $ 29,527,521 | $ 86,988,601 | $ 5,597,475 | $ 11,600,604 | $ - | $ 169,724,894 |

| December 31, 2010 | Commercial | Commercial Real Estate | Residential Real Estate | Construction and Land Development | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|
| Ending allowance balance attributable to loans: | | | | | | | |
| Individually evaluated for impairment | $ - | $ - | $ - | $ - | $ - | $ - | $ - |
| Collectively evaluated for impairment | 654,839 | 337,696 | 775,296 | 169,551 | 115,386 | 138,281 | 2,191,049 |
| Total ending allowance balance | $ 654,839 | $ 337,696 | $ 775,296 | $ 169,551 | $ 115,386 | $ 138,281 | $ 2,191,049 |
| Loans: | | | | | | | |
| Individually evaluated for impairment | $ - | $ - | $ - | $ - | $ - | $ - | $ - |
| Collectively evaluated for impairment | 28,348,063 | 19,982,147 | 86,143,375 | 7,667,097 | 9,344,924 | - | 151,485,606 |
| Total ending loans balance | $ 28,348,063 | $ 19,982,147 | $ 86,143,375 | $ 7,667,097 | $ 9,344,924 | $ - | $ 151,485,606 |

At December 31, 2011, the Corporation had one residential real estate loan classified as impaired. This loan is on nonaccrual with a specific reserve equal to the outstanding principal balance as of December 31, 2011. The Corporation did not have any classified as loans past due greater than 30 days or as troubled debt restructurings at December 31, 2011. The Corporation did not have any loans classified as nonaccrual, past due greater than 30 days, or troubled debt restructurings at December 31, 2010.

**NOTE 3 - LOANS** (Continued)

**Credit Quality Indicators:**

The Corporation categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Corporation analyzes loans individually by classifying the loans as to credit risk. This analysis is performed on an annual basis. The Corporation uses the following 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 institution'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 institution 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.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans. As of December 31, 2011 and 2010, based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

| December 31, 2011 | Pass | Special Mention | Substandard | Doubtful |
|---|---|---|---|---|
| Commercial | $ 35,201,409 | $ - | $ 809,284 | $ - |
| Commercial real estate | 29,527,521 | - | - | - |
| Residential real estate: | | | | |
| Closed-end | 53,233,437 | 900,666 | - | - |
| Open-end | 32,037,563 | - | 816,935 | - |
| Construction and land development: | | | | |
| Owner occupied | 2,344,330 | - | - | - |
| Development | 3,012,209 | 166,144 | 74,792 | - |
| Consumer | 11,580,500 | 20,104 | - | - |
| Total | $ 166,936,969 | $ 1,086,914 | $ 1,701,011 | $ - |
| **December 31, 2010** | | | | |
| Commercial | $ 25,705,881 | $ - | $ 2,642,182 | $ - |
| Commercial real estate | 19,982,147 | - | - | - |
| Residential real estate: | | | | |
| Closed-end | 49,694,696 | - | - | - |
| Open-end | 35,064,499 | 707,066 | 677,114 | - |
| Construction and land development: | | | | |
| Owner occupied | 1,831,519 | 183,569 | - | - |
| Development | 5,212,855 | - | 439,154 | - |
| Consumer | 9,103,625 | 241,299 | - | - |
| Total | $ 146,595,222 | $ 1,131,934 | $ 3,758,450 | $ - |

## NOTE 4 - PREMISES AND EQUIPMENT

Year end premises and equipment were as follows:

| | 2011 | 2010 |
|---|---|---|
| Leasehold improvements | $ 234,103 | $ 225,945 |
| Furniture, fixtures and equipment | 494,845 | 511,997 |
| Computer software | 302,074 | 289,996 |
| | 1,031,022 | 1,027,938 |
| Less: Accumulated depreciation and amortization | 818,905 | 795,750 |
| Net premises and equipment | $ 212,117 | $ 232,188 |

Depreciation and amortization expense totaled $84,013 and $100,859 for 2011 and 2010, respectively.

The Corporation's main office facility is subject to a three year lease, terminating December 31, 2012. The lease agreement includes one renewal option of three years. Rent expense for 2011 and 2010 was $290,408 and $236,333. Subsequent to December 31, 2011, the Corporation executed a new 6 year lease, terminating June 1, 2018.

Rent commitments under non-cancelable operating leases were as follows, before considering renewal options that are present.

| | |
|---|---|
| 2012 | $ 339,920 |
| 2013 | 380,160 |
| 2014 | 380,160 |
| 2015 | 380,160 |
| 2016 | 380,160 |
| Thereafter | 538,560 |

The Corporation had operating leases for property and equipment that have non-cancelable lease commitments as follows: $48,311 for 2012 and $25,719 for 2013 and $10,225 for 2014. These leases have terms of three years and resulted in lease expense of $88,609 and $85,288 for the years ending December 31, 2011 and 2010.

## NOTE 5 - DEPOSITS

Scheduled maturities of time deposits for the next five years were as follows:

| | |
|---|---|
| 2012 | $ 22,811,147 |
| 2013 | 7,325,440 |
| 2014 | 1,118,135 |
| 2015 | 790,736 |
| 2016 | 531,813 |

Time deposits of $100,000 or more were $24,450,548 and $29,176,091 at December 31, 2011 and 2010, respectively.

## NOTE 6 - FEDERAL HOME LOAN BANK ADVANCES

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

| | 2011 | 2010 |
|---|---|---|
| For 2011, rates range from 0.07% to 2.94%, averaging 1.37% with maturities between January 24, 2012 and August 4, 2015. For 2010, interest rates ranged from 0.45% to 2.94%, averaging 1.58% with maturities between January 4, 2011 and August 4, 2015. | $ 17,343,000 | $ 15,250,000 |

The advances are subject to penalties if repaid before scheduled payments are due. The Corporation's outstanding borrowings from the Federal Home Loan Bank are secured by a blanket pledge agreement of 150% of 1-4 family loans, first lien mortgage loans. The Corporation has approximately $45,350,000 of 1-4 family, first mortgage loans available to pledge under the blanket pledge arrangement dated March 16, 2006. Based on the collateral and the Corporation's holdings of Federal Home Loan Bank Stock, the Corporation is eligible to borrow additional advances of $28,007,000 as of December 31, 2011.

Payments over the next five years are as follows:

| | |
|---|---|
| 2012 | $ 5,493,000 |
| 2013 | 7,550,000 |
| 2014 | 1,800,000 |
| 2015 | 2,500,000 |
| 2016 | - |
| | $ 17,343,000 |

## NOTE 7 - INCOME TAXES

Income tax expense was as follows:

| | 2011 | 2010 |
|---|---|---|
| Current expense | | |
| Federal | $ 1,206,961 | $ 620,044 |
| State | 261,892 | 148,267 |
| Total current | 1,468,853 | 768,311 |
| Deferred expense (benefit) | | |
| Federal | (280,875) | 60,846 |
| State | (30,507) | (8,667) |
| Total deferred | (311,382) | 52,179 |
| Total | $ 1,157,471 | $ 820,490 |

Effective tax rates differ from federal statutory rate of 34% applied to income before income taxes due to the following:

| | 2011 | 2010 |
|---|---|---|
| Federal statutory rate times financial statement income | $ 1,078,771 | $ 728,389 |
| Effect of: | | |
| State taxes, net of federal benefit | 152,714 | 92,136 |
| Tax exempt interest income | (59,740) | (16,309) |
| Other, net | (14,274) | 16,274 |
| Total income tax expense | $ 1,157,471 | $ 820,490 |

**NOTE 7 - INCOME TAXES** (Continued)

Year-end deferred tax assets and liabilities were due to the following:

| | 2011 | 2010 |
|---|---|---|
| Deferred tax assets: | | |
| Allowance for loan losses | $ 898,778 | $ 643,700 |
| Organizational and start-up expenditures | 10,735 | 11,593 |
| Loan origination income | 69,327 | 38,249 |
| Deferred lease incentive | 1,687 | 16,018 |
| Net unrealized loss on available for sale securities | - | 628 |
| Other | 6,847 | 8,341 |
| Total deferred tax assets | 987,374 | 718,529 |
| Deferred tax liabilities: | | |
| Prepaid expenses | (103,706) | (148,810) |
| Stock based compensation expense | (143,697) | (131,508) |
| Net unrealized gain on available for sale securities | (259,139) | - |
| Restricted equity stock dividends | (9,643) | (9,643) |
| Loan origination expenses | (45,749) | (50,496) |
| Depreciation | (50,236) | (54,483) |
| Total deferred tax liabilities | (612,170) | (394,940) |
| Deferred tax asset, net | $ 375,204 | $ 323,589 |

The Corporation does not have any uncertain tax positions and does not have any interest and penalties recorded or accrued in the consolidated financial statements for the years ended December 31, 2011 and 2010. The Corporation and its subsidiary are subject to U.S. federal income tax as well as income tax of the state of Tennessee. The Corporation is no longer subject to examination by taxing authorities for years before 2008.

**NOTE 8 - RELATED PARTY TRANSACTIONS**

Loans to principal officers, directors and their affiliates at December 31, 2011 and 2010 totaled $3,782,549 and $4,638,218, respectively.

Deposits from principal officers, directors and their affiliates at December 31, 2011 and 2010 totaled $2,431,419 and $1,694,560, respectively.

Wealth management fees earned from assets under management for principal officers, directors and their affiliates at December 31, 2011 and 2010 totaled $255,193 and $228,197, respectively.

**NOTE 9 - REGULATORY CAPITAL MATTERS**

Banks are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and prompt corrective action regulations involve quantitative measures of assets, liabilities and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action. Management believes as of December 31, 2011, the Bank meets all capital adequacy requirements to which it is subject.

**NOTE 9 - REGULATORY CAPITAL MATTERS** (Continued)

Prompt corrective action regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion and capital restoration plans are required. As of December 31, 2011 and 2010, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the institution's category.

Actual and required capital amounts (shown in thousands) and ratios for the Bank are presented below as of December 31, 2011 and 2010.

| | Actual | | For Capital Adequacy Purposes | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| 2011 | | | | | | |
| Total Capital to risk weighted assets | $ 27,002 | 15.88% | $ 13,601 | 8.00% | $ 17,001 | 10.00% |
| Tier 1 (Core) Capital to risk weighted assets | 24,872 | 14.63% | 6,800 | 4.00% | 10,201 | 6.00% |
| Tier 1 (Core) Capital to average assets | 24,872 | 10.02% | 9,926 | 4.00% | 12,408 | 5.00% |
| 2010 | | | | | | |
| Total Capital to risk weighted assets | $ 24,641 | 15.69% | $ 12,562 | 8.00% | $ 15,702 | 10.00% |
| Tier 1 (Core) Capital to risk weighted assets | 22,675 | 14.44% | 6,281 | 4.00% | 9,421 | 6.00% |
| Tier 1 (Core) Capital to average assets | 22,675 | 9.99% | 9,081 | 4.00% | 11,352 | 5.00% |

**Dividend Restrictions** - The Corporation's principal source of funds for dividend payments is dividends received from the Bank. Banking regulations limit the amount of dividends that may be paid without prior approval of regulatory agencies. Under these regulations, the amount of dividends that may be paid in any calendar year is limited to the current year's net profits, combined with the retained net profits of the preceding two years, subject to the capital requirements described above. During 2012, the Bank could, without prior approval, declare dividends of approximately $3,369,000 plus any 2012 net profits retained to date of declaration.

**NOTE 10 - OFF-BALANCE SHEET ACTIVITIES**

Some financial instruments, such as loan commitments, credit lines, letters of credit and overdraft protection, are issued to meet customer financing needs. These are agreements to provide credit or to support the credit of others as long as conditions established in the contract are met. In addition, these agreements usually have expiration dates, and the commitments may expire without being used.

Off-balance sheet risk to credit loss exists up to the face amount of these instruments, although material losses are not anticipated. The same credit policies are used to make such commitments as are used for loans, including obtaining collateral at the exercise of the commitment. The majority of the Corporation's commitments to extend credit have maturities of less than one year and reflect the prevailing market interest rates at the time of the commitment.

**NOTE 10 - OFF-BALANCE SHEET ACTIVITIES** (Continued)

The contractual amount of financial instruments with off-balance sheet risk was as follows at December 31:

| | 2011 | 2010 |
|---|---|---|
| Letters of Credit | $ 1,217,820 | $ 1,344,910 |
| Unused Lines of Credit | 46,896,627 | 43,502,297 |

**NOTE 11 - STOCK BASED COMPENSATION PLAN**

Total stock based compensation expense in 2011 and 2010 was $168,606 and $119,842, respectively. Related to the 2011 and 2010 restricted stock grants, some employees made an election, in accordance with Section 83(b) of the Internal Revenue Code, to have the fair value of the awards taxable immediately. In connection with the election, the Corporation allowed the employees to forfeit shares to cover the related personal tax obligation. During 2011 employees forfeited 6,494 shares with a fair value of $66,434. During 2010, employees forfeited 3,175 shares with a fair value of $31,750. These amounts were recorded in salaries and employee benefits on the Corporation's consolidated statements of income in 2011 and 2010.

The Corporation's 2008 Equity Incentive Plan provides for the grant of stock options, restricted stock and other equity based incentives up to 600,000 shares. As of December 31, 2011, the Corporation had issued grants totaling 491,200 shares under the 2008 Equity Incentive Plan and its predecessor, the 2004 Employee Share Option Plan.

Stock Option Grants

Option awards are granted with an exercise price equal to the market price of the Corporation's common stock at the date of grant. Option awards have vesting periods of one to three years and have 10-year contractual terms. The Corporation uses newly-issued shares to satisfy share option exercises.

The fair value of each option award is estimated on the date of grant using a closed form option valuation (Black-Scholes) model that uses the assumptions noted in the table below. Expected volatilities are based on historical trading of the shares of NBT Holdings, Inc, common stock for 2011 and by the average share price volatilities of publicly traded Mid-South community banks for 2010. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding taking into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant.

The Corporation issued non-qualified options for the purchase of 3,500 shares of common stock to outside directors in 2011 and 2010. The fair value of options granted in 2011 and 2010 was determined using the following assumptions as of grant date:

| | 2011 | 2010 |
|---|---|---|
| Risk-free interest rate | 2.20% | 2.46% |
| Expected term | 10 years | 6 years |
| Expected stock price volatility | 15.60% | 41.70% |
| Dividend yield | 0.00% | 0.00% |

**NOTE 11 - STOCK BASED COMPENSATION PLAN** (Continued)

A summary of the stock option activity for 2011 follows:

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding at beginning of year | 269,750 | $ 10.25 | | |
| Granted | 3,500 | 12.00 | | |
| Forfeited | (5,250) | 10.02 | | |
| Exercised | (6,350) | 10.10 | | |
| Outstanding at end of year | 261,650 | $ 10.28 | 3.5 | $253,801 |
| Vested or expected to vest | 261,650 | $ 10.28 | 3.5 | 253,801 |
| Exercisable at end of year | 258,150 | $ 10.25 | 3.4 | 258,150 |

During 2011, 6,350 shares were exercised in exchange for 772 shares of common stock in a cashless exercise of vested options.

Information related to stock options during each year follows:

| | 2011 | 2010 |
|---|---|---|
| Intrinsic value of options exercised | $ 8,890 | $ - |
| Cash received from option exercises | $ - | $ - |
| Tax benefit realized from option exercises | $ - | $ - |
| Weighted average fair value of options granted | $ 3.49 | $ 4.36 |

There was a total of $9,161 unrecognized compensation cost related to non-vested stock options granted under the Plan as of December 31, 2011. The cost is expected to be recognized over a weighted-average period of 0.8 years.

Restricted Stock Grants

In 2011 and 2010, the Corporation issued 31,275 and 23,175 restricted shares of common stock. Compensation expense is recognized over the vesting period of the awards based on the value of the stock at issue date. The fair value of the stock was determined by current stock trade activity or by a third party appraisal dated June 30, 2010. These shares vest in 20% increments through 2016.

A summary of the changes in the Corporation's non-vested shares for the year follows:

| Non-vested shares | Shares | Weighted-Average Grant-Date Fair Value |
|---|---|---|
| Non-vested at January 1, 2011 | 40,820 | $ 10.26 |
| Granted | 31,275 | 10.19 |
| Vested | (10,940) | 10.31 |
| Forfeited | (6,494) | 10.23 |
| Non-vested at December 31, 2011 | 54,661 | $ 10.21 |

**NOTE 11 - STOCK BASED COMPENSATION PLAN** (Continued)

As of December 31, 2011, there was $469,539 of total unrecognized compensation cost related to non-vested restricted shares granted under the Plan. The cost is expected to be recognized over a weighted-average period of 3.4 years.

**NOTE 12 - STOCK WARRANTS**

Warrants for the purchase of 100,000 shares of common stock at $10 per share were granted to the organizers of the Corporation, eight of which are also executive officers or directors. No warrants were exercised in 2011 or 2010. As of December 31, 2011, 100,000 warrants were outstanding and exercisable, with weighted average exercise price of $10.00 and weighted average remaining contractual term of 2.7 years. The outstanding and exercisable warrants had intrinsic value of $125,000 as of December 31, 2011.

**NOTE 13 - FAIR VALUES OF FINANCIAL INSTRUMENTS**

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

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

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

The Corporation used the following methods and significant assumptions to estimate the fair value of each type of financial instrument:

Investment Securities: The fair values for investment securities are determined by quoted market prices, if available "Level 1". For securities where quoted prices are not available, fair values are calculated using a matrix pricing model, which is based on market prices of similar securities "Level 2".

**NOTE 13 - FAIR VALUES OF FINANCIAL INSTRUMENTS** (Continued)

Assets and liabilities measured at fair value on a recurring basis are summarized below:

| | Fair Value Measurements at December 31, 2011 Using: | | |
|---|---|---|---|
| Financial Assets | Carrying Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) |
| Investment securities available for sale | | | |
| U.S. government sponsored entities and agencies | $ 4,210,210 | $ - | $ 4,210,210 |
| State and political subdivisions | 10,952,381 | - | 10,952,381 |
| Corporate bonds | 5,294,759 | - | 5,294,759 |
| Collateralized mortgage obligations | 1,600,426 | - | 1,600,426 |
| Mortgage backed securities - residential | 10,797,098 | - | 10,797,098 |
| Mortgage backed securities - commercial | 7,004,208 | - | 7,004,208 |
| Total investment securities available for sale | $ 39,859,082 | $ - | $ 39,859,082 |

There were no significant transfers between Level 1 and Level 2 during 2011 or 2010.

| | Fair Value Measurements at December 31, 2010 Using: | | |
|---|---|---|---|
| Financial Assets | Carrying Value | Quoted Prices in Active Markets for Identical Assets "Level 1" | Significant Other Observable\ Inputs "Level 2" |
| Investment securities available for sale | | | |
| U.S. government sponsored entities and agencies | $ 7,002,307 | $ - | $ 7,002,307 |
| State and political subdivisions | 3,325,523 | - | 3,325,523 |
| Corporate bonds | 3,582,115 | - | 3,582,115 |
| Collateralized mortgage obligations | 127,354 | - | 127,354 |
| Mortgage backed securities - residential | 3,786,284 | - | 3,786,284 |
| Total investment securities available for sale | $ 17,823,583 | $ - | $ 17,823,583 |

**NOTE 13 - FAIR VALUES OF FINANCIAL INSTRUMENTS (**Continued)

Carrying amount and estimated fair values of financial instruments, at year end were as follows:

| | 2011 | | 2010 | |
|---|---|---|---|---|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial assets | | | | |
| Cash and cash equivalents | $ 18,679,737 | $ 18,679,737 | $ 18,111,938 | $ 18,111,938 |
| Time deposits in other financial institutions | 12,368,000 | 12,436,725 | 17,805,000 | 18,402,211 |
| Securities available for sale | 39,859,082 | 39,859,082 | 17,823,583 | 17,823,583 |
| Loans, net | 167,116,983 | 168,791,565 | 149,326,542 | 147,861,597 |
| Restricted equity securities | 1,866,350 | n/a | 1,360,350 | n/a |
| Accrued interest receivable | 718,984 | 718,984 | 513,535 | 513,535 |
| Financial liabilities | | | | |
| Deposits | $ 197,525,826 | $ 194,451,024 | $ 167,059,843 | $ 162,272,291 |
| Federal Home Loan Bank advances | 17,343,000 | 17,575,000 | 15,250,000 | 15,120,000 |
| Accrued interest payable | 25,216 | 25,216 | 56,284 | 56,284 |

Carrying amount is the estimated fair value for cash and cash equivalents, interest bearing deposits, accrued interest receivable and payable, demand deposits, short-term debt, and variable rate loans or deposits that reprice frequently and fully. For fixed rate loans or deposits and for variable rate loans or deposits and for time deposits in other financial institutions with infrequent repricing or repricing limits, fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk. Fair value of Federal Home Loan Bank advances is based on current rates for similar financing. It was not practicable to determine the fair value of restricted equity securities due to restrictions placed on transferability.

**NOTE 14 - OTHER BENEFIT PLANS**

In 2005, the Corporation adopted a 401(k) benefit plan that covers all employees who meet certain eligibility requirements and choose to participate in the plan. The plan allows employee contributions up to 15% of their compensation, which are matched 100% for the first 3% of compensation contributed. 87.5% is matched on the first 4% of compensation contributed, and 80% is matched on the first 5% of compensation contributed beginning on the first day of the calendar quarter following the employee's one year anniversary. The 401(k) benefit plan expense for 2011 and 2010 was $124,188 and $108,599 respectively.

**NOTE 15 – EARNINGS PER SHARE**

Basic earnings per share available to common shareholders is computed by dividing net income adjusted for income allocated to participating securities by the weighted average number of common shares outstanding during the period. All outstanding unvested share-based payment awards that contain rights to nonforfeitable dividends are considered participating securities for this calculation. Diluted earnings per share available to common shareholders reflects the potential dilution that could occur if stock options to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity.

**NOTE 15 – EARNINGS PER SHARE** (Continued)

The factors used in the earnings per share computation follows:

| | 2011 | 2010 |
|---|---|---|
| Basic | | |
| Net income | $ 2,015,386 | $ 1,321,831 |
| Less: Undistributed income allocated to participating securities | (49,644) | (24,831) |
| Net earnings allocated to common stock | $ 1,965,742 | $ 1,297,000 |
| Weighted common shares outstanding including participating securities | 2,219,066 | 2,172,960 |
| Less: Participating securities | (54,661) | (40,820) |
| Weighted average shares | 2,164,405 | 2,132,140 |
| Basic earnings per share | $ 0.91 | $ 0.61 |
| Diluted earnings allocated to common stock | $ 1,965,742 | $ 1,297,000 |
| Weighted average shares | 2,164,405 | 2,132,140 |
| Add: Diluted effects of assumed exercises of stock options and warrants | 34,698 | - |
| Average shares and dilutive potential common shares | 2,199,103 | 2,132,140 |
| Dilutive earnings per share | $ 0.89 | $ 0.61 |

At year end 2011 and 2010, there were 0 and 269,750 stock options and 0 and 100,000 warrants that were considered antidilutive and were excluded from the diluted earnings per common share calculation.