

---

---

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**FORM 10-K**

**FOR ANNUAL AND TRANSITION REPORTS  
PURSUANT TO SECTIONS 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934**

[X] Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange  
Act of 1934  
For the Fiscal Year Ended December 31, 2008  
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 No. 0-25766*

**Community Bank Shares of Indiana, Inc.**

(Exact Name of Registrant as Specified in its Charter)

Indiana  
(State or Other Jurisdiction of  
Incorporation or Organization)

35-1938254  
(I.R.S. Employer  
Identification Number)

101 West Spring Street, New Albany, Indiana 47150  
(Address of Principal Executive Offices) (Zip Code)

Registrant's telephone number, including area code: (812) 944-2224

Securities Registered Pursuant to Section 12(b) of the Act:  
Title of Each Class

Name of Each Exchange on Which Registered

Common Stock, par value \$0.10 per share

NASDAQ National Market

Securities Registered Pursuant to Section 12(g) of the Act:  
None

Indicate by checkmark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES\_\_NO X

Indicate by checkmark if the Registrant is not required to file requests pursuant to Section 13 or 15(d) of the Act. YES\_\_NO X

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 twelve months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such requirements for the past 90 days. YES X NO\_\_

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition 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 ☐

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES ☐ NO ☒

As of June 30, 2008, the aggregate market value of the Registrant's common stock held by non-affiliates of the Registrant was \$44,717,422 based on the closing sale price as reported on the National Association of Securities Dealers Automated Quotation System National Market System. Shares of common stock held by each officer, director, and holder of 10% or more of the outstanding common stock of the Registrant have been excluded from this calculation in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of March 19, 2009, there were issued and outstanding 3,251,437 shares of the Registrant's Common Stock.

#### **DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant's definitive Proxy Statement for its Annual Meeting of Stockholders to be held on May 19, 2009 are incorporated by reference into Items 10, 11, 12, 13 and 14 of Part III.

Form 10-K  
Index

	<u>Page</u>
<u>Part I:</u>	
<u>Item 1.</u> <a href="#">Business</a>	<u>4</u>
<u>Item 1A</u> <a href="#">Risk Factors</a>	<u>12</u>
<u>Item 1B</u> <a href="#">Unresolved Staff Comments</a>	<u>17</u>
<u>Item 2.</u> <a href="#">Properties</a>	<u>18</u>
<u>Item 3.</u> <a href="#">Legal Proceedings</a>	<u>19</u>
<u>Item 4.</u> <a href="#">Submission of Matters to a Vote of Security Holders</a>	<u>19</u>
 <u>Part II:</u>	
<u>Item 5.</u> <a href="#">Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</a>	<u>20</u>
<u>Item 6.</u> <a href="#">Selected Financial Data</a>	<u>22</u>
<u>Item 7.</u> <a href="#">Management's Discussion and Analysis of Financial Condition and Results of Operations</a>	<u>23</u>
<u>Item 7A.</u> <a href="#">Quantitative and Qualitative Disclosures about Market Risk</a>	<u>45</u>
<u>Item 8.</u> <a href="#">Financial Statements and Supplementary Data</a>	<u>48</u>
<u>Item 9.</u> <a href="#">Changes in and Disagreements with Accountants on Accounting and Financial Disclosures</a>	<u>93</u>
<u>Item 9A.</u> <a href="#">Controls and Procedures</a>	<u>93</u>
<u>Item 9B</u> <a href="#">Other Information</a>	<u>95</u>
 <u>Part III:</u>	
<u>Item 10.</u> <a href="#">Directors and Executive Officers of the Registrant</a>	<u>95</u>
<u>Item 11.</u> <a href="#">Executive Compensation</a>	<u>95</u>
<u>Item 12.</u> <a href="#">Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</a>	<u>95</u>
<u>Item 13.</u> <a href="#">Certain Relationships and Related Transactions</a>	<u>95</u>
<u>Item 14.</u> <a href="#">Principal Accountant Fees and Services</a>	<u>95</u>
 <u>Part IV:</u>	
<u>Item 15.</u> <a href="#">Exhibits and Financial Statement Schedules</a>	<u>96</u>
 <a href="#">Signatures</a>	<u>97</u>
 <a href="#">Index of Exhibits</a>	<u>98</u>

## Part I

### Item 1. Business

#### **General**

Community Bank Shares of Indiana, Inc. (the "Company") is a bank holding company headquartered in New Albany, Indiana. The Company's wholly-owned banking subsidiaries are Your Community Bank ("YCB"), which changed its name effective November 1, 2005, from Community Bank of Southern Indiana, and The Scott County State Bank ("SCSB"), which was acquired on July 1, 2006 through the Company's acquisition of The Bancshares, Inc (YCB and SCSB are at times collectively referred to herein as the "Banks"). Until November 14, 2003, the Company also operated four bank offices in Jefferson and Nelson County, Kentucky through its wholly-owned banking subsidiary, Community Bank of Kentucky, Inc. ("CBKY"). On November 14, 2003 CBKY was merged with and into YCB. The Banks are state-chartered commercial banks headquartered in New Albany, Indiana and Scottsburg, Indiana, respectively, and are both regulated by the Indiana Department of Financial Institutions. YCB is also regulated by the Federal Deposit Insurance Corporation and (with respect to its Kentucky branches) the Kentucky Office of Financial Institutions while SCSB is also regulated by the Federal Reserve.

YCB has three wholly-owned subsidiaries to manage its investment portfolio. CBSI Holdings, Inc. and CBSI Investments, Inc. are Nevada corporations which jointly own CBSI Investment Portfolio Management, LLC, a Nevada limited liability corporation which holds and manages investment securities previously owned by the Bank.

YCB also has a Community Development Entity (CDE) subsidiary named CBSI Development Fund, Inc. The CDE enables YCB to participate in the federal New Markets Tax Credit (NMTC) Program. The NMTC Program is administered by the Community Development Financial Institutions Fund of the United States Treasury and is designed to promote investment in low-income communities by providing a tax credit over seven years for equity investments in CDE's.

In June 2004 and June 2006, the Company completed placements of floating rate subordinated debentures through two trusts formed by the Company, Community Bank Shares (IN) Statutory Trust I and Trust II ("Trusts"). Because the Trusts are not consolidated with the Company, pursuant to FASB Interpretation No. 46R, the Company's financial statements reflect the subordinated debt issued by the Company to the Trusts.

The Company had total assets of \$877.4 million, total deposits of \$603.2 million, and stockholders' equity of \$62.6 million as of December 31, 2008. The Company's principal executive office is located at 101 West Spring Street, New Albany, Indiana 47150, and the telephone number at that address is (812) 944-2224.

#### **Business Strategy**

The Company's current business strategy is to operate well-capitalized, profitable and independent community banks with a significant presence in their primary market areas. The Company's growth strategy is focused on expansion through organic growth within its market areas. The Company offers business and personal banking services through a full range of deposit products that include non-interest and interest-bearing checking accounts, ATM's, debit cards, savings accounts, money market accounts, certificates of deposit and individual retirement accounts. The Company's loan products include: secured and unsecured business loans of various terms to local businesses and professional organizations; consumer loans including home equity lines of credit, automobile and recreational vehicle, credit cards, construction, and loans secured by deposit accounts; and residential real estate loans. In addition, the Company also offers non-deposit investment products such as stocks, bonds, mutual funds, and annuities to customers within its banking market areas through a strategic alliance with Smith Barney.

*Internal Growth.* Management believes the optimum way to grow the Company is by attracting new loan and deposit customers within its existing markets through its extensive product offerings and attentive customer service. Management believes the Company's customers seek a banking relationship with a service-oriented community banking institution and feels the Company's banking centers have an atmosphere which facilitates personalized service and a broad range of product offerings to meet customers' needs. However, the Company will consider acquisition opportunities that help advance its strategic objectives.

*Branch Expansion.* Management continues to consider opportunities for branch expansion and is focusing its current efforts within existing markets. Management considers a variety of criteria when evaluating potential branching opportunities. These include: the market location of the potential branch and demographics of the surrounding communities; the investment required and opportunity costs; staffing needs; and other criteria management deems of particular importance.

## Lending Activities

*Commercial Business Loans.* The Company originates non-real estate related business loans to local businesses and professional organizations. This type of commercial loan has been offered at both variable rates and fixed rates and can be unsecured or secured by general business assets such as equipment, accounts receivable or inventory. Such loans generally have shorter terms and higher interest rates than commercial real estate loans. However, commercial business loans also involve a higher level of credit risk because of the type and nature of the collateral.

*Commercial Real Estate Loans.* The Company's commercial real estate loans are secured by improved property such as offices, small business facilities, apartment buildings, nursing homes, warehouses and other non-residential buildings, most of which are located in the Company's primary market area and some of which are to be used or occupied by the borrowers. Commercial real estate loans have been offered at adjustable interest rates and at fixed rates with balloon provisions at the end of the term financing. The Company continues to originate commercial real estate loans, commercial real estate construction and development loans and land loans. Loans secured by commercial real estate generally involve a greater degree of risk than residential mortgage loans and carry larger loan balances. This increased credit risk is a result of several factors, including the concentrations of principal in a limited number of loans and borrowers, the effects of general economic conditions on income producing properties, and the increased difficulty of evaluating and monitoring these types of loans. Furthermore, the repayment of loans secured by multifamily and commercial real estate is typically dependent upon the successful operation of the related real estate project. If the cash flow from the project is reduced, the borrower's ability to repay the loan may be impaired. The Company has sought to increase its origination of multi-family residential or commercial real estate loans over the last few years and has attempted to protect itself against the increased credit risk associated with these loans through its underwriting standards and ongoing monitoring processes.

*Residential Real Estate Loans.* The Company originates one-to-four family, owner-occupied, residential mortgage loans secured by property located in the Company's market area. While the Company currently sells a portion of its residential real estate loans into the secondary market, the Company does originate and retain a significant amount of these loans in its own portfolio. The majority of the Company's residential mortgage loans consist of loans secured by owner-occupied, single family residences. The Company currently offers residential mortgage loans for terms up to thirty years, with adjustable ("ARM") or fixed interest rates. Origination of fixed-rate mortgage loans versus ARM loans is monitored continuously and is affected significantly by the level of market interest rates, customer preference, and loan products offered by the Company's competitors. Therefore, even if management's strategy is to emphasize ARM loans, market conditions may be such that there is greater demand for fixed-rate mortgage loans and/or fixed rate mortgage loans with balloon payment features.

The Company's fixed and adjustable rate residential mortgage loans are amortized on a monthly basis with principal and interest due each month. Residential real estate loans often remain outstanding for significantly shorter periods than their contractual terms because borrowers may refinance or prepay loans at their option.

The primary purpose of offering ARM loans is to make the Company's loan portfolio more interest rate sensitive. ARM loans, however, can carry increased credit risk because during a period of rising interest rates the risk of default on ARM loans may increase due to increases in borrowers' monthly payments.

After the initial fixed rate period, the Company's ARM loans generally adjust annually with interest rate adjustment limitations of two percentage points per year and six percentage points over the life of the loan. The Company also makes ARM loans with interest rates that adjust every one, three or five years. Under the Company's current practice, after the initial fixed rate period the interest rate on ARM loans adjusts to the applicable index plus a spread. The Company's policy is to qualify borrowers for one-year ARM loans based on the initial interest rate plus the maximum annual rate increase.

The Company has used different indices for its ARM loans such as the National Average Median Cost of Funds, the Sixth District Net Cost of Funds Monthly Index, the National Average Contract Rate for Previously Occupied Homes, the average three year Treasury Bill Rate, and the Eleventh District Cost of Funds. Consequently, the adjustments in the Company's portfolio of ARM loans tend not to reflect any one particular change in any specific interest rate index, but general interest rate trends overall.

Secondary market regulations limit the amount that a bank may lend based on the appraised value of real estate. Such regulations permit a maximum loan-to-value ratio of 95% percent for residential property and from 65-90% for all other real estate related loans.

The Company occasionally makes real estate loans with loan-to-value ratios in excess of 80%. For the loans sold into the secondary market, individual investor requirements pertaining to private mortgage insurance apply. For the mortgage real estate loans retained by the Company with loan-to-value ratios of 80-90%, the Company may require the first 20% of the loan to be covered by private mortgage insurance. For the mortgage real estate loans retained by the Company with loan-to-value ratios of 90-95%, the Company may require private mortgage insurance to cover the first 25-30% of the loan amount. The Company requires fire and casualty insurance, as well as title insurance or an opinion of counsel regarding good title, on all properties securing real estate loans made by the Company.

*Construction Loans.* The Company originates loans to finance the construction of owner-occupied residential property. The Company makes construction loans to private individuals for the purpose of constructing a personal residence or to local real estate builders and developers. Construction loans generally are made with either adjustable or fixed-rate terms, typically up to 12 months. Loan proceeds are disbursed in increments as construction progresses and as inspections warrant. Construction loans are structured to be converted to permanent loans at the end of the construction period or to be terminated upon receipt of permanent financing from another financial institution.

*Consumer Loans.* The principal types of consumer loans offered by the Company are home equity lines of credit, auto loans, home improvement loans, and loans secured by deposit accounts. Home equity lines of credit are predominately made at rates which adjust periodically and are indexed to the prime rate. Some consumer loans are offered on a fixed-rate basis depending upon the borrower's preference. The Company's home equity lines of credit are generally secured by the borrower's principal residence and a personal guarantee.

The underwriting standards employed by the Company for consumer loans include a determination of the applicant's credit history and an assessment of the prospective borrower's ability to meet existing obligations and payments on the proposed loan. The stability of the applicant's monthly income may be determined by verification of gross monthly income from primary employment and from any verifiable secondary income. The underwriting process also includes a comparison of the value of the collateral in relation to the proposed loan amount.

*Mortgage-Banking Operations.* The Company originates qualified government guaranteed loans and conventional secondary market loans which are generally sold with the servicing released. This arrangement provides necessary liquidity to the Company while providing additional loan products to the Company's customers.

*Loan Solicitation and Processing.* Loans are originated through a number of sources including loan sales staff, real estate broker referrals, existing customers, borrowers, builders, attorneys and walk-in customers. Processing procedures are affected by the type of loan requested and whether the loan will be funded by the Company or sold into the secondary market.

Mortgage loans that are sold into the secondary market are submitted, when possible, for Automated Underwriting, which allows for faster approval and an expedited closing. The Company's responsibility on these loans is the fulfillment of the loan purchaser's requirements. These loans often have reduced underwriting features and may be made without an appraisal or credit report at the option of the purchaser. Loans that are reviewed in a more traditional manner, which are mostly loans held for the Company's own portfolio, require credit reports, appraisals, and income verification before they are approved or disapproved. Private mortgage insurance is generally required on loans with a ratio of loan to appraised value of greater than eighty percent. Property insurance and flood certifications are required on all real estate loans.

Installment loan documentation varies by the type of collateral offered to secure the loan. In general, an application and credit report is required before a loan is submitted for underwriting. The underwriter determines the necessity of any additional documentation, such as income verification or appraisal of collateral. An authorized loan officer approves or declines the loan after review of all applicable loan documentation collected during the underwriting process.

Commercial loans are underwritten by the commercial loan officer who makes the initial contact with the customer applying for credit. The underwriting of these loans is reviewed after the fact by the Risk Management area for compliance with the Company's general underwriting standards. A loan exceeding the authority of the underwriting loan officer requires the approval of other officers of the Banks based upon individual lending authorities, the Executive Committee, or the Board of Directors of the Banks, depending on the loan amount.

*Loan Commitments.* The Company issues loan origination commitments to qualified borrowers primarily for the construction and purchase of residential real estate and commercial real estate. Such commitments are made with specified terms and conditions for periods of thirty days for commercial real estate loans and sixty days for residential real estate loans.

#### **Employees**

As of December 31, 2008, the Company employed 253 employees, 230 full-time and 23 part-time. None of these employees are represented by a collective bargaining group. Neither the Company nor any subsidiary has ever experienced a work stoppage.

#### **Competition and Market Area Served**

The banking business is highly competitive, and as such the Company competes not only with other commercial banks, but also with savings and loan associations, trust companies and credit unions for deposits and loans, as well as stock brokerage firms, insurance companies, and other entities providing one or more of the services and products offered by the Company. In addition to competition, the Company's business and operating results are affected by the general economic conditions prevalent in its market.

The Company's primary market areas consist of Floyd, Clark, and Scott counties in Southern Indiana and Jefferson and Nelson counties in Kentucky. These are four (excluding Scott County) of the thirteen counties comprising the Louisville, Kentucky Standard Metropolitan Statistical Area, which has a population in excess of 1.2 million. The aggregate population of Floyd, Clark, and Scott counties is approximately 202,000 while the populations of Jefferson and Nelson Counties are approximately 709,000 and 43,000, respectively. The Company's headquarters are located in New Albany, Indiana, a city of 37,000 located approximately three miles from the center of Louisville.

#### **Nature of Company's Business**

The business of the Company is not seasonal. The Company's business does not depend upon a single customer, or a few customers, the loss of any one or more of which would have a material adverse effect on the Company. No material portion of the Company's business is subject to renegotiation of profits or termination of contracts or subcontracts at the election of any governmental entity.

#### **Regulation and Supervision**

As a bank holding company, the Company is regulated under the Bank Holding Company Act of 1956, as amended (the "Act"). The Act limits the business of bank holding companies to banking, managing or controlling banks and other subsidiaries authorized under the Act, performing certain servicing activities for subsidiaries and engaging in such other activities as the Board of Governors of the Federal Reserve System ("Federal Reserve Board") may determine to be closely related to banking. The Company is registered with and is subject to regulation by the Federal Reserve Board. Among other things, applicable statutes and regulations require the Company to file an annual report and such additional information as the Federal Reserve Board may require pursuant to the Act and the regulations which implement the Act. The Federal Reserve Board also conducts examinations of the Company.

The Act provides that a bank holding company must obtain the prior approval of the Federal Reserve Board to acquire more than five percent of the voting stock or substantially all the assets of any bank or bank holding company. The Act also provides that, with certain exceptions, a bank holding company may not (i) engage in any activities other than those of banking or managing or controlling banks and other authorized subsidiaries, or (ii) own or control more than five percent of the voting shares of any company that is not a bank, including any foreign company. A bank holding company is permitted, however, to acquire shares of any company, the activities of which the Federal Reserve Board has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. A bank holding company may also acquire shares of a company which furnishes or performs services for a bank holding company and acquire shares of the kinds and in the amounts eligible for investment by national banking associations. In addition, the Federal Reserve Act restricts the Bank's extension of credit to the Company.

On November 12, 1999, Congress enacted the Gramm-Leach-Bliley Act. The Gramm-Leach-Bliley Act permits bank holding companies to qualify as "financial holding companies" that may engage in a broad range of financial activities, including underwriting, dealing in and making a market in securities, insurance underwriting and agency activities and merchant banking. The Federal Reserve Board is authorized to expand the list of permissible financial activities. The Gramm-Leach-Bliley Act also authorizes banks to engage through financial subsidiaries in nearly all of the activities permitted for financial holding companies. The Company has not elected the status of financial holding company and at this time has no plans for these investments or broader financial activities.

As state-chartered commercial banks, the Company's subsidiary banks are subject to examination, supervision and extensive regulation by the Federal Deposit Insurance Corporation ("FDIC"), the Indiana Department of Financial Institutions ("DFI") and (with respect to YCB and its branch offices located in Kentucky) the Kentucky Office of Financial Institutions ("KOFI"). The Banks are members of and own stock in the Federal Home Loan Bank ("FHLB") of Indianapolis and Cincinnati. The FHLB institutions located in Indianapolis and Cincinnati are two of the twelve regional banks in the FHLB system. The Banks are also subject to regulation by the Federal Reserve Board, which governs reserves to be maintained against deposits and regulates certain other matters. The extensive system of banking laws and regulations to which the Banks are subject is intended primarily for the protection of the Company's customers and depositors, and not its shareholders.

The FDIC, Federal Reserve, and DFI/KOFI regularly examine the Banks and prepare reports for the consideration of the Banks' Board of Directors on any deficiencies that they may find in the Banks' operations. The relationship of the Banks with their depositors and borrowers also is regulated to a great extent by both federal and state laws, especially in such matters as the form and content of the Banks' mortgage documents and communication of loan and deposit rates to both existing and prospective customers.

The investment and lending authority of a state-chartered bank is prescribed by state and federal laws and regulations, and such banks are prohibited from engaging in any activities not permitted by such laws and regulations. These laws and regulations generally are applicable to all state chartered banks. The Banks may not lend to a single or related group of borrowers on an unsecured basis an amount in excess of the greater of \$500,000 or fifteen percent of the Banks unimpaired capital and surplus on a disaggregated basis. An additional amount may be lent, equal to ten percent of unimpaired capital and surplus, if such loan is secured by readily marketable collateral, which is defined to include certain securities, but generally does not include real estate.

#### **Federal Regulations**

Sections 22(h) and (g) of the Federal Reserve Act place restrictions on loans to executive officers, directors and principal stockholders. Under Section 22(h), loans to a director, an executive officer and to a greater than ten percent stockholder of a bank, and certain affiliated interests of either, may not exceed, together with all other outstanding loans to such person and affiliated interests, the institution's loans to one borrower limit (15% of the Bank's unimpaired capital and surplus). Section 22(h) also requires that loans to directors, executive officers and principal stockholders be made on terms substantially the same as offered in comparable transactions to other persons and also requires prior board of directors approval for certain loans. In addition, the aggregate amount of extensions of credit to all insiders cannot exceed the institution's unimpaired capital and surplus. At December 31, 2008 the Banks were in compliance with the above restrictions.



*Safety and Soundness.* The Federal Deposit Insurance Act ("FDIA"), as amended by the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") and the Riegle Community Development and Regulatory Improvement Act of 1994, requires the federal bank regulatory agencies to prescribe standards, by regulations or guidelines, relating to the internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest-rate-risk exposure, asset growth, asset quality, earnings, stock valuation and compensation, fees and benefits and such other operational and managerial standards as the agencies may deem appropriate. The federal bank regulatory agencies adopted, effective August 9, 1995, a set of guidelines prescribing safety and soundness standards pursuant to FDICIA, as amended. In general, the guidelines require, among other things, appropriate systems and practices to identify and manage the risks and exposures specified in the guidelines.

The FDIC generally is authorized to take enforcement action against a financial institution that fails to meet its capital requirements; such action may include restrictions on operations and banking activities, the imposition of a capital directive, a cease and desist order, civil money penalties or harsher measures such as the appointment of a receiver or conservator or a forced merger into another institution. In addition, under current regulatory policy, an institution that fails to meet its capital requirements is prohibited from paying any dividends. Except under certain circumstances, further disclosure of final enforcement action by the FDIC is required.

*Prompt Corrective Action.* Under Section 38 of the FDIA, as amended by the FDICIA, each federal banking agency was required to implement a system of prompt corrective action for institutions which it regulates. The federal banking agencies, including the FDIC, adopted substantially similar regulations to implement Section 38 of the FDIA, effective as of December 19, 1992. Under the regulations, an institution is deemed to be (i) "well-capitalized" if it has total risk-based capital of 10.0% or more, a Tier 1 risk-based capital ratio of 6.0% or more, a Tier 1 leverage capital ratio of 5.0% or more and is not subject to any order or final capital directive to meet and maintain a specific capital level for any capital measure, (ii) "adequately-capitalized" if it has a total risk-based capital ratio of 8.0% or more, a Tier 1 risk-based capital ratio of 4.0% or more and a Tier 1 leverage capital ratio of 4.0% or more (3.0% under certain circumstances) and does not meet the definition of "well-capitalized," (iii) "undercapitalized" if it has a total risk-based capital ratio that is less than 8.0%, a Tier 1 risk-based capital ratio that is less than 4.0% or a Tier 1 leverage capital ratio that is less than 4.0% (3.0% under certain circumstances), (iv) "significantly undercapitalized" if it has a total risk-based capital ratio that is less than 6.0%, a Tier 1 risk-based capital ratio that is less than 3.0% or a Tier II average capital ratio that is less than 3.0%, and (v) "critically undercapitalized" if it has a ratio of tangible equity to total assets that is equal to or less than 2.0%. Section 38 of the FDIA and the regulations promulgated thereunder also specify circumstances under which a federal banking agency may reclassify a well-capitalized institution as adequately-capitalized and may require an adequately-capitalized institution or an undercapitalized institution to comply with supervisory actions as if it were in the next lower category (except that the FDIC may not reclassify a significantly undercapitalized institution as critically undercapitalized). At December 31, 2008, the Company and the Banks were deemed well-capitalized for purposes of the above regulations.

*Federal Home Loan Bank System.* The Banks are members of the FHLB of Indianapolis and Cincinnati. The FHLB of Indianapolis and Cincinnati are two of the 12 regional FHLB's that, prior to the enactment of FIRREA, were regulated by the Federal Home Loan Bank Board (FHLBB). FIRREA separated the home financing credit function of the FHLB's from the regulatory functions of the FHLB's regarding savings institutions and their insured deposits by transferring oversight over the FHLB's from the FHLBB to a new federal agency, the Federal Home Financing Board ("FHFB"). On July 30, 2008, the Federal Housing Finance Agency ("FHFA") was created due to the enactment of the Housing and Economic Recovery Act of 2008. The Act empowered the FHFA with the powers to oversee and regulate Fannie Mae, Freddie Mac, and the FHLBs.

As members of the FHLB system, the Banks are required to purchase and maintain stock in the FHLB in an amount equal to the greater of one percent of its aggregate unpaid residential mortgage loans, home purchase contracts or similar obligations at the beginning of each year, or 1/20 (or such greater fraction as established by the FHLB) of outstanding FHLB advances. At December 31, 2008, \$7.6 million of FHLB stock was outstanding for the Banks, which were in compliance with this requirement. In past years, the Banks have received dividends on its FHLB stock.

*Insurance of Accounts.* Prior to October 2, 2008, the Banks' deposits were insured up to \$100,000 per insured member (as defined by law and regulation). Effective October 3, 2008, the basic limit on federal deposit insurance coverage was temporarily increased from \$100,000 to \$250,000 per depositor through December 31, 2009. On January 1, 2010, FDIC deposit insurance for all deposit accounts—except for certain retirement accounts—will return to at least \$100,000 per depositor. Insurance coverage for certain retirement accounts, which include all IRA deposit accounts, was increased permanently to \$250,000 per depositor in 2006. This insurance is backed by the full faith and credit of the United States Government. Certain deposits assumed by YCB upon the merger of Heritage Bank of Southern Indiana into YCB in 2002 (which are insured by the Bank Insurance Fund (BIF)), are insured by the Savings Association Insurance Fund (SAIF). The SAIF and the BIF are both administered and managed by the FDIC. As insurer, the FDIC is authorized to conduct examinations of and to require reporting by SAIF and BIF insured institutions. It also may prohibit any insured institution from engaging in any activity the FDIC determines by regulation or order to pose a serious threat to either fund. The FDIC also has the authority to initiate enforcement actions against financial institutions. The annual assessment for deposit insurance is based on a risk-related premium system. Each insured institution is assigned to one of three capital groups: well-capitalized, adequately-capitalized or undercapitalized. Within each capital group, institutions are assigned to one of three subgroups (A, B, or C) on the basis of supervisory evaluations by the institution's primary federal supervisor and if applicable, state supervisor. Assignment to one of the three capital groups, coupled with assignment to one of three supervisory subgroups, will determine which of the four risk classifications is appropriate for an institution. Institutions are assessed insurance rates based on their assigned risk classifications. The well-capitalized, subgroup "A" category institutions are assessed the lowest insurance rate, while institutions assigned to the undercapitalized subgroup "C" category are assessed the highest insurance rate. As of December 31, 2008, SCSB was assigned to the well-capitalized, subgroup "A" category and paid an annual insurance rate of 5.5 cents per \$100 of deposits while YCB was assigned to the well-capitalized, subgroup "B" category and paid an annual insurance rate of 10.0 cents per \$100 of deposits. In the fourth quarter of 2008, the Company received notification that FDIC was modifying its risk based assessment to incorporate additional risk-based adjustments for unsecured and secured borrowings and for institutions categorized in risk categories II, III, and IV, an adjustment for brokered deposits beginning with assessment period starting on April 1, 2009. The FDIC also announced that, beginning April 1, 2009, the base assessment rate would increase for all risk categories before application of the risk-based adjustments. Additionally, the FDIC announced a uniform 7 basis point increase to the base assessment rate (before risk-based adjustments) for the assessment period beginning on January 1, 2009. Subsequent to year-end, the Banks received notification the FDIC was imposing a one-time special assessment of 20 basis points on June 30, 2009 and payable on September 30, 2009. There has been continued debate about the amount of the assessment subsequent to its announcement with the possibility existing that the assessment may be lowered. The effect of these changes by the FDIC will result in a significant increase in the Company's FDIC assessment expense for 2009. If the one time special assessment passes, the Company estimates these changes will result in an increase in FDIC assessment expense of \$2.0 million in 2009 as compared to 2008 based on the current risk ratings of the Banks and their deposit bases as of December 31, 2008.

The FDIC may terminate the deposit insurance of any insured depository institution if it determines, after a hearing, that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, order or any condition imposed by an agreement with the FDIC.

*The Federal Reserve System.* The Federal Reserve Board requires all depository institutions to maintain reserves against their transaction accounts and non-personal time deposits. Cash on hand or on deposit with the Federal Reserve Bank of \$1.4 million was required to meet regulatory reserve and clearing requirements at year-end 2008 and 2007. In October 2008, the Federal Reserve began paying interest on these balances. Banks are authorized to borrow from the Federal Reserve Bank "discount window," but Federal Reserve Board regulations require banks to exhaust other reasonable alternative sources of funds, including FHLB advances, before borrowing from the Federal Reserve Bank.

*Federal Taxation.* For federal income tax purposes, the Company and its subsidiaries file a consolidated federal income tax return on a calendar year basis. Consolidated returns have the effect of eliminating intercompany distributions, including dividends, from the computation of consolidated taxable income for the taxable year in which the distributions occur.

The Company and its subsidiaries are subject to the rules of federal income taxation generally applicable to corporations under the Internal Revenue Code of 1986, as amended (the "Code").

Management has evaluated its tax positions in association with the adoption of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109 (FIN 48), which prescribes a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return effective for its fiscal year beginning January 1, 2007. The adoption of FIN 48 did not have a material effect upon adoption. As of December 31, 2007, the Company's 2004 and 2005 federal tax returns were being audited by the Internal Revenue Service ("IRS"). In 2008, the Company was notified by the IRS that the examinations were complete and that there would be no adjustments made for 2004 and 2005 and a refund would be issued for 2006 for \$20,000. Accordingly, the Company reduced its reserve for unrecognized tax benefits in 2008 by \$55,000.

*Indiana Taxation.* The Company is subject to an income tax imposed by the State of Indiana. The tax is imposed at the rate of 8.5 percent of the Company's adjusted gross income. In computing adjusted gross income, no deductions are allowed for municipal interest and U.S. Government interest. In 2000, the Indiana financial institution tax law was amended to treat resident financial institutions the same as nonresident financial institutions by providing for apportionment of Indiana income based on receipts in Indiana. This revision allowed for the exclusion of receipts from out of state sources and federal government and agency obligations.

Currently, income from YCB's subsidiaries CBSI Holdings, Inc., CBSI Investments, Inc. and CBSI Investment Portfolio Management, LLC is not subject to the Indiana income tax.

The Company's December 31, 2004, 2003, and 2002 Indiana state income tax returns were audited in 2006. The Indiana Department of Revenue concluded that no adjustments were necessary as a result of their audits.

*Kentucky Taxation.* The Company is subject to a franchise tax imposed by the Commonwealth of Kentucky on its operations in Kentucky. The tax is imposed at a rate of 1.1% on taxable net capital, which equals capital stock paid in, surplus, undivided profits and capital reserves, net unrealized holding gains or losses on available for sale securities, and cumulative foreign currency translation adjustments less an amount equal to the same percentage of the total as the book value of United States obligations and Kentucky obligations bears to the book value of the total assets of the financial institution. A financial institution whose business activity is taxable within and without Kentucky must apportion its net capital based on the three factor apportionment formula of receipts, property and payroll unless the Kentucky Revenue Cabinet has granted written permission to use another method.

*Recent legislation affecting the Company.* In response to recent market and economic conditions, the United States government, particularly the U.S. Department of the Treasury (the "U.S. Treasury"), the Board of Governors of the Federal Reserve System (the "Federal Reserve") and the Federal Deposit Insurance Corporation (the "FDIC"), have taken a variety of extraordinary measures designed to provide fiscal stimulus, restore confidence in the financial markets and to strengthen financial institutions, including capital injections, guarantees of bank liabilities and the acquisition of illiquid assets from banks. In particular on October 3, 2008 and February 17, 2009, the Emergency Economic Stabilization Act of 2008 (the "EESA") and the American Recovery and Reinvestment Act of 2009 (the "ARRA"), respectively, were signed into law.

Other programs and actions taken include (1) the U.S. Treasury's Temporary Guarantee Program for Money Market Funds, which is designed to guarantee the share price of eligible money market funds that apply to the program and pay a fee to participate, (2) the Federal Reserve Bank of New York's Money Market Investor Funding Facility (the "MMIFF"), which is designed to provide liquidity to U.S. money market investors, (3) the Federal Reserve's Commercial Paper Funding Facility, which is designed to provide liquidity to term funding markets by providing a liquidity backstop to U.S. issuers of commercial paper, (4) the Federal Reserve's Asset Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (the "AML Facility"), which is designed to provide liquidity to money market mutual funds under certain conditions by providing funding to U.S. depository institutions and bank holding companies secured by high-quality asset-backed commercial paper they purchased from those money market mutual funds, (5) the FDIC's Temporary Liquidity Guarantee Program (the "TLG Program"), which enables the FDIC to temporarily provide a 100% guarantee of the senior debt of all FDIC-insured institutions and their holding companies, as well as deposits in noninterest-bearing transaction deposit accounts, (6) the Federal Reserve's Primary Dealer Credit Facility (the "PDCF"), which is designed to foster the financial markets generally, was modified to expand the eligible collateral to include any collateral eligible for tri-party repurchase agreements, (7) the Federal Reserve's Term Securities Lending Facility (the "TSLF"), which is designed to promote liquidity in the financial markets for treasuries and other collateral, was expanded to (a) include all investment-grade debt securities as eligible collateral for schedule 2 auctions and (b) increase the frequency of schedule 2 auctions, (8) the Federal Reserve's adoption of an interim rule that provides an exemption, until January 30, 2009, to the Federal Reserve Act to allow insured depository institutions to provide liquidity to their affiliates for assets typically funded in the tri-party repurchase agreement market, (9) the Federal Reserve's Term Auction Facility (the "TAF"), which is designed to allow financial institutions to borrow funds at a rate that is below the discount rate, (10) the Federal Reserve's Term Asset-Backed Securities Loan Facility (the "TALF"), which is designed to assist in the credit markets in accommodating the credit needs of consumers and small businesses by facilitating the issuance of asset-backed securities and improving the conditions for asset-backed securities more generally, (11) the Federal Reserve's announcement that it will purchase up to \$600 billion of direct obligations of housing-related government-sponsored enterprises ("GSEs") and mortgage-backed securities of GSEs, (12) the U.S. Treasury's Financial Stability Plan, which involves (a) the creation of a public-private investment fund of up to \$1 trillion, (b) the expansion of the TALF program up to \$1 trillion under the consumer and business lending initiative, and (c) the creation of a financial stability trust for bank investment and additional transparency, and (13) President Obama's Home Owner Affordability and Stability Plan, which is intended to (a) provide refinancing assistance for responsible homeowners suffering from falling home prices, (b) a comprehensive \$75 billion homeowner stability initiative, and (c) strengthen confidence in the GSEs. The Company is currently participating in certain of these programs and may become a future participant in others of these programs, or additional new programs established by the U.S. government.

**Available Information.** The Company files annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports with the Securities and Exchange Commission ("SEC") pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934. The public may read and copy any material the Company files with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549 and may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC on its website at [www.sec.gov](http://www.sec.gov). The Company makes available through its website, [www.yourcommunitybank.com](http://www.yourcommunitybank.com), its annual report on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K.

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

There are a number of factors, including those specified below, that may adversely affect our business, financial results or stock price. Additional risks that we currently do not know about or currently view as immaterial may also impair our business or adversely impact our financial results or stock price.

As used in this Item 1A of the Form 10-K, the terms "we", "us" and "our" refer to Community Bank Shares of Indiana, Inc., an Indiana corporation and its subsidiaries (unless the context clearly implies otherwise).

## Industry Risk Factors

*Economic Conditions.* Our earnings are affected by the general economic conditions in the United States, and to a lesser extent, general international economic conditions. Economic conditions in the United States and abroad deteriorated significantly in the latter part of 2008. The United States is currently in a recession. The housing market is in decline reflected by falling home prices and increases in foreclosures. Unemployment has increased. These factors have affected the performance of mortgage loans and resulted in financial institutions, including government-sponsored entities, in making significant write-downs of asset values of mortgage-backed securities, credit default swaps and other derivative and cash securities. Some financial institutions have failed. Many financial institutions and institutional investors have tightened the availability of credit to borrowers and other financial institutions, which, in turn, results in more loan defaults and decreased business activity. Consumer confidence regarding the economy is low and the financial markets reflect this lack of confidence. This recession has adversely affected our business, financial condition, results of operations, liquidity and access to capital and credit. We do not expect significant improvement in the economy in the near future, and future declines in the economy will likely make the credit market crisis worse.

*Recent Regulations Regarding U.S. Financial System.* In response to the economic downturn and financial crisis, the U.S. government has enacted legislation by passing the Emergency Economic Stabilization Act of 2008 (the “Stabilization Act”) followed by the American Recovery and Reinvestment Act of 2009 (the “Recovery Act”). These Acts have enabled the U.S. Treasury, the FDIC and the Federal Reserve Board to develop programs, such as the TARP Capital Purchase Program, the Financial Stability Plan and the foreclosure prevention program, to improve funding to consumers, increase interbank lending and reduce home foreclosures. The U.S. government continues to closely evaluate the economy, the effect of its legislation and resulting programs and initiatives on the economy. We expect that the U.S. government will continue to refine these programs and develop new programs. We do not know whether these Acts and programs will positively affect the economy, help stabilize the financial markets and increase the availability of credit. Our business, financial condition, results of operations, liquidity and access to capital and credit will likely be negatively affected if the economy worsens or the financial markets do not stabilize.

*Changes in the laws, regulations and policies governing financial services companies could alter our business environment and adversely affect our operations.* The Board of Governors of the Federal Reserve System regulates the supply of money and credit in the United States. Its fiscal and monetary policies determine in a large part our cost of funds for lending and investing and the return that can be earned on those loans and investments, both of which affect our net interest margin. Federal Reserve Board policies can also materially affect the value of financial instruments that we hold, such as debt securities.

*We, along with our subsidiaries, are heavily regulated at the federal and state levels. This regulation is to protect depositors, federal deposit insurance funds and the banking system as a whole.* Congress and state legislatures and federal and state agencies continually review banking laws, regulations and policies for possible changes. Changes in statutes, regulations or policies could affect us in substantial and unpredictable ways, including limiting the types of financial services and products that we offer and/or increasing the ability of non-banks to offer competing financial services and products. We cannot predict whether any of this potential legislation will be enacted, and if enacted, the effect that it or any regulations would have on our financial condition or results of operations.

*The financial services industry is highly competitive, and competitive pressures could intensify and adversely affect our financial results.* We operate in a highly competitive industry that could become even more competitive as a result of legislative, regulatory and technological changes and continued consolidation. We compete with other commercial banks, savings and loan associations, mutual savings banks, finance companies, mortgage banking companies, credit unions and investment companies. In addition, technology has lowered barriers to entry and made it possible for non-banks to offer products and services traditionally provided by banks. Many of our competitors have fewer regulatory constraints and some have lower cost structures. Also, the potential need to adapt to industry changes in information technology systems, on which we and the financial services industry are highly dependent, could present operational issues and require capital spending.

*Changes in consumer use of banks and changes in consumer spending and saving habits could adversely affect our financial results.* Technology and other changes now allow many consumers to complete financial transactions without using banks. For example, consumers can pay bills and transfer funds directly without going through a bank. This “disintermediation” could result in the loss of fee income, as well as the loss of customer deposits and income generated from those deposits. In addition, changes in consumer spending and saving habits could adversely affect our operations, and we may be unable to timely develop competitive new products and services in response to these changes that are accepted by new and existing customers.

*Risks associated with unpredictable economic and political conditions may be amplified as a result of our limited market area.* Commercial banks and other financial institutions are affected by economic and political conditions, both domestic and international, and by governmental monetary policies. Conditions such as inflation, value of the dollar, recession, unemployment, high interest rates, short money supply, scarce natural resources, international disorders, terrorism and other factors beyond our control may adversely affect profitability. In addition, almost all of our primary business area is located in Southern Indiana and Jefferson County, Kentucky. A significant downturn in this regional economy may result in, among other things, deterioration in our credit quality or a reduced demand for credit and may harm the financial stability of our customers. Due to the regional market area, these negative conditions may have a more noticeable effect on us than would be experienced by an institution with a larger, more diverse market area.

*Changes in the domestic interest rate environment could reduce our net interest income.* Interest rate volatility could significantly harm our business. Our results of operations are affected by the monetary and fiscal policies of the federal government and the regulatory policies of governmental authorities. A significant component of earnings is net interest income, which is the difference between the income from interest-earning assets, such as loans, and the expense of interest-bearing liabilities, such as deposits. A change in market interest rates could adversely affect earnings if market interest rates change such that the interest we pay on deposits and borrowings increases faster than the interest we collect on loans and investments. Consequently, along with other financial institutions generally, we are sensitive to interest rate fluctuations.

#### **Company Risk Factors**

*Our allowance for loan losses may not be adequate to cover actual losses.* Like all financial institutions, we maintain an allowance for loan losses to provide for loan defaults and non-performance. Our allowance for loan losses is based on our historical loss experience as well as an evaluation of the risks associated with our loan portfolio, including the size and composition of the loan portfolio, loan portfolio performance, current economic conditions and geographic concentrations within the portfolio. Our allowance for loan losses may not be adequate to cover actual loan losses, and future provisions for loan losses could materially and adversely affect its financial results.

*We may suffer losses in our loan portfolio despite our underwriting practices.* Our results of operations are significantly affected by the ability of borrowers to repay their loans. Lending money is an essential part of the banking business. However, borrowers do not always repay their loans. The risk of non-payment is historically small, but if nonpayment levels are greater than anticipated, our earnings and overall financial condition, as well as the value of our common stock, could be adversely affected. No assurance can be given that our underwriting practices or monitoring procedures and policies will reduce certain lending risks. Loan losses can cause insolvency and failure of a financial institution and, in such an event, our stockholders could lose their entire investment. In addition, future provisions for loan losses could materially and adversely affect profitability. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount that can be recovered on these loans.

*Maintaining or increasing our market share may depend on lowering prices and market acceptance of new products and services.* Our success depends, in part, on our ability to adapt our products and services to evolving industry standards. There is increasing pressure to provide products and services at lower prices. Lower prices can reduce our net interest margin and revenues from our fee-based products and services. In addition, the widespread adoption of new technologies, including internet services, could require us to make substantial expenditures to modify or adapt our existing products and services. Also, these and other capital investments in our businesses may not produce expected growth in earnings anticipated at the time of the expenditure. We might not be successful in introducing new products and services, achieving market acceptance of its products and services, or developing and maintaining loyal customers.

*Because the nature of the financial services business involves a high volume of transactions, we face significant operational risks.* Operational risk is the risk of loss resulting from our operations, including, but not limited to, the risk of fraud by employees or persons outside of the Company, the execution of unauthorized transactions by employees, errors relating to transaction processing and technology, breaches of the internal control system and compliance requirements and business continuation and disaster recovery. This risk of loss also includes the potential legal actions that could arise as a result of an operational deficiency or as a result of noncompliance with applicable regulatory standards, adverse business decisions or their implementation, and customer attrition due to potential negative publicity. In the event of a breakdown in the internal control system, improper operation of systems or improper employee actions, we could suffer financial loss, face regulatory action and suffer damage to its reputation.

*Acquisitions and the addition of branch facilities may not produce revenue enhancements or cost savings at levels or within timeframes originally anticipated and may result in unforeseen integration difficulties.* We regularly explore opportunities to establish branch facilities and acquire other banks or financial institutions. New or acquired branch facilities and other facilities may not be profitable. We may not be able to correctly identify profitable locations for new branches. The costs to start up new branch facilities or to acquire existing branches, and the additional costs to operate these facilities, may increase our noninterest expense and decrease earnings in the short term. It may be difficult to adequately and profitably manage growth through the establishment of these branches. In addition, we can provide no assurance that these branch sites will successfully attract enough deposits to offset the expenses of operating these branch sites. Any new or acquired branches will be subject to regulatory approval, and there can be no assurance that we will succeed in securing such approvals.

We cannot predict the number, size or timing of acquisitions. Difficulty in integrating an acquired business or company may cause us not to realize expected revenue increases, cost savings, increases in geographic or product presence, and/or other projected benefits from the acquisition. The integration could result in higher than expected deposit attrition (run-off), loss of key employees, disruption of our business or the business of the acquired company, or otherwise adversely affect our ability to maintain relationships with customers and employees or achieve the anticipated benefits of the acquisition. Also, the negative effect of any divestitures required by regulatory authorities in acquisitions or business combinations may be greater than expected.

*Our business could suffer if we fail to attract and retain skilled people.* Our success depends, in large part, on our ability to attract and retain key people. Competition can be intense for the best people in most activities in which we engage. We may not be able to hire the best people or to keep them.

*Significant legal actions could subject us to substantial uninsured liabilities.* We are from time to time subject to claims related to our operations. These claims and legal actions, including supervisory actions by our regulators, could involve large monetary claims and significant defense costs. To protect us from the cost of these claims, we maintain insurance coverage in amounts and with deductibles that we believe are appropriate for our operations. However, our insurance coverage may not cover all claims against us or continue to be available to us at a reasonable cost. As a result, we may be exposed to substantial uninsured liabilities, which could adversely affect our results of operations and financial condition.

*We are exposed to risk of environmental liability when we take title to properties.* In the course of our business, we may foreclose on and take title to real estate. As a result, we could be subject to environmental liabilities with respect to these properties. We may be held liable to a governmental entity or to third parties for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination or may be required to investigate or clean up hazardous or toxic substances or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, if we are the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. If we become subject to significant environmental liabilities, our financial condition and results of operations could be adversely affected.

*Our stock price can be volatile and there is a limited trading market for our stock.* Our stock price can fluctuate widely in response to a variety of factors, including:

- actual or anticipated variations in our quarterly operating results;
- recommendations by securities analysts; acquisitions or business combinations;
- operating and stock price performance of other companies that investors deem comparable to us;
- new technology used or services offered by our competitors;
- news reports relating to trends, concerns and other issues in the financial services industry; and
- changes in government regulations.

General market fluctuations, industry factors and general economic and political conditions and events, including terrorist attacks, economic slowdowns or recessions, interest rate changes, credit loss trends or currency fluctuations, could also cause our stock price to decrease regardless of our operating results.

In addition, there is a limited trading market for our common stock and shareholders may not be able to resell shares at or above the price paid for them. The price of the common stock purchased may decrease significantly. Although our common stock is quoted on the Nasdaq Capital Market under the symbol "CBIN", trading activity in the stock historically has been sporadic. A public trading market having the desired characteristics of liquidity and order depends on the presence in the market of willing buyers and sellers at any given time. The presence of willing buyers and sellers depends on the individual decisions of investors and general economic conditions, all of which are beyond our control.

*Our historical growth rates may not be sustainable.* We may not be able to maintain and manage our growth, which may adversely affect our results of operations and financial condition and the value of our common stock. We cannot assure you that we will continue to be successful in increasing the volume of loans and deposits at acceptable risk levels and upon acceptable terms. Additionally, we may not continue to be successful in expanding our asset base to a targeted size and managing the costs and implementation risks associated with our growth strategy. We cannot assure you that further expansion will be profitable or that our historical rate of growth will continue to be sustained, either through internal growth or otherwise, or that capital will be maintained sufficient to support continued growth. Furthermore, if we grow too quickly and are not able to control costs and maintain asset quality, rapid growth also could adversely affect our financial performance.

*We rely on dividends from our subsidiaries for our liquidity needs.* Our holding company status makes us dependent on dividends from our subsidiaries to meet our obligations. We do not have any significant assets other than cash and the stock of our subsidiaries. Accordingly, we depend on dividends from our subsidiaries (and, in turn, their subsidiaries) to meet our obligations and obtain revenue. Our right to participate in any distribution of earnings or assets of our subsidiaries is subject to the prior claims of creditors of our subsidiaries. Under federal and state law, our subsidiaries are limited in the amount of dividends they may pay to us without prior regulatory approval. Also, bank regulators have the authority to prohibit our subsidiaries from paying dividends if the bank regulators determine the payment would be an unsafe and unsound banking practice.

*Our ability to pay dividends on our common stock is limited.* We cannot assure you that we will continue to pay dividends at our current annual dividend rate or at all. In particular, the ability to pay dividends in the future will depend upon, among other things, our future earnings and cash requirements.

*Our FDIC Insurance Assessment could significantly increase.* On February 27, 2009, the FDIC approved an interim rule to institute a one-time special emergency assessment of 20 cents per \$100 in domestic deposits on June 30, 2009, to be collected by September 30, 2009, to restore the Deposit Insurance Fund ("DIF") reserves depleted by recent bank failures. The interim rule also permits the FDIC to impose an additional special emergency assessment after June 30, 2009 of up-to-10 basis points, if necessary. The FDIC also adopted amendments to its restoration plan for the DIF. The amendments changes to the risk-based assessment system and set assessment rates to require most banks to initial base rates ranging from 12 cents per \$100 to 16 cents per \$100 on an annual basis, beginning on April 1, 2009. The amendments also change the assessment system include higher rates for institutions that rely significantly on secured liabilities, which may increase the FDIC's loss in the event of failure without providing additional assessment revenue. Assessments will also be higher for institutions that rely significantly on brokered deposits but, for well-managed and well-capitalized institutions, only when accompanied by rapid asset growth. Based on our budgeted deposit levels, the final approval of this interim rule and the increase of the quarterly assessments would impact the Company by increasing FDIC Insurance Assessment expense by approximately \$2.0 million. Our projection will vary to the extent actual deposit levels fluctuate compared to budget. There has been continued debate about the amount of the assessment subsequent to its announcement with the possibility existing that the assessment may be lowered. Should the assessment be lowered, our estimate of the increase in FDIC assessment expense for 2009 will be lowered as well.

*Other-than-temporary impairment.* Our investment portfolio has approximately \$3.0 million of unrealized losses as of December 31, 2008. While we have evaluated each security with an unrealized loss for other-than-temporary impairment under the applicable accounting guidance and concluded that an impairment loss should not be recorded, we cannot assure you that we will not need to record an impairment loss in the future. Should there be deterioration in the credit quality and/or the severity and length of the underlying unrealized losses in our portfolio in the future, we may be required to record an impairment charge that could significantly impact our earnings and capital ratios.



[Index](#)

*Goodwill impairment.* We currently have \$15.3 million of goodwill reported as an asset on our balance sheet associated with our acquisition of SCSB for which we are required to at least annually to evaluate for impairment. We have determined that our goodwill is not impaired and have not recorded a charge through earnings. We cannot assure you that we will not need to record a goodwill impairment charge in the future if market conditions do not improve and our stock price does not increase. Also, if the Company's profitability does not improve, our stock price may decline further which may lead to an increase in the possibility of a goodwill impairment charge. Should we have to record a goodwill impairment charge in the future, our earnings could possibly be significantly impacted.

**Item 1B. Unresolved Staff Comments**

This item of Form 10-K is inapplicable to the Company inasmuch as it is not an accelerated filer or large accelerated filer, nor is it a well-known seasoned issuer. Moreover, the Company has received no written communication from the staff of the SEC regarding its periodic or current reporting under the Exchange Act.

**Item 2. Properties**

The Company conducts its business through its corporate headquarters located in New Albany, Indiana. YCB operates a main office and eleven branch offices in Clark and Floyd Counties, Indiana, and six branch offices in Jefferson and Nelson Counties, Kentucky. SCSB operates a main office and three branch offices in Scott County, Indiana. The following table sets forth certain information concerning the main offices and each branch office at December 31, 2008. The Company's aggregate net book value of premises and equipment was \$15.1 million at December 31, 2008.

<u>Location</u>	<u>Year Opened</u>	<u>Owned or Leased</u>
<b>Your Community Bank:</b>		
101 West Spring Street - Main Office New Albany, IN 47150	1937	Owned
401 East Spring Street - Drive Thru for Main Office New Albany, IN 47150	2001	Owned
2626 Charlestown Road New Albany, IN 47150	1995	Owned
4328 Charlestown Road New Albany, IN 47150	2004	Leased
480 New Albany Plaza New Albany, IN 47130	1974	Leased
901 East Highway 131 Clarksville, IN 47130	1981	Owned
701 Highlander Point Drive Floyds Knobs, IN 47119	1990	Owned
102 Heritage Square Sellersburg, IN 47172	1992	Owned
201 W. Court Avenue Jeffersonville, IN 4710	1996	Owned
5112 Highway 62 Jeffersonville, IN 47130	1997	Owned
2917 E. 10 <sup>th</sup> Street Jeffersonville, IN 47130	2007	Leased
2910 Grantline Road New Albany, IN 47150	2002	Leased
400 Blankenbaker Parkway, Suite 100 Louisville, KY 40243	2002	Leased
106A West John Rowan Boulevard. - Main Office Bardstown, KY 40004	1997	Leased
119 East Stephen Foster Avenue Bardstown, KY 40004	1972	Owned
7101 Cedar Springs Louisville, KY 40291	2002	Leased
4510 Shelbyville Road Louisville, KY 40207	2003	Leased
13205 Magisterial Drive Louisville, KY 40223	2006	Leased
471 West Main Street Louisville, KY 40202	2008	Leased
<b>The Scott County State Bank:</b>		
136 West McClain Avenue - Main Office Scottsburg, IN 47170	1890	Owned
125 West Wardell - Drive Thru Scottsburg, IN 47170	1981	Owned
1050 North Gardner Scottsburg, IN 47170	1974	Owned
57 North Michael Drive Scottsburg, IN 47170	1998	Owned

**Item 3. Legal Proceedings**

There are various claims and law suits in which the Company or its subsidiaries are periodically involved, such as claims to enforce liens, foreclosure or condemnation proceedings on properties in which the Banks hold mortgages or security interests, claims involving the making and servicing of real property loans and other issues incident to the Banks' business. In the opinion of management, no material loss is expected from any of such pending claims or lawsuits with the possible exception of the following matter.

YCB made loans to borrower MW Development Services, LLC ("Borrower") beginning in September, 2004, guaranteed by the borrower's two principals. The loans were to enable the borrower to purchase real estate and develop it for sale as residential subdivision lots. The loans are secured by first and second mortgage liens in favor of YCB on the real property. The borrower defaulted on the loans and in July 2005 D.F. Crane Construction Corp. ("Crane") filed a foreclosure action on its mechanic's lien in the Jefferson Circuit Court (Commonwealth of Kentucky) naming the borrower and YCB defendants, among others. YCB, borrower and guarantors asserted claims against each other, which were settled by agreement in 2006. Crane subsequently sought to subordinate YCB's mortgages to its lien claim but during 2008 YCB and Crane settled Crane's claims and those of the contractors claiming through it.

The Court entered a judgment and an order of sale in favor of YCB, which was the successful bidder at the September 23, 2008 foreclosure sale, purchasing the real property with a credit bid of \$1,500,000. YCB has moved the Court to confirm the Master Commissioner's September 26, 2008 Report of Sale and to direct the Master Commissioner to deliver a deed conveying title to it. The Court has referred this motion to the Master Commissioner's Office and YCB and the Master Commissioner are in the process finalizing the deed conveying the real property to YCB.

**Item 4. Submission Of Matters To A Vote Of Security Holders**

No matter was submitted to a vote of security holders, through the solicitation of proxies or otherwise, during the quarter ended December 31, 2008.

## Part II

### Item 5. Market For Registrant's Common Equity, Related Stockholder Matters And Issuer Purchases of Equity Securities

#### Market Information

The Company's common stock is traded on the Nasdaq National Market under the symbol "CBIN". The quarterly range of low and high trade prices per share of the Company's common stock for the periods indicated as reported on the Nasdaq National Market, as well as the per share dividend paid in each such quarter by the Company on its common stock is shown below.

2008				2007			
QUARTER ENDED	HIGH	LOW	DIVIDEND	QUARTER ENDED	HIGH	LOW	DIVIDEND
March 31	\$ 20.50	\$ 17.75	\$ 0.175	March 31	\$ 22.99	\$ 21.44	\$ 0.160
June 30	20.00	15.16	0.175	June 30	21.85	19.74	0.175
September 30	17.06	11.05	0.175	September 30	21.45	19.25	0.175
December 31	15.50	10.37	0.175	December 31	21.35	17.30	0.175

#### Holders

As of March 19, 2009 there were 870 holders of the Company's common stock.

#### Dividends

The Company intends to continue its historical practice of paying quarterly cash dividends although there is no assurance that such dividends will continue to be paid in the future. The payment of dividends in the future is dependent on future income, financial position, capital requirements, the discretion and judgment of the Board of Directors, and other considerations. In addition, the payment of dividends is subject to the regulatory restrictions described in Note 14 to the Company's consolidated financial statements.

#### Securities Authorized for Issuance under Equity Compensation Plans

The following table sets forth certain information regarding Company compensation plans under which equity securities of the Company are authorized for issuance.

	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	Weighted-Average Exercise Price Of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance under equity compensation plans (excluding securities reflected in column 1)
Equity compensation plans approved by security holders	277,595(1)	\$ 20.56	450,450(2)
Equity compensation plans not approved by security holders	-	-	-
Total	277,595(1)	\$ 20.56	450,450(2)

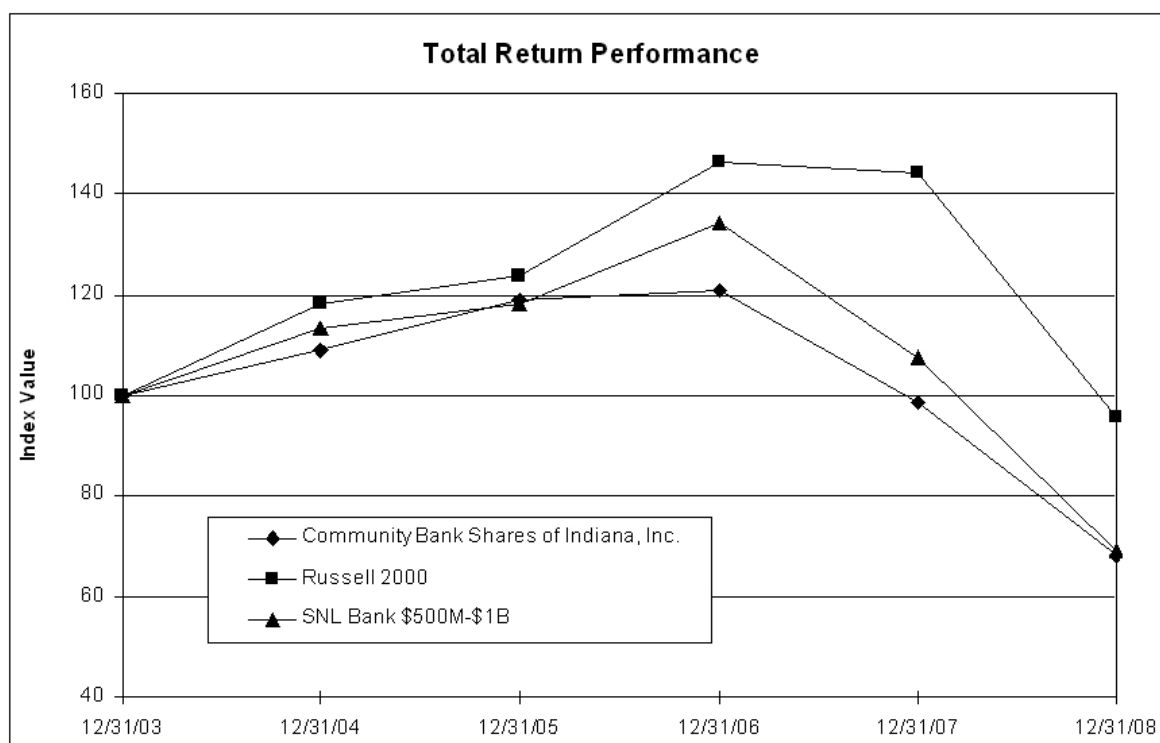
(1) Of the shares reflected, 262,970 shares have been granted under the Company's Stock Award Plan and 22,500 performance units have been granted under the Company's Performance Units Plan of which 14,625, or 65%, will be paid in shares (see Note 11 of the Company's consolidated financial statements for further information on the Company's Performance Units Plan). The awards under the Company's Performance Units Plan have been excluded from the weighted-average exercise price column.

(2) Of the shares reflected, 197,550 shares are available to be awarded under the Company's Stock Award Plan and 252,900 shares are available to be awarded under the Company's Performance Units Plan.

# Performance Graph

The following performance graph and included data shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934 or otherwise subject to the liabilities of that section, nor shall it be deemed soliciting material or subject to Regulation 14A of the Exchange Act or incorporated by reference in any filing under the Exchange Act or the Securities Act of 1933, except as shall be expressly set forth by specific reference in such filing.

The graph compares the performance of Community Bank Shares of Indiana, Inc. common stock to the Russell 2000 index and the SNL Bank \$500 MM - \$1 B Bank index for the Company's last five fiscal years. The graph assumes the value of the investment in Company common stock and in each index was \$100 at December 31, 2003 and that all dividends were reinvested.



Index	12/31/03	Period Ending				
		12/31/04	12/31/05	12/31/06	12/31/07	12/31/08
Community Bank Shares of Indiana, Inc.	100.00	108.82	118.94	120.77	98.63	68.08
Russell 2000	100.00	118.33	123.72	146.44	144.15	95.44
SNL Bank \$500M-\$1B Index	100.00	113.32	118.18	134.41	107.71	69.02

**Item 6. Selected Financial Data**

The following table sets forth the Company's selected historical consolidated financial information from 2004 through 2008. This information should be read in conjunction with the Consolidated Financial Statements and the related Notes. Factors affecting the comparability of certain indicated periods are discussed in "Management's Discussion And Analysis Of Financial Condition And Results Of Operations." For analytical purposes, net interest margin is adjusted to a taxable equivalent adjustment basis to recognize the income tax savings on tax-exempt assets, such as state and municipal securities. A tax rate of 34% was used in adjusting interest on tax-exempt assets to a fully taxable equivalent ("FTE") basis.

	Years Ended December 31,				
(Dollars in thousands, except per share data)	2008	2007	2006	2005	2004
<b>Income Statement Data:</b>					
Interest income	\$ 44,907	\$ 51,776	\$ 47,094	\$ 35,220	\$ 27,009
Interest expense	21,453	28,395	25,995	17,344	12,796
Net interest income	23,454	23,381	21,099	17,876	14,213
Provision for loan losses	6,857	1,296	262	1,750	1,105
Non-interest income	6,087	4,127	3,733	4,703	4,048
Non-interest expense	22,554	21,804	19,116	16,155	13,903
Income before taxes	130	4,408	5,454	4,674	3,253
Net income	821	3,503	4,111	3,749	2,588
<b>Balance Sheet Data:</b>					
Total assets	\$ 877,363	\$ 823,568	\$ 816,633	\$ 665,008	\$ 590,066
Total securities	121,659	99,465	121,311	98,835	90,152
Total loans, net	623,103	629,732	607,932	512,448	450,676
Allowance for loan losses	9,478	6,316	5,654	5,920	4,523
Total deposits	603,185	573,346	549,918	464,836	411,306
Other borrowings	78,983	72,796	84,335	47,735	43,629
FHLB advances	111,943	91,376	92,756	98,000	82,000
Subordinated debenture	17,000	17,000	17,000	7,000	7,000
Total shareholders' equity	62,599	64,465	65,541	42,775	42,781
<b>Per Share Data:</b>					
Basic earnings per share	\$ 0.25	\$ 1.05	\$ 1.36	\$ 1.43	\$ 0.98
Diluted earnings per share	0.25	1.04	1.35	1.41	0.97
Book value	19.31	19.77	19.06	16.42	16.27
Cash dividends per share	0.700	0.685	0.640	0.580	0.540
<b>Performance Ratios:</b>					
Return on average assets	0.10%	0.43%	0.55%	0.59%	0.47%
Return on average equity	1.29	5.39	7.73	8.68	6.10
Net interest margin	3.09	3.16	3.04	3.00	2.74
Efficiency ratio	76.35	79.26	76.98	71.55	76.13
<b>Asset Quality Ratios:</b>					
Non-performing assets to total loans	3.45%	1.88%	0.98%	1.08%	0.37%
Net loan charge-offs to average loans	0.58	0.10	0.22	0.07	0.15
Allowance for loan losses to total loans	1.50	0.99	0.92	1.14	0.99
Allowance for loan losses to non-performing loans	46	56	102	108	285
<b>Capital Ratios:</b>					
Leverage ratio	7.6%	8.0%	8.1%	8.0%	8.7%
Average stockholders' equity to average total assets	7.6	8.0	7.1	6.8	7.7
Tier 1 risk-based capital ratio	9.5	9.9	10.5	9.5	10.4
Total risk-based capital ratio	10.7	10.9	11.4	10.5	11.3
Dividend payout ratio	277.2	65.6	46.7	40.5	54.8
<b>Other Key Data:</b>					
End-of-period full-time equivalent employees	238	232	224	182	169
Number of bank offices	23	22	21	16	16

## **Item 7. Management's Discussion And Analysis Of Financial Condition And Results of Operations**

### **Overview**

This section presents an analysis of the consolidated financial condition of the Company and its wholly-owned subsidiaries, the Banks, at December 31, 2008 and 2007, and the consolidated results of operations for each of the years in the three year period ended December 31, 2008. The information contained in this section should be read in conjunction with the consolidated financial statements, notes to consolidated financial statements and other financial data presented elsewhere in this annual report on Form 10-K.

The Company conducts its primary business through the Banks, which are community-oriented financial institutions offering a variety of financial services to its local communities. The Banks are engaged primarily in the business of attracting deposits from the general public and using such funds for the origination of: 1) commercial business and real estate loans and 2) secured consumer loans such as home equity lines of credit, automobile loans, and recreational vehicle loans. Additionally, YCB originates and sells into the secondary market mortgage loans for the purchase of single-family homes in Floyd and Clark counties, Indiana, and Jefferson and Nelson counties, Kentucky, including surrounding communities. The Banks invest excess liquidity balances in mortgage-backed, U.S. agency, state and municipal and corporate securities.

The operating results of the Company depend primarily upon the Banks' net interest income, which is the difference between interest earned on interest-earning assets and interest incurred on interest-bearing liabilities. Interest-earning assets principally consist of loans, taxable and tax-exempt securities, and FHLB stock. Interest-bearing liabilities principally include deposits, retail repurchase agreements, federal funds purchased, and advances from the FHLB Indianapolis and Cincinnati. The net income of the Banks is also affected by 1) provision for loan losses, 2) non-interest income (including mortgage banking income, net gains on sales of securities, deposit account service charges and commission-based income on non-deposit investment products), 3) non-interest expenses (including compensation and benefits, occupancy, equipment, data processing expenses, marketing and advertising, and other expenses, such as audit, postage, printing, and telephone expenses), and 4) income tax expense.

### **Forward Looking Information**

Statements contained within this report that are not statements of historical fact constitute forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934. When used in this discussion the words "anticipate," "project," "expect," "believe," and similar expressions are intended to identify forward-looking statements. The Company cautions that these forward-looking statements are subject to numerous assumptions, risks and uncertainties, all of which may change over time. Actual results could differ materially from forward-looking statements.

In addition to factors disclosed by the Company elsewhere in this annual report on Form 10-K, the following factors, among others, could cause actual results to differ materially from such forward-looking statements: 1) adverse changes in economic conditions affecting the banking industry in general and, more specifically, the market areas in which the Company and its subsidiary Banks operate, 2) adverse changes in the legislative and regulatory environment affecting the Company and its subsidiary Banks, 3) increased competition from other financial and non-financial institutions, 4) the impact of technological advances on the banking industry, and 5) other risks detailed at times in the Company's filings with the Securities and Exchange Commission. The Company does not assume an obligation to update or revise any forward-looking statements subsequent to the date on which they are made.

## **Application of Critical Accounting Policies**

The Company's consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles and follow general practices within the financial services industry. The most significant accounting policies followed by the Company are presented in Note 1 to the Consolidated Financial Statements. These policies, along with the disclosures presented in the other financial statement notes and in this financial review, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has identified the determination of the allowance for loan losses, valuation of goodwill and other intangible assets, fair value of investment securities and deferred tax assets to be the accounting areas that require the most subjective or complex judgments, and as such could be most subject to revision as new information becomes available.

### **Allowance for Loan Losses**

The allowance for loan losses represents management's estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated fair value of collateral securing the loans, estimated losses on loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on the consolidated balance sheet. Note 1 to the Consolidated Financial Statements describes the methodology used to determine the allowance for loan losses, and a discussion of the factors driving changes in the amount of the allowance for loan losses is included under "Asset Quality" below.

Loans that exhibit probable or observed credit weaknesses are subject to individual review. Where appropriate, amounts of allowances are allocated to individual loans based on management's estimate of the borrower's ability to repay the loan given the availability of collateral, other sources of cash flow and legal options available to the Company. Included in the review of individual loans are those that are impaired as provided in SFAS No. 114, "Accounting by Creditors for Impairment of a Loan." The Company evaluates the collectability of both principal and interest when assessing the need for a loss accrual. Historical loss rates are applied to other loans not subject to allowance allocations. These historical loss rates may be adjusted for significant factors that, in management's judgment, reflect the impact of any current conditions on loss recognition. Factors which management considers in the analysis include the effects of the national and local economies, trends in the nature and volume of loans (delinquencies, charge-offs and nonaccrual loans), changes in mix, asset quality trends, risk management and loan administration, changes in internal lending policies and credit standards, and examination results from bank regulatory agencies and the Company's internal credit examiners.

The Company has not substantively changed any aspect to its overall approach in the determination of the allowance for loan losses. There have been no material changes in assumptions or estimation techniques as compared to prior periods that impacted the determination of the current period allowance.

Based on the procedures discussed above, management is of the opinion that the allowance of \$9.5 million was adequate to address probable incurred credit losses associated with the loan portfolio at December 31, 2008.



### **Goodwill and Other Intangible Assets**

The Company has a recorded balance of \$15.3 million of goodwill and \$2.5 million of other intangible assets at December 31, 2008 in association with its acquisition of SCSB in 2006. The Company is required to perform an assessment of goodwill and other intangible assets to determine potential impairment at least annually. Also, management, on an on-going basis, informally reviews and analyzes certain transactions or events that may indicate potential impairment of goodwill and other intangible assets throughout the year. The analysis and determination of potential impairment and the identification of relevant factors and events indicating potential impairment require a high degree of judgment from management. The Company performed a formal assessment of goodwill and other intangible assets in the 4<sup>th</sup> quarter of the 2008 utilizing the Company's results of operations through September 30, 2008 which indicated that goodwill and intangible assets were not impaired. Due to the continued decline in the Company's stock price during the 4<sup>th</sup> quarter of 2008 and the 1<sup>st</sup> quarter of 2009 and the results of operations for the 4<sup>th</sup> quarter of 2008 the Company performed another formal impairment assessment in the 1<sup>st</sup> quarter of 2009. The second assessment utilized the Company's results of operations through December 31, 2008. For purposes of assessing impairment, the Company contracted a third party consulting firm to assess the fair value of the Company, as the market capitalization of the Company was below the book value of equity for most of 2008. The impairment analyses utilized several different approaches and significant assumptions to establish the fair value of the Company including: the long and short term earnings potential of the Company, recent mergers and acquisitions in the Company's geographical region, asset valuations, and potential overhead reduction available to an acquirer. In evaluating these factors, the third party consultants relied on management's representations in providing relevant estimates and the budgeted 2009 earnings. The consultants also considered the thinly traded volume of the Company's stock in determining the fair value. Based on the result of the assessment, the Company determined that goodwill was not impaired as of December 31, 2008. No other events were identified in 2008 which caused us to believe that goodwill or intangible assets were impaired.

### **Fair Value of Investment Securities**

The Company had six trust preferred securities in its investment portfolio as of December 31, 2008 with a combined book value of \$5.7 million and a fair value of \$3.3 million as of the same date. During 2008, the market for these types of securities effectively froze as market participants were unwilling to conduct transactions unless forced to do so. As a result, the fair value of these securities deteriorated significantly during 2008. Given the market conditions, management changed the valuation source for these types of securities which are provided by a third party to the Company. The fair value of these securities is an estimate which is more difficult to determine due to the current market volatility and illiquidity. The new valuation utilizes discounted cash flow models to value the securities utilizing significant unobservable inputs as defined by FSP SFAS 157-3. In management's estimate, the new valuation method provided a more relevant and accurate representation of the fair value of these securities as of December 31, 2008. Management evaluated the trust preferred securities for other-than-temporary impairment under FSP EITF 99-20-1 and determined that unrealized losses on these securities should not be recorded in 2008 earnings.

### **Deferred Tax Assets**

The Company has a net deferred tax asset of approximately \$1.5 million. The Company evaluates this asset on a quarterly basis. To the extent the Company believes it is more likely than not that it will not be utilized, the Company will establish a valuation allowance to reduce its carrying amount to the amount it expects to be realized. At December 31, 2008, a valuation allowance of \$806,000 has been established against the outstanding deferred tax asset. Note 12 to the Consolidated Financial Statements describes the net deferred tax asset. The deferred tax asset will be utilized as the Company is profitable or as the Company carries back tax losses to periods in which it paid income taxes. The estimate of the realizable amount of this asset is a critical accounting policy.

## Highlights

The Company's net income decreased to \$821,000 for the year ended December 31, 2008 from \$3.5 million for 2007, or 76.6%. The decrease in net income was due to a significant increase in the Company's provision for loan losses of \$5.6 million to \$6.9 million for 2008 compared to \$1.3 million in 2007 as the Company's loan portfolio experienced a significant increase in past due loans, further weakening of collateral securing certain commercial credits, and continued weakness in the Company's local market for commercial construction and development loans. Net income for 2008 was also negatively impacted by an increase in non-interest expense of \$750,000, or 3.4%. The increases in provision for loan losses and non-interest expense were partially offset by an increase in non-interest income from 2007 of \$2.0 million and a decrease in provision for income taxes of \$1.6 million. The Company's book value per share decreased to \$19.31 per share at December 31, 2008 from \$19.77 at December 31, 2007.

The following table summarizes selected financial information regarding the Company's financial performance:

**Table 1 – Summary**

	For the Year Ended December 31,		
<i>(Dollars in thousands, except per share amounts)</i>	2008	2007	2006
Net income	\$ 821	\$ 3,503	\$ 4,111
Basic earnings per share	0.25	1.05	1.36
Diluted earnings per share	0.25	1.04	1.35
Return on average assets	0.10%	0.43%	0.55%
Return on average equity	1.29	5.39	7.73

The Company's total assets increased to \$877.4 million at December 31, 2008 from \$823.6 million at December 31, 2007 primarily due to an increase in interest-bearing deposits in other financial institutions of \$31.8 million, an increase in securities available for sale of \$22.2 million, and an increase in cash and due from financial institutions of \$5.2 million, offset by a decrease in net loans of \$6.6 million. Total deposits increased by \$29.8 million to \$603.2 million at December 31, 2008 with \$12.6 million of the increase attributable to non-interest bearing deposits. Other borrowings and FHLB advances increased by \$6.2 million and \$20.6 million, respectively, to \$79.0 million and \$111.9 million as of December 31, 2008. Total shareholders' equity decreased by \$1.9 million to \$62.6 million at December 31, 2008 as the Company declared and paid dividends that were in excess of net income by \$1.5 million in 2008.

## Results of Operations

### Net Interest Income

The Company's principal revenue source is net interest income. Net interest income is the difference between interest income on interest-earning assets, such as loans and securities, and the interest expense on the liabilities used to fund those assets, such as interest-bearing deposits and borrowings. Net interest income is impacted by both changes in the amount and composition of interest-earning assets and interest-bearing liabilities as well as changes in market interest rates.

In 2008, net interest income increased by \$73,000 to \$23.5 million for the year ended December 31, 2008 from \$23.4 million for the equivalent period in 2007 while the net interest margin on a taxable equivalent basis decreased to 3.09% for 2008 compared to 3.16% for 2007. The decrease in net interest margin was the result of the Federal Open Market Committee's dramatic reduction in the federal funds rate throughout 2008. As a result, the Company's yield on interest bearing assets decreased by 109 basis points to 5.87% for 2008 compared to 6.96% in 2007, with most of the decrease attributable to a decrease in the yield on the Company's loan portfolio. The cost on interest bearing liabilities also decreased in 2008 from 4.29% for the year ended December 31, 2007 to 3.15% for the same period in 2008. Most of the decrease in the cost of interest-bearing deposits was due to decreases in the cost of savings and other deposit accounts of 130 basis points, other borrowings of 245 basis points, and subordinated debentures of 223 basis points.

Average interest earning assets increased to \$770.6 million for the year ended December 31, 2008 from \$748.1 million for the equivalent period in 2007 as most of the increase was attributable to increases in interest-bearing deposits in other financial institutions and loans. The effect of the increase in interest-bearing deposits in other financial institutions was to decrease the yield on average interest earning assets as those deposits primarily consisted of federal funds sold and other short-term deposits that had an average yield of 1.99% in 2008. The yield on the Company's loan portfolio decreased to 6.07% in 2008 from 7.35% in 2007, or 128 basis points. A large portion of the Company's loan portfolio is variable and tied to the prime rate which decreased throughout 2008 in conjunction with the decrease in the federal funds rate to a historically low level. Offsetting the decrease in loan and interest-bearing deposits in other financial institutions yields, was an increase in the yield on taxable securities to 5.07% in 2008 from 4.79% in 2007. Management attributes the increase in yield to maturities of lower yielding U.S. Government securities that were replaced with higher yielding mortgage backed securities.

Average interest bearing liabilities increased to \$680.0 million for 2008 from \$662.4 million for 2007 due to increases in the average balances of other borrowings and FHLB advances. The reduction in the cost of interest bearing liabilities was affected by the aforementioned decrease in the federal funds rate as management aggressively lowered rates on the Company's deposit offerings throughout 2008 in an effort to substantially match the decrease. As a result, the cost of savings and other was reduced to 1.30% in 2008 from 2.60% in 2007 and time deposits decreased to 3.94% in 2008 from 4.83% in 2007. As time deposits mature, management plans to price them accordingly and anticipates a further reduction in the cost over 2009. The cost of other borrowings decreased to 1.98% for 2008 from 4.43% in 2007, or 245 basis points due primarily to a reduction in rates of the Company's repurchase agreements which had carried a weighted average interest rate of 3.36% at December 31, 2007 compared to a weighted average rate of 0.42% at December 31, 2008.

Net interest income increased by \$2.3 million, or 10.8%, to \$23.4 million for the twelve months ended December 31, 2007 from \$21.1 million for the same period in 2006 due primarily to the acquisition of SCSB on July 1, 2006. Net interest margin on a taxable equivalent basis increased by 12 bps to 3.16% for the year ended 2007 as compared to 3.04% for the same period in 2006. The increase in net interest margin was driven primarily by an increase in the yield on interest earning assets, which increased by 22 bps to 6.96% on a fully taxable equivalent basis for the year ended December 31, 2007 from 6.74% for the year ended December 31, 2006. Most of the increase in yield on interest earning assets was due to the increase in yield on the Company's loan portfolio. The cost on interest bearing liabilities increased by 17 bps to 4.29% for the twelve months ended 2007 from 4.12% for the same period in 2006 due to an increase in the average rate on time deposits.

Average interest earning assets increased by 6.5% from \$702.2 million for 2006 to \$748.1 million for 2007. The increase in interest earning assets was primarily due to an increase in average loans of \$50.9 million as a result of the acquisition of SCSB on July 1, 2006 and an increase in the Company's loan portfolio during 2007 of \$22.5 million. The yield on the Company's loan portfolio increased to 7.35% for the twelve months ended 2007 from 7.19% for the same period in 2006. Management attributes the increase in loan yield to a continued focus on enhancing the net interest margin through profitable growth in the Company's loan portfolio and an emphasis on increasing current and existing customer profitability through evaluation of the entire relationship, including deposits. The yield on average earning assets was also impacted by an increase in the yield on taxable securities of 29 bps from 4.50% for the year ended 2006 to 4.79% in 2007. The increase in the yield on taxable securities was due to maturities and sales of lower yielding U.S Government and federal agency securities during the year. Offsetting the increase in yield on interest earning assets was a decrease in the fully taxable equivalent yield of tax-exempt securities to 6.69% for the year ended December 31, 2007 from 7.51% for the year ended December 31, 2006. Management attributes the decrease to maturities of higher yielding tax-exempt securities replaced with lower yielding tax-exempt securities.

In 2007, average interest bearing liabilities increased by 5.0% to \$662.4 million from \$630.7 million in 2006. The increase in average interest bearing liabilities was primarily due to an increase in time deposits which increased to \$273.1 million for the year ended December 31, 2007 from \$249.0 million for the year ended December 31, 2006 with the average rate increasing to 4.83% from 4.36% over the same period. The increase in the average rate of time deposits was the result of management's efforts to maintain and increase the Company's deposit base in a competitive local market. The Company was able to decrease its cost on other borrowings to 4.43% for the twelve months ended in 2007 from 4.76% for the same period in 2006 by obtaining a \$9.8 million structured repurchase agreement entered into in the fourth quarter of 2007 that had a yield of 2.79% at December 31, 2007. Also contributing to the reduction in the average rate of other borrowings was a decrease in the average rate paid on the Company's repurchase agreements from 4.84% for 2006 to 3.36% for 2007 and a decrease in the federal funds rate of 100 bps during 2007. The increase in the net interest margin on a fully taxable equivalent basis in 2007 was further enhanced by an increase in average non-interest bearing deposits of \$18.7 million, or 30.1%, to \$80.8 million for 2007 from \$62.1 million for 2006 due to the acquisition of SCSB on July 1, 2006 and a focused effort to increase non-interest bearing deposits through employee incentives, increased deposit product offerings including remote deposit capture and lockbox, and cross-selling of current and prospective loan customers.

Table 2 provides detailed information as to average balances, interest income/expense, and rates by major balance sheet category for 2006 through 2008.

**Table 2 - Average Balance Sheets and Rates for Years Ended 2008, 2007 and 2006**

For analytical purposes, net interest margin and net interest spread are adjusted to a taxable equivalent adjustment basis to recognize the income tax savings on tax-exempt assets, such as state and municipal securities. A tax rate of 34% was used in adjusting interest on tax-exempt assets to a fully taxable equivalent ("FTE") basis.

(Dollars in thousands)	2008			2007			2006		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
<b>ASSETS</b>									
Earning assets:									
Interest-bearing deposits in other financial institutions	\$ 12,122	\$ 241	1.99%	\$ 4,279	\$ 144	3.37%	\$ 4,365	\$ 132	3.02%
Taxable securities	94,667	4,798	5.07	98,342	4,711	4.79	105,287	4,738	4.50
Tax-exempt securities	16,350	1,056	6.46	11,546	773	6.69	9,419	708	7.51
Total loans and fees (1)(2)	639,275	38,833	6.07	625,972	46,030	7.35	575,100	41,360	7.19
FHLB and Federal Reserve stock	8,141	338	4.15	7,928	381	4.81	8,028	397	4.95
Total earning assets	770,555	45,266	5.87	748,067	52,039	6.96	702,199	47,335	6.74
Non-interest earning assets:									
Less: Allowance for loan losses	(6,763)			(5,684)			(5,823)		
Non-earning assets:									
Cash and due from banks	24,924			17,047			15,759		
Bank premises and equipment, net	15,160			15,320			13,827		
Other assets	40,266			40,440			22,505		
Total assets	<u>\$ 844,142</u>			<u>\$ 815,190</u>			<u>\$ 748,467</u>		
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>									
Interest bearing liabilities:									
Savings and other	\$ 212,475	\$ 2,771	1.30%	\$ 214,683	\$ 5,582	2.60%	\$ 218,981	\$ 6,071	2.77%
Time deposits	272,847	10,758	3.94	273,078	13,201	4.83	249,036	10,862	4.36
Other borrowings	70,691	1,403	1.98	63,713	2,824	4.43	64,153	3,054	4.76
FHLB advances	106,969	5,605	5.24	93,889	5,492	5.85	86,024	5,066	5.89
Subordinated debenture	17,000	916	5.39	17,000	1,296	7.62	12,479	942	7.55
Total interest bearing liabilities	679,982	21,453	3.15	662,363	28,395	4.29	630,673	25,995	4.12
Non-interest bearing liabilities:									
Non-interest bearing deposits	97,726			80,782			62,079		
Other liabilities	2,633			7,048			2,507		
Shareholders' equity	63,801			64,997			53,208		
Total liabilities and shareholders' equity	<u>\$ 844,142</u>			<u>\$ 815,190</u>			<u>\$ 748,467</u>		
Net interest income (taxable equivalent basis)									
		23,813			23,644			21,340	
Less: taxable equivalent adjustment		(359)			(263)			(241)	
Net interest income		<u>23,454</u>			<u>23,381</u>			<u>21,099</u>	
Net interest spread			2.72%			2.67%			2.62%
Net interest margin			3.09%			3.16%			3.04%

(1) The amount of direct loan origination cost included in interest on loans was \$412 for the year ended December 31, 2008. The amount of fee income included in interest on loans was \$566 and \$697 for the years ended December 31, 2007 and 2006, respectively.

(2) Includes loans held for sale and non-accruing loans in the average loan amounts outstanding.

Table 3 illustrates the extent to which changes in interest rates and changes in the volume of interest-earning assets and interest-bearing liabilities affected the Company's interest income and interest expense during the periods indicated. Information is provided in each category with respect to (i) changes attributable to changes in volume (changes in volume multiplied by prior rate), (ii) changes attributable to changes in rate (changes in rate multiplied by prior volume), and (iii) the net change. The changes attributable to the combined impact of volume and rate have been allocated proportionately to the changes due to volume and the changes due to rate.

**Table 3 - Volume/Rate Variance Analysis**

	Year Ended December 31, 2008 compared to Year Ended December 31, 2007			Year Ended December 31, 2007 compared to Year Ended December 31, 2006		
	INCREASE/(DECREASE) Due to			INCREASE/(DECREASE) Due to		
	Total Net Change	Volume	Rate	Total Net Change	Volume	Rate
Interest income:						
Interest-bearing deposits with banks	\$ 97	176	(79)	\$ 12	(3)	15
Taxable securities	87	(180)	267	(27)	(323)	296
Tax-exempt securities	187	205	(18)	43	98	(55)
Total loans and fees	(7,197)	960	(8,157)	4,670	3,724	946
FHLB and Federal Reserve stock	(43)	10	(53)	(16)	(5)	(11)
Total increase (decrease) in interest income	(6,869)	1,171	(8,040)	4,682	3,491	1,191
Interest expense:						
Savings and other	(2,811)	(57)	(2,754)	(489)	(117)	(372)
Time deposits	(2,443)	(11)	(2,432)	2,339	1,102	1,237
Other borrowings	(1,421)	281	(1,702)	(230)	(21)	(209)
FHLB advances	113	719	(606)	426	460	(34)
Subordinated debenture	(380)	-	(380)	354	345	9
Total increase (decrease) in interest expense	(6,942)	932	(7,874)	2,400	1,769	631
Increase (decrease) in net interest income	\$ 73	\$ 239	\$ (166)	\$ 2,282	\$ 1,722	\$ 560

#### Non-interest Income

Non-interest income was \$6.1 million for 2008, \$4.1 million for 2007, and \$3.7 million for 2006. For the year ended December 31, 2008, non-interest income increased 47.5% as compared to 2007 due to an increase in service charges on deposit accounts of \$169,000, a net gain on sales of available for sale securities of \$405,000, and a change in the fair value and cash settlement of interest rate swaps that had a positive impact of \$1.4 million, offset by decreases in mortgage banking income of \$69,000 and other income of \$158,000. In 2007, non-interest income increased 10.6% compared to 2006 primarily due to the acquisition of SCSB which provided twelve months of non-interest income in 2007 as compared to six months in 2006. Also factoring into the increase in non-interest income were increases in service charges on deposit accounts of \$233,000, commission income of \$65,000, interchange income of \$171,000, other income of \$152,000, and earnings on company owned life insurance of \$105,000, offset by an increase in the change in fair value and cash settlement of interest rate swaps of \$187,000 and a decrease in mortgage banking income of \$86,000.

Table 4 provides a breakdown of the Company's non-interest income during the past three years.

**Table 4 - Analysis of Non-interest Income**

(Dollars in thousands)	Year Ended December 31,			Percent Increase/(Decrease)	
	2008	2007	2006	2008/2007	2007/2006
Service charges on deposit accounts	\$ 3,356	\$ 3,187	\$ 2,954	5.3%	7.9%
Commission income	194	172	107	12.8	60.7
Mortgage banking income	167	236	322	(29.2)	(26.7)
Earnings on company owned life insurance	734	678	573	8.3	18.3
Change in fair value and cash settlement of interest rate swaps	180	(1,248)	(1,061)	NM	17.6
Interchange income	811	704	533	15.2	32.1
Other	281	439	287	(36.0)	53.0
Subtotal	5,723	4,168	3,715	37.3	12.2
Gain on disposition of equity stock	-	-	18	-	(100.0)
Gain (loss) on sale of available for sale securities	364	(41)	-	NM	NM
Total	\$ 6,087	\$ 4,127	\$ 3,733	47.5%	10.6%

Service charges on deposit accounts increased by \$169,000, or 5.3%, to \$3.4 million for the year ended December 31, 2008 primarily due to fee income related to a new retail deposit product implemented during 2007 and secondarily to an increase in non-sufficient funds fees. In 2007, service charges on deposit accounts increased by 7.9% from 2006 to \$3.2 million due primarily to acquisition of SCSB in 2006 which provided deposit service charge income of \$700,000 in 2007 as compared to \$326,000 in 2006. Excluding the impact of the SCSB acquisition, income from service charges on deposit accounts was relatively flat as the Company experienced moderate deposit growth without significant changes in its service charge fee structure.

Commission income from investment products offered to customers through its alliance with Smith Barney increased 60.7% in 2007 as compared to 2006 due to changes in Smith Barney's fee commission structure and an increase in assets under management which led to an increase in fees realized.

In 2008, the Company sold certain available for sale securities for a net gain of \$364,000 as compared to a net loss of \$41,000 in 2007. Management was able to sell certain securities within its portfolio at a gain and reinvest the proceeds into securities with substantially the same yield with slightly longer maturities.

Earnings on company owned life insurance increased to \$734,000 for the twelve months in 2008 as compared to \$678,000 in 2007. In the first quarter of 2008, the Company exchanged a significant portion of its outstanding contracts for higher yielding contracts resulting in increased income. In 2007, earnings on company owned life insurance increased by 18.3% from 2006 to \$678,000 in 2007 as the Company purchased \$2.1 million of life insurance in the second half of 2006 for certain key executives of SCSB. Earnings on company owned life insurance of SCSB was \$87,000 for the year ended December 31, 2007 as compared to \$21,000 for the same period in 2006.

The change in fair value and cash settlement of interest rate swaps was \$180,000 for the twelve months ended December 31, 2008 as compared to \$(1.2) million in 2007. In the fourth quarter of 2007, management determined that the Company's documentation of the effectiveness of the hedge relationship was insufficient to support hedge accounting. Accordingly, the Company was disqualified from hedge accounting treatment and began accounting for the interest rate swap as a stand-alone derivative; the unrealized loss on the interest rate swap at December 31, 2007 of \$234,000 was reclassified from accumulated other comprehensive loss to non-interest income. In accordance with the Company's accounting policy, the change in the fair value of the swap was reported prospectively in non-interest income along with interest rate settlements associated with the swap agreement. For purposes of improving comparability of the Company's financial statements, interest rate settlements for the Company's interest rate swaps for the years ended December 31, 2007 and 2006 were reclassified to non-interest income from interest income as well. In 2008, the Company's last remaining interest rate swap contract expired; the Company reported an unrealized gain of \$234,000 on the interest rate swap in 2008, netted against interest rate settlements of \$54,000 compared to an unrealized loss of \$234,000 and interest rate settlements of \$1.0 million in 2007.

Mortgage banking income decreased to \$167,000 in 2008 from \$236,000 in 2007. The decline is attributable to an impairment charge of \$69,000 recorded in 2008 related to the Company's mortgage servicing rights. In 2008, the Company determined the fair value of its mortgage servicing rights had declined due to a significant increase in the assumed prepayments for the loan portfolio serviced. Excluding the impairment charge, mortgage banking income was consistent with 2007. Mortgage banking income declined by 26.7% for the year ended December 31, 2007 as compared to 2006. The decrease in mortgage banking income in 2007 reflects decreased origination activity in the two periods.

Other income was \$281,000 for the year ended December 31, 2008 as compared to \$439,000 for the same period in 2007, a decrease of \$158,000, or 36.0%. The decline was driven by a decrease in income from merchant card services during 2008 of approximately \$100,000 due to a change in a third party vendor during the year that temporarily disrupted the Company's income and also due to a one-time gain recorded in 2007 related to the settlement of the SCSB pension plan. In 2007, other income increased by \$152,000, or 53.0% from \$287,000 for the twelve months ended December 31, 2006 to \$439,000 for 2007 due primarily to the acquisition of SCSB, which provided \$139,000 of other income in 2007 as compared to \$27,000 in 2006 and the settlement of the SCSB pension plan that had been curtailed in accordance with the merger agreement, resulting in a gain of \$49,000.

#### **Non-interest Expense**

Non-interest expense increased to \$22.6 million for the year ended December 31, 2008 from \$21.8 million as of December 31, 2007, or 3.4% due to increases in salaries and employee benefits of \$659,000, occupancy expense of \$409,000, and marketing and advertising of \$155,000, offset by decreases in data processing expenses of \$252,000, legal and professional services of \$230,000, and other expenses of \$80,000. Total non-interest expense increased 14.1% to \$21.8 million in 2007 when compared with 2006 primarily due to the acquisition of SCSB in 2006 which incurred six months of expense in 2006 as compared to twelve months in 2007. Other factors for the increase in non-interest expense include occupancy expenses, equipment, legal and professional, and other expenses.

Table 5 provides a breakdown of the Company's non-interest expense for the past three years.



**Table 5 - Analysis of Non-interest Expense**

(Dollars in thousands)	Year Ended in December 31,			Percent Increase/(Decrease)	
	2008	2007	2006	2008/2007	2007/2006
Salaries and employee benefits	\$ 12,125	\$ 11,466	\$ 10,345	5.7%	10.8%
Occupancy	2,169	1,760	1,479	23.2	19.0
Equipment	1,535	1,446	1,188	6.2	21.7
Data processing	1,931	2,183	2,162	(11.5)	1.0
Marketing and advertising	738	583	527	26.6	10.6
Legal and professional	1,153	1,383	1,097	(16.6)	26.1
Other	2,903	2,983	2,318	(2.7)	28.7
Total	<u>\$ 22,554</u>	<u>\$ 21,804</u>	<u>\$ 19,116</u>	3.4%	14.1%

Salaries and benefits, the largest component of non-interest expense, increased to \$12.1 million for the twelve months ended December 31, 2008 compared to \$11.5 million for the same period in 2007 due primarily to increases in benefits provided to employees. In 2008, health insurance premiums for employees increased by approximately \$160,000 while other benefits, including the Company match for the 401(k), increased by approximately \$246,000. The Company's full-time equivalent employees increased to 238 at December 31, 2008 from 232 at December 31, 2007 due to a new branch location in Louisville, Kentucky which also increased the Company's salary expense in addition to normal, recurring raises. The increase in salaries and benefits was partially offset by an increase in deferred loan origination costs of \$355,000. In 2007, salaries and benefits increased 10.8% to \$11.5 million in 2007 compared to \$10.3 million in 2006 due primarily to the acquisition of SCSB. The Company's full-time equivalent employees increased to 232 at December 31, 2007 compared to 224 at December 31, 2006 due to the opening of new YCB branch in Jeffersonville, Indiana and the hiring of additional commercial loan officers.

Occupancy expense increased to \$2.2 million for 2008 compared to \$1.8 million in 2007 as the Company opened a new YCB branch location in the second quarter of 2008 which resulted in approximately \$107,000 in additional 2008 lease expense. In addition to the new branch location, the Company incurred increased expenses in maintenance expense and property taxes. Occupancy expenses increased 19.0% to \$1.8 million for 2007 compared with \$1.5 million for 2006. The increase in occupancy expense is due primarily to the opening of a new YCB branch in Jeffersonville, Indiana in the second quarter of 2007 which contributed to an increase in rent expense to \$512,000 for 2007 compared to \$409,000 for 2006 along with slight increases in renewed lease agreements. The remaining increase is related to increased utilities, taxes, repairs and maintenance, and depreciation associated with new branches opened in 2006 and 2007 and the acquisition of SCSB, which accounted for a full year of occupancy expenses versus six months in 2006.

Data processing expenses decreased by \$252,000 from the twelve months ended December 31, 2007 to \$1.9 million in 2008. The decrease was due to repricing of service fees that was negotiated with YCB's third party core data processor in connection with executing a new contract and upgrading from YCB's current system. Data processing expenses increased slightly by \$21,000 to \$2.2 million for the year ended December 31, 2007 as compared to the prior year. An increase in data processing expense due to the acquisition of SCSB in 2006, which resulted in six months of expenses in 2006 compared to twelve 2007, was almost fully offset by decreases in software maintenance expenditures and a decrease in processing charges from YCB's third party core data processor.

Equipment expense was \$1.5 million for the year ended December 31, 2008, an increase of 6.2% from 2007 due to additional equipment additions related to the new YCB branch. Equipment expenses increased 21.7% to \$1.4 million at December 31, 2007 compared to \$1.2 million at December 31, 2006 primarily due to the acquisition of SCSB. Excluding the effect of the SCSB acquisition, equipment expenses increased 7.3% in 2007 compared to 2006. The increase is primarily due to additional depreciation expense on software from replacements and renewals of software licenses and in furniture and fixtures expenses related to the new YCB branch in Jeffersonville, Indiana.

Marketing and advertising expense increased to \$738,000 for the year ended December 31, 2008 from \$583,000 for the equivalent period in 2007. The increase was due to marketing efforts in the second quarter of 2008 related to the new YCB branch, a new branding campaign and related materials, and other promotional expenditures.

Legal and professional fees decreased by \$230,000, or 16.6%, to \$1.2 million for the year ended December 31, 2008. The decrease was attributable to certain consulting projects performed in 2007 that were not repeated in 2008 including studies related to compensation and assistance with selecting and negotiating the Company's contract with its third party core data processor. Legal and professional fees increased 26.1% to \$1.4 million in 2007 compared to \$1.1 million in 2006. The increase was due to additional consulting expenses incurred for implementation of Section 404 of the Sarbanes-Oxley Act and the evaluation of prospective data service providers as well as legal fees related to loan collection efforts, human resource consultations, assistance with the audits of our tax returns, and the review of various SEC filings.

Other expenses decreased to \$2.9 million for the year ended December 31, 2008 from \$3.0 million for the equivalent period in 2007. The decrease is attributable to a decline in deposit account charge-offs from external fraud due to the implementation of software and procedures during 2008 that has allowed the Company to more effectively monitor and identify unusual activity in customer accounts. Also, in 2007, the Company accrued \$200,000 for the probable settlement of ongoing litigation. In 2008, the Company settled the litigation with the third party and paid an amount materially consistent with the amount accrued. Accordingly, the Company did not recognize additional expense in 2008 associated with any ongoing litigation. Offsetting the decreases described above, was an increase in the Company's FDIC assessment to insure the Company's depositors against loss. During 2008, YCB's assessment increased dramatically due to the expiration of a credits granted and an increase in its assessment base. As a result, the Company's FDIC assessment increased by approximately \$414,000 (see Part I, Item 1A "Risk Factors" for discussion of subsequent changes to the Company's FDIC assessment). Other expenses increased 28.7% to \$3.0 million in 2007 compared to 2006 primarily due to the acquisition of SCSB, which incurred approximately \$853,000 and \$344,000 of other expenses in 2007 and 2006, respectively. The Company recognized amortization expense of a core deposit and customer intangible assets acquired as part of the transaction of \$438,000 and \$176,000 for 2007 and 2006, respectively (see Note 5 to the Company's consolidated financial statements). Another factor contributing to the increase in other expenses was the accrual of \$200,000 for the probable settlement of ongoing litigation as noted above (see Part I, Item 3 for further discussion).

## **Financial Condition**

### **Loan Portfolio**

The Company's loan portfolio decreased by 0.5% to \$632.6 million as of December 31, 2008 from \$636.0 million as of the same date in 2007. The decrease in the loan portfolio was primarily concentrated in residential real estate, construction, and consumer loans, which was partially offset by increases in the commercial and commercial real estate portfolio. Given the current economic and interest rate environment, management has attempted to focus on originating loans that will improve profitability and meet the Company's underwriting criteria. The Company's loan portfolio mix remained relatively consistent with the percentage of commercial and commercial real estate loans to total loans increasing to 47.8% as of December 31, 2008 from 44.0% at December 31, 2007.

Residential real estate loans decreased by \$9.6 million to \$177.2 million at December 31, 2008 from \$186.8 million as of December 31, 2007. The Company currently sells a majority of the residential real estate loans it originates into the secondary market resulting in payments not being fully offset by new residential real estate originations. Also impacting residential real estate loans during the year, was a decline in demand as sales of residential properties slowed amid declining home values and the weaker local economic environment. Residential real estate loans represented 28.0% of outstanding loans as of December 31, 2008, down from 29.4% at December 31, 2007.

Construction real estate loans declined by \$13.4 million in 2008 to \$73.9 million as of the year ended December 31, 2008 from \$87.4 million at December 31, 2007. Beginning in late 2007 and continuing into 2008, the Company experienced a high rate of delinquencies in its construction loan portfolio in addition to a noted deterioration in the collateral values of the developments securing the loans. The Company has noted that real estate developers in its market have experienced greater strain in the current economic climate which has reduced their ability to withstand a slowdown in sales of their developed units. Accordingly, the Company has significantly reduced its loan originations to real estate developers during 2008 resulting in a substantial decline in the outstanding balance as those loans are paid (see further discussion below in "Allowance and Provision for Loan Losses" regarding the Company's construction portfolio).

Commercial and commercial real estate loans grew by \$7.0 million and \$15.2 million in 2008 to \$95.4 million and \$207.0 million, respectively, from \$88.4 million and \$191.8 million as of December 31, 2007. The growth in Commercial loans during 2008 is attributable to management's focus on diversifying the Company's commercial loan portfolio, particularly from construction real estate loans. Commercial real estate loans have also increased in 2008 as the Company continued to focus on growing the portfolio at a measured pace, focusing on loan quality and profitability.

At the end of 2008, the Company was servicing \$14.4 million in mortgage loans for other investors compared to \$17.3 million in 2007. Loans serviced for others consist of loans the Company has sold to the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation with servicing rights retained by the Company.

The Company's lending activities remain primarily concentrated within its existing markets, and are principally comprised of loans secured by single-family residential housing developments, owner occupied manufacturing and retail facilities, general business assets, and single-family residential real estate. The Company emphasizes the acquisition of deposit relationships from new and existing commercial business and real estate loan clients.

Table 6 provides a breakdown of the Company's loans by type during the past five years.

**Table 6 - Loans by Type**

(Dollars in thousands)	As of December 31,				
	2008	2007	2006	2005	2004
<b>Real estate:</b>					
Residential	\$ 177,230	\$ 186,831	\$ 187,080	\$ 111,969	\$ 100,553
Commercial	206,973	191,774	179,405	186,644	186,175
Construction	73,936	87,364	83,944	61,031	38,638
Commercial	95,365	88,353	80,132	92,640	73,374
Home equity	60,539	60,380	62,720	58,060	49,677
Consumer	17,296	20,024	19,549	7,295	6,095
Loans secured by deposit accounts	1,242	1,322	756	729	687
<b>Total loans</b>	<b>\$ 632,581</b>	<b>\$ 636,048</b>	<b>\$ 613,586</b>	<b>\$ 518,368</b>	<b>\$ 455,199</b>

Table 7 illustrates the Company's fixed rate maturities and repricing frequency for the loan portfolio.

**Table 7 - Selected Loan Distribution**

As of December 31, 2008 (Dollars in thousands)	Total	One Year or Less	Over One Through Five Years	Over Five Years
Fixed rate maturities:				
Real estate:				
Residential	\$ 141,594	\$ 6,913	\$ 33,281	\$ 101,400
Commercial	95,283	9,871	61,745	23,667
Construction	9,467	1,616	3,748	4,103
Commercial	40,286	7,943	25,929	6,414
Home equity	15,165	271	6,190	8,704
Consumer	17,043	3,448	12,579	1,016
Loans secured by deposit accounts	1,242	420	804	18
Total fixed rate maturities	<u>\$ 320,080</u>	<u>\$ 30,482</u>	<u>\$ 144,276</u>	<u>\$ 145,322</u>
Variable rate maturities:				
Real estate:				
Residential	\$ 35,636	\$ 13,907	\$ 1,185	\$ 20,544
Commercial	111,690	19,701	5,224	86,765
Construction	64,469	53,853	7,901	2,715
Commercial	55,079	50,113	3,382	1,584
Home equity	45,374	5,535	11,253	28,586
Consumer	253	222	31	-
Total variable rate maturities	<u>\$ 312,501</u>	<u>\$ 143,331</u>	<u>\$ 28,976</u>	<u>\$ 140,194</u>

#### Allowance and Provision for Loan Losses

Federal regulations require insured institutions to classify their assets on a regular basis. The regulations provide for three categories of classified loans: substandard, doubtful and loss. The regulations also contain a special mention and a specific allowance category. Special mention is defined as loans that do not currently expose an insured institution to a sufficient degree of risk to warrant classification but do possess credit deficiencies or potential weaknesses deserving management's close attention. Assets classified as substandard or doubtful require the institution to establish general allowances for loan losses. If an asset or portion thereof is classified as loss, the insured institution must either establish specified allowances for loan losses in the amount of 100% of the portion of the asset classified loss, or charge off such amount.

The Company maintains the allowance for loan losses at a level that is sufficient to absorb probable credit losses incurred in its loan portfolio. The allowance is determined based on the application of loss estimates to graded loans by categories. Management determines the level of the allowance for loan losses based on its evaluation of the collectability of the loan portfolio, including the composition of the portfolio, historical loan loss experience, specific impaired loans, and general economic conditions. Allowances for impaired loans are generally determined based on collateral values or the present value of estimated future cash flows. The allowance for loan losses is increased by a provision for loan losses, which is charged to expense, and reduced by charge-offs of specific loans, net of recoveries. Changes in the allowance relating to impaired loans are charged or credited directly to the provision for loan losses. As of December 31, 2008, the Company's allowance for loan losses totaled \$9.5 million, an increase of \$3.2 million from December 31, 2007 which increased the allowance for loan losses to total loans ratio to 1.50% from 0.99% for the same periods, respectively. The increase in the allowance was attributable to a significant increase in the provision for loan losses, offset by an increase in charge-offs. The Company's net charge-offs totaled \$3.7 million in 2008, up from \$634,000 for the 2007 fiscal year as all loan categories experienced a substantial increase from the prior year. Beginning in late 2007 and continuing into 2008 the Company's loan portfolio has experience an increase in past due loans, impaired loans, and classified loans which has led to an increase in charge-offs for those credits management has determined to be uncollectible. Management has allocated amounts for probable incurred losses in the Company's loan portfolio based on the best estimate available as of December 31, 2008.

Provisions for loan losses are charged against earnings to bring the total allowance for loan losses to a level considered adequate by management based on historical experience, the volume and type of lending conducted by the Company, the status of past due principal and interest payments, general economic conditions, and inherent credit risk related to the collectability of the Company's loan portfolio. The provision for loan losses increased to \$6.9 million for the twelve months ended December 31, 2008 from \$1.3 million for the same period in 2007, an increase of \$5.6 million, or 429.1%. In 2008, the Company experienced a dramatic increase in the metrics it uses to monitor its loan portfolio for increased risk of loss as evidenced by increases in classified, non-performing, and impaired loans which grew to \$44.1 million, \$20.7 million, and \$20.2 million, at December 31, 2008, respectively from \$29.4 million, \$11.4 million, and \$9.3 million at December 31, 2007, respectively. In addition, the Company's loans internally classified as "substandard" and "doubtful" increased to \$14.2 million and \$16.9 million as of December 31, 2008, respectively, from \$7.1 million and \$9.5 million as of December 31, 2007, respectively. Of the total loans classified as either "substandard" or "doubtful" at year-end 2008, \$10.4 million were not included in the non-performing loan total above. The 2008 provision for loan losses was impacted by deterioration in the underlying collateral values of certain impaired commercial and construction real estate credits. Throughout 2008, and particularly in the fourth quarter of 2008, the Company obtained updated appraisals of the underlying collateral on certain large credits which indicated the fair value had declined significantly from previously prepared appraisals. Accordingly, the Company increased its provision for loan losses related to those collateral dependent impaired loans. Management assumed, based on the results of the updated appraisals, that the collateral value for other similar impaired loans had also deteriorated at a similar rate (outside of contradictory evidence) and reviewed and adjusted the loss exposures for all collateral dependent impaired loans. As a result, the Company's provision for loan losses was significantly increased. Also, the Company increased its exposure related to unclassified loans based on an increase in charge-offs, past due loans, classified loans, and a deterioration in the economic environment. During 2008, management internally conducted a full review of its entire construction loan portfolio to identify other potential problem credits in addition to outsourcing a loan review in the fourth quarter of 2008 to a third party consultant to review other commercial credits. As a result of these efforts, in addition to the Company's ongoing system of monitoring and identifying problem credits, management believes all problem credits have been appropriately classified and an appropriate amount provided to reserve for probable incurred losses as of December 31, 2008.

Statements made in this section regarding the adequacy of the allowance for loan losses are forward-looking statements that may or may not be accurate due to the impossibility of predicting future events. Because of uncertainties inherent in the estimation process, management's estimate of credit losses in the loan portfolio and the related allowance may differ from actual results.

Table 8 provides the Company's loan charge-off and recovery activity during the past five years.

**Table 8 - Summary of Loan Loss Experience**

(Dollars in thousands)	Year Ended in December 31.				
	2008	2007	2006	2005	2004
Allowance for loan losses at beginning of year	\$ 6,316	\$ 5,654	\$ 5,920	\$ 4,523	\$ 4,034
Acquired allowance of SCSB, July 1, 2006	-	-	754	-	-
Charge-offs:					
Residential real estate	(239)	(173)	(35)	(83)	(22)
Commercial real estate	(720)	(44)	(193)	-	(339)
Construction	(780)	-	(600)	-	-
Commercial business	(1,080)	(207)	(138)	(194)	(245)
Home equity	(491)	(187)	(26)	(198)	(22)
Consumer	(503)	(190)	(362)	(64)	(52)
Total	(3,813)	(801)	(1,354)	(539)	(680)
Recoveries:					
Residential real estate	1	14	-	-	1
Commercial real estate	4	9	9	7	24
Construction	2	-	-	-	-
Commercial business	7	92	26	34	18
Home equity	4	2	-	3	-
Consumer	100	50	37	142	21
Total	118	167	72	186	64
Net loan charge-offs	(3,695)	(634)	(1,282)	(353)	(616)
Provision for loan losses	6,857	1,296	262	1,750	1,105
Allowance for loan losses at end of year	\$ 9,478	\$ 6,316	\$ 5,654	\$ 5,920	\$ 4,523
Ratios:					
Allowance for loan losses to total loans	1.50%	0.99%	0.92%	1.14%	0.99%
Net loan charge-offs to average loans	0.58	0.10	0.22	0.07	0.15
Allowance for loan losses to non-performing loans	46	56	102	108	285

The following table depicts management's allocation of the allowance for loan losses by loan type during the last five years. Allowance funding and allocation is based on management's assessment of economic conditions, past loss experience, loan volume, past-due history and other factors. Since these factors and management's assumptions are subject to change, the allocation is not necessarily indicative of future loan portfolio performance. Allocations of the allowance may be made for specific loans or loan categories, but the entire allowance is available for any loan that may be charged off. Loan losses are charged against the allowance when management deems a loan uncollectible.

**Table 9 - Management's Allocation of the Allowance for Loan Losses**

	As of December 31,									
	2008		2007		2006		2005		2004	
	Allowance	Percent of Loans to Total Loans	Allowance	Percent of Loans to Total Loans	Allowance	Percent of Loans to Total Loans	Allowance	Percent of Loans to Total Loans	Allowance	Percent of Loans to Total Loans
(Dollars in thousands)										
Residential Real Estate	\$ 644	28.0%	\$ 681	29.3%	\$ 479	30.5%	\$ 336	21.6%	\$ 325	22.1%
Commercial Real Estate	3,244	32.7	2,857	30.2	2,992	29.2	3,544	36.0	2,162	40.9
Construction	3,492	11.7	199	13.7	48	13.7	23	11.8	17	8.5
Commercial Business	1,119	15.1	1,716	13.9	1,501	13.1	1,407	17.9	1,533	16.1
Home Equity	510	9.6	662	9.5	435	10.2	495	11.2	389	10.9
Consumer	469	2.9	201	3.4	199	3.3	115	1.5	97	1.5
<b>Total</b>	<b>\$ 9,478</b>	<b>100.0%</b>	<b>\$ 6,316</b>	<b>100.0%</b>	<b>\$ 5,654</b>	<b>100.0%</b>	<b>\$ 5,920</b>	<b>100.0%</b>	<b>\$ 4,523</b>	<b>100.0%</b>

### Asset Quality

Loans (including impaired loans under Statements of Financial Accounting Standards 114 and 118) are placed on non-accrual status when they become past due 90 days or more as to principal or interest. When loans are placed on non-accrual status, all unpaid accrued interest is reversed. These loans remain on non-accrual status until the loan becomes current or the loan is deemed uncollectible and is charged off. The Company defines impaired loans to be those loans that management has determined it is probable, based on current information and events, the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loans individually classified as impaired increased to \$20.2 million at December 31, 2008 from \$9.3 million at December 31, 2007.

Total non-performing loans increased from \$11.4 million at December 31, 2007 to \$20.7 million at December 31, 2008 with total non-performing assets increasing to \$21.9 million from \$11.9 million as of the same dates, respectively. Non-performing assets also include foreclosed real estate that has been acquired through foreclosure or acceptance of a deed in lieu of foreclosure. Foreclosed real estate is carried at fair value less estimated selling costs, and is actively marketed for sale.

In order to identify and appropriately classify all impaired and other problem credits, management undertook several initiatives. In early 2008, the Company's risk management department conducted an extensive review of the Company's construction and development portfolio given the evidence of deterioration in that portfolio beginning in late 2007. Also, the Company contracted with an independent consultant to review other commercial loans in the portfolio in the fourth quarter of 2008. As a result of these reviews, the Company downgraded a few credits, none of which were considered significant or severely problematic. In addition, the Company has strengthened its internal loan review and identification processes through operational and structuring changes and additional senior management oversight. Based on these initiatives, management is confident that all problem credits were appropriately identified and classified as of December 31, 2008.

Table 10 provides the Company's non-performing loan experience during the past five years.

**Table 10 - Non-Performing Assets**

(Dollars in thousands)	As of December 31,				
	2008	2007	2006	2005	2004
Loans on non-accrual status (1)	\$ 20,702	\$ 11,134	\$ 5,566	\$ 5,498	\$ 1,588
Loans past due 90 days or more and still accruing	-	244	-	5	-
Total non-performing loans	20,702	11,378	5,566	5,503	1,588
Other assets owned	1,147	575	457	106	106
Total non-performing assets	\$ 21,849	\$ 11,953	\$ 6,023	\$ 5,609	\$ 1,694
Percentage of non-performing loans to total loans	3.27%	1.79%	0.91%	1.06%	0.35%
Percentage of non-performing assets to total loans	3.45	1.88	0.98	1.08	0.37

(1) Impaired loans on non-accrual status are included in loans. See Note 3 to the Consolidated Financial Statements for additional discussion on impaired loans.

## Investment Securities

Table 11 sets forth the breakdown of the Company's securities portfolio for the past five years.

**Table 11 - Securities Portfolio**

(Dollars in thousands)	December 31,				
	2008	2007	2006	2005	2004
Securities Available for Sale:					
U.S. Government and federal agency	\$ -	\$ 6,077	\$ 29,972	\$ 10,921	\$ 4,739
State and municipal	20,542	13,312	11,645	6,449	6,613
Mortgage-backed	97,588	73,252	67,304	66,752	63,943
Corporate bonds, including trust preferred securities	3,285	6,583	12,150	14,471	14,611
Mutual Funds	244	241	240	242	246
Total securities available for sale	\$ 121,659	\$ 99,465	\$ 121,311	\$ 98,835	\$ 90,152



Table 12 sets forth the breakdown of the Company's investment securities available for sale by type and maturity as of December 31, 2008. For analytical purposes, the weighted average yield on state and municipal securities is adjusted to a taxable equivalent adjustment basis to recognize the income tax savings on tax-exempt securities. A tax rate of 34% was used in adjusting interest on tax-exempt securities to a fully taxable equivalent ("FTE") basis.

**Table 12 - Investment Securities Available for Sale**

As of December 31, 2008			
(Dollars in thousands)	Amortized Cost	Fair Value	Weighted Average Yield
<b>State and municipal</b>			
Within one year	\$ 587	\$ 594	5.11%
Over one through five years	2,124	2,177	5.85
Over five through ten years	3,538	3,493	5.89
Over ten years	14,677	14,278	6.29
<b>Total state and municipal</b>	<b>20,926</b>	<b>20,542</b>	<b>6.14</b>
<b>Corporate bonds, including trust preferred securities</b>			
Over ten years	5,696	3,285	3.94
<b>Total mutual funds</b>	<b>250</b>	<b>244</b>	<b>2.32%</b>
<b>Mortgage-backed securities</b>			
Over one through five years	4,195	4,248	4.06
Over five through ten years	16,037	16,338	4.25
Over ten years	74,938	77,002	5.55
<b>Total mortgage-backed securities</b>	<b>95,170</b>	<b>97,588</b>	<b>5.27</b>
<b>Total available for sale securities</b>	<b>\$ 122,042</b>	<b>\$ 121,659</b>	<b>5.37%</b>

Securities available for sale increased from \$99.5 million at December 31, 2007 to \$121.7 million at December 31, 2008. The increase in available for sale securities was due primarily to purchases of \$65.3 million, offset by maturities, prepayments, and calls of \$24.2 million and sales of \$19.1 million during 2008. The current strategy for the securities portfolio is to maintain an intermediate average life that remains relatively stable in a changing interest rate environment, thus minimizing exposure to sustained increases in interest rates. The investment portfolio primarily consists of mortgage-backed securities, securities issued by the United States government and its agencies, securities issued by states and municipalities, and trust preferred securities. Mortgage-backed securities consist primarily of obligations insured or guaranteed by Federal Home Loan Mortgage Corporation, Federal National Mortgage Association, or Government National Mortgage Association.

A significant portion of the Company's unrealized losses at December 31, 2008 were related to six trust preferred securities comprised of debt of banks and insurance companies. The decrease in the fair value of these securities is due primarily to the lack of transactions for these types of securities as market participants are currently unwilling to conduct transactions unless forced to do so. See footnote 2 to the Company's financial statements for further discussion of the fair value of these securities and management's evaluation for other-than-temporary impairment.

## Deposits

The Company attracts deposits from the market areas it serves by offering a wide range of deposit accounts with a variety of rate structures and terms. The Company uses interest rate risk simulations to assist management in monitoring the Company's deposit pricing, and periodically may offer special rates on certificates of deposits and money market accounts to maintain sufficient liquidity levels. The Company relies primarily on its retail and commercial sales staff and current customer relationships to attract and retain deposits. Market interest rates and competitive pressures can significantly affect the Company's ability to attract and retain deposits. The Company's strategic plan includes continuing to grow non-interest bearing accounts which contribute to higher levels of non-interest income and net interest margin.

Total deposits increased 5.2% to \$603.2 million at December 31, 2008 compared to \$573.3 million at December 31, 2007, primarily due to increases in non-interest bearing demand accounts, time deposit accounts, and savings accounts, offset by decreases in money market and interest bearing demand accounts. Management attributes the increase in non-interest bearing accounts to an emphasis on enhancing profitability of its commercial relationships by evaluating the entire relationship, including the balance of non-interest bearing deposits, when reviewing new and existing loans and their terms. It is the Company's philosophy to price our new loans based on the deposit relationship as well as the based on the risk of the credit and the terms which has lead to increased non-interest bearing deposit accounts. Also, the Company continues to develop and enhance our retail deposit product offerings in an effort to grow our retail deposit base. The decrease in our money market and interest bearing demand accounts is primarily the result of the Company's aggressive rate cutting in lieu of the interest rate environment during 2008. In 2008, the Federal Open Market Committee reduced its target for federal funds significantly. As a result, the Company sought to adjust its cost on its interest bearing deposits to match the downward interest rate trends which led to a loss of accounts as certain customers have pursued higher interest rates other financial institutions.

Table 13 provides a profile of the Company's deposits during the past five years.

**Table 13 – Deposits**

(Dollars in thousands)	December 31,				
	2008	2007	2006	2005	2004
Demand (NOW)	\$ 91,641	\$ 94,939	\$ 63,542	\$ 36,496	\$ 38,243
Money market accounts	101,032	107,880	115,248	146,659	114,332
Savings	29,302	26,971	30,264	22,507	26,159
Individual retirement accounts-certificates of deposit	28,981	29,298	27,054	19,674	18,771
Certificates of deposit, \$100,000 and over	97,440	87,887	95,069	88,592	65,705
Other certificates of deposit	162,322	146,515	143,891	103,335	104,259
Total interest bearing deposits	510,718	493,490	475,068	417,263	367,469
Total non-interest bearing deposits	92,467	79,856	74,850	47,573	43,837
Total	<u>\$ 603,185</u>	<u>\$ 573,346</u>	<u>\$ 549,918</u>	<u>\$ 464,836</u>	<u>\$ 411,306</u>

## Other Borrowings

The Company's other borrowings consist of repurchase agreements, lines of credit with other financial institutions, federal funds purchased, which represent overnight liabilities to non-affiliated financial institutions, and a structured repurchase agreement. While repurchase agreements are effectively deposit equivalents, these arrangements consist of securities that are sold to commercial customers under agreements to repurchase. Other borrowings increased \$6.2 million from \$72.8 million at December 31, 2007 to \$79.0 million at December 31, 2008 primarily due to an increase in repurchase agreements of \$5.6 million and an increase in line of credit borrowings of \$619,000.

## Federal Home Loan Bank Advances

FHLB advances increased from \$91.4 million at December 31, 2007 to \$111.9 million at December 31, 2008 as the Company utilized the proceeds to increase its available liquidity on-hand and fund purchases of available for sale securities. These advances principally consist of putable (or convertible) instruments that give the FHLB the option quarterly to put the advance back to the Company, at which time the Company can prepay the advance without penalty or can allow the advance to become variable adjusting to three-month LIBOR (London Interbank Offer Rate). However, there is a substantial penalty if the Company prepays the advances prior to the FHLB exercising its option. In calculations provided by the FHLB to the Company, three month LIBOR would have to rise by more than 300 basis points from December 31, 2008 levels before the FHLB would exercise its put option. These advances have various maturities through 2010 (see Note 8 to the Consolidated Financial Statements for additional information). The Company does not anticipate that it will enter into putable advances for the foreseeable future, but instead may use fixed or variable rate advances to fund balance sheet growth as needed.

## Liquidity

Liquidity levels are adjusted in order to meet funding needs for deposit outflows, repayment of borrowings, and loan commitments and to meet asset/liability objectives. The Bank's primary sources of funds are deposits; repayment of loans and mortgage-backed securities; Federal Home Loan Bank advances; maturities of investment securities and other short-term investments; and income from operations. While scheduled loan and mortgage-backed security repayments are a relatively predictable source of funds, deposit flows and loan and mortgage-backed security prepayments are greatly influenced by general interest rates, economic conditions and competition. Liquidity management is both a daily and long term function of business management. If the Banks require funds beyond those generated internally, as of December 31, 2008 the Banks had \$46.7 million in additional capacity under its borrowing agreements with the FHLB based on the Banks' current FHLB stock holdings and approximately \$39.0 million in federal funds purchased with other financial institutions. Also, the holding company had \$828,000 of additional borrowing capacity under a line of credit agreement with another financial institution. The holding company has other sources of liquidity outside of the line of credit, primarily dividends from its subsidiaries, YCB and SCSB which are limited by banking regulations. Currently, the Company can declare and pay dividends without prior regulatory approval from its subsidiaries of \$799,000. Subsequent to year end, YCB received notification from a correspondent financial institution that one of its federal funds purchased lines of credit had been canceled, reducing the Company's federal funds purchased availability by \$10.0 million. The decrease in capacity does not currently impact YCB's or the Company's operations given YCB's current liquidity position. The Company is currently negotiating with the correspondent financial institution to have its line of credit restored. The Company anticipates it will have sufficient funds available to meet current loan commitments and other credit commitments.

## Capital

Total capital of the Company decreased to \$62.6 million at December 31, 2008 from \$64.5 million as of December 31, 2007, a decrease of \$1.9 million or 2.9%. The decrease in capital was primarily due to dividends of \$2.3 million. Also contributing to the decrease in capital was an increase in accumulated other comprehensive loss of \$401,000 related to the decline in the fair value of the Company's securities available for sale and an increase in the unrealized loss on pension benefits and the repurchase of 24,817 shares of the Company's common stock during the year for an aggregate cost of \$400,000, offset by net income of \$821,000.

The Company has actively been repurchasing shares of its common stock since May 21, 1999. A net total of 621,365 shares at an aggregate cost of \$10.7 million have been repurchased since that time under both the current and prior repurchase plans. The Company's Board of Directors authorized a share repurchase plan in June 2007 under which a maximum of \$5.0 million of the Company's common stock could be purchased. Through December 31, 2008, a total of \$1.6 million had been expended to purchase 85,098 shares under this plan.

Regulatory agencies measure capital adequacy within a framework that makes capital requirements, in part, dependent on the risk inherent in the balance sheets of individual financial institutions. The Company and the Banks continue to exceed the regulatory requirements for Tier I, Tier I leverage and total risk-based capital ratios (see Note 13 to the Consolidated Financial Statements).

#### Off Balance Sheet Arrangements

The Company uses off balance sheet financial instruments, such as commitments to make loans, credit lines and letters of credit to meet customer financing needs. These agreements provide credit or support the credit of others and usually have expiration dates but may expire without being used. In addition to credit risk, the Company also has liquidity risk associated with these commitments as funding for these obligations could be required immediately. The contractual amount of these financial instruments with off balance sheet risk was as follows at December 31, 2008:

(Dollars in thousands)	
Commitments to make loans	\$ 2,084
Unused lines of credit	122,296
Standby letters of credit	5,737
Total	<u>\$ 130,117</u>

#### Aggregate Contractual Obligations

As of December 31, 2008	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
(Dollars in thousands)					
Time deposits	\$ 288,744	\$ 238,867	\$ 46,406	\$ 3,234	\$ 237
Repurchase agreements	69,811	60,011	-	9,800	-
FHLB borrowings	111,943	31,991	74,952	5,000	-
Subordinated debentures	17,000	-	-	-	17,000
Lease commitments	4,017	626	1,100	936	1,355
Total	<u>\$ 491,515</u>	<u>\$ 331,495</u>	<u>\$ 122,458</u>	<u>\$ 18,970</u>	<u>\$ 18,592</u>

Time deposits represent certificates of deposit held by the Company.

FHLB advances represent the amounts that are due the FHLB and consist of \$67.0 million in convertible fixed rate advances and \$44.9 million in fixed rate advance. With respect to the convertible fixed rate advances, the FHLB has the quarterly right to require the Company to choose either conversion of the fixed rate to a variable rate tied to the three month LIBOR index or prepayment of the advance without penalty. There is a substantial penalty if the Company prepays the advances before FHLB exercises its right. Management does not expect these advances to be converted in the near term. In 2009, \$20.0 million of the convertible fixed rate advances mature which carry a weighted average cost of 5.90%. The Company anticipates utilizing interest bearing deposits in other financial institutions to pay the advances which, given management's current assumptions about available liquidity and the interest rate environment, should increase net interest income by approximately \$550,000 in 2009.

Subordinated debentures represent the scheduled maturities of subordinated debentures issued to trusts formed by the Company in connection with the issuance of trust preferred securities.

Lease commitments represent the total minimum lease payments under noncancelable operating leases, before considering renewal options that generally are present.

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

Asset/liability management is the process of balance sheet control designed to ensure safety and soundness and to maintain liquidity and regulatory capital standards while maintaining acceptable net interest income. Interest rate risk is the exposure to adverse changes in net interest income as a result of market fluctuations in interest rates. Management continually monitors interest rate and liquidity risk so that it can implement appropriate funding, investment, and other balance sheet strategies. Management considers market interest rate risk to be one of the Company's most significant ongoing business risk considerations.

The Company currently contracts with an independent third party consulting firm to measure its interest rate risk position. The consulting firm utilizes an earnings simulation model to analyze net interest income sensitivity. Current balance sheet amounts, current yields and costs, corresponding maturity and repricing amounts and rates, other relevant information, and certain assumptions made by management are combined with gradual movements in interest rates of 200 basis points up and 200 basis points down within the model to estimate their combined effects on net interest income over a one-year horizon. In 2008, the Federal Open Market Committee lowered its target for the federal funds rate to 0-25 bps. A majority of our loans are indexed to prime, therefore, the Company has excluded an evaluation of the effect on net interest income assuming a decrease in interest rates as further reductions in the prime rate are extremely unlikely. Interest rate movements are spread equally over the forecast period of one year. The Company feels that using gradual interest rate movements within the model is more representative of future rate changes than instantaneous interest rate shocks. The Company does not project growth in amounts for any balance sheet category when constructing the model because of the belief that projected growth can mask current interest rate risk imbalances over the projected horizon. The Company believes that the changes made to its interest rate risk measurement process have improved the accuracy of results of the process. Consequently, the Company believes that it has better information on which to base asset and liability allocation decisions going forward.

Assumptions based on the historical behavior of the Company's deposit rates and balances in relation to changes in interest rates are incorporated into the model. These assumptions are inherently uncertain and, as a result, the model cannot precisely measure future net interest income or precisely predict the impact of fluctuations in market interest rates on net interest income. The Company continually monitors and updates the assumptions as new information becomes available. Actual results will differ from the model's simulated results due to timing, magnitude and frequency of interest rate changes, and actual variations from the managerial assumptions utilized under the model, as well as changes in market conditions and the application and timing of various management strategies.

The base scenario represents projected net interest income over a one year forecast horizon exclusive of interest rate changes to the simulation model. Given a gradual 200 basis point increase in the projected yield curve used in the simulation model ("Up 200 Scenario"), it is estimated that as of December 31, 2008 the Company's net interest income would decrease by an estimated 2.21%, or \$571,000, over the one year forecast horizon. However, considering reasonable growth assumptions, the Company expects that net interest income will grow over the forecast horizon. As of December 31, 2007, in the Up 200 Scenario the Company estimated that net interest income would decrease 0.15%, or \$36,000, over a one year forecast horizon ending December 31, 2008. Given a gradual 200 basis point decrease in the projected yield curve used in the simulation model ("Down 200 Scenario"), it is estimated that as of December 31, 2007, the Company's estimated net interest income would decrease 0.16%, or \$37,000, over a one year forecast horizon ending December 31, 2008.

The projected results are within the Company's asset/liability management policy limits, which states that the negative impact to net interest income should not exceed 7% in a 200 basis point decrease or increase in the projected yield curve over a one year forecast horizon. The forecast results are heavily dependent on the assumptions regarding changes in deposit rates; the Company can minimize the reduction in net interest income in a period of rising interest rates to the extent that it can curtail raising deposit rates during this period. The Company continues to explore transactions and strategies to both increase its net interest income and minimize its interest rate risk.

The interest sensitivity profile of the Company at any point in time will be affected by a number of factors. These factors include the mix of interest sensitive assets and liabilities as well as their relative repricing schedules. Such profile is also influenced by market interest rates, deposit growth, loan growth, and other factors.

The following tables, which are representative only and are not precise measurements of the effect of changing interest rates on the Company's net interest income in the future, illustrate the Company's estimated one year net interest income sensitivity profile based on the above referenced asset/liability model as of December 31, 2008 and 2007, respectively:

#### Interest Rate Sensitivity For 2008

(Dollars in thousands)	Base	Gradual Increase In Interest Rates of 200 Basis Points
<b>Projected interest income:</b>		
Loans	\$ 36,673	\$ 38,562
Investments	5,666	5,975
FHLB and FRB stock	432	432
Interest-bearing deposits in other financial institutions	1	148
Federal funds sold	11	185
<b>Total interest income</b>	<b>42,783</b>	<b>45,302</b>
<b>Projected interest expense:</b>		
Deposits	10,729	12,914
Federal funds purchased, line of credit and Repurchase agreements	740	1,437
FHLB advances	4,809	4,875
Subordinated debentures	623	765
<b>Total interest expense</b>	<b>16,901</b>	<b>19,991</b>
<b>Net interest income</b>	<b>\$ 25,882</b>	<b>\$ 25,311</b>
<b>Change from base</b>		<b>\$ (571)</b>
<b>% Change from base</b>		<b>(2.21)%</b>

**Interest Rate Sensitivity For 2007**

	Gradual Decrease In Interest Rates of 200 Basis Points	Base	Gradual Increase In Interest Rates of 200 Basis Points
(Dollars in thousands)			
Projected interest income:			
Loans	\$ 41,263	\$ 43,909	\$ 46,469
Investments	4,648	4,886	5,027
FHLB and FRB stock	377	377	377
Interest-bearing deposits in other financial institutions	29	49	68
Federal funds sold	844	1,152	1,433
Total interest income	47,161	50,373	53,374
Projected interest expense:			
Deposits	15,079	17,216	19,233
Federal funds purchased, line of credit and Repurchase agreements	2,122	2,864	3,589
FHLB advances	5,092	5,216	5,340
Other borrowings	175	204	233
Subordinated debentures	1,041	1,184	1,326
Total interest expense	23,509	26,684	29,721
Net interest income	\$ 23,652	\$ 23,689	\$ 23,653
Change from base	\$ (37)		\$ (36)
% Change from base	(0.16)%		(0.15)%

COMMUNITY BANK SHARES OF INDIANA, INC.  
New Albany, Indiana

FINANCIAL STATEMENTS  
December 31, 2008, 2007, and 2006

<a href="#"><u>REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM</u></a>	<a href="#"><u>49</u></a>
<a href="#"><u>FINANCIAL STATEMENTS</u></a>	
<a href="#"><u>CONSOLIDATED BALANCE SHEETS</u></a>	<a href="#"><u>50</u></a>
<a href="#"><u>CONSOLIDATED STATEMENTS OF INCOME</u></a>	<a href="#"><u>51</u></a>
<a href="#"><u>CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY</u></a>	<a href="#"><u>52</u></a>
<a href="#"><u>CONSOLIDATED STATEMENTS OF CASH FLOWS</u></a>	<a href="#"><u>54</u></a>
<a href="#"><u>NOTES TO CONSOLIDATED FINANCIAL STATEMENTS</u></a>	<a href="#"><u>56</u></a>



REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM



Board of Directors and Shareholders  
Community Bank Shares of Indiana, Inc.  
New Albany, Indiana

We have audited the accompanying consolidated balance sheets of Community Bank Shares of Indiana, Inc. as of December 31, 2008 and 2007, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2008. These financial statements are the responsibility of the Company's management. 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 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 opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Community Bank Shares of Indiana, Inc. as of December 31, 2008 and 2007, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2008 in conformity with United States generally accepted accounting principles.

/s/ Crowe Horwath LLP

Louisville, Kentucky  
March 30, 2009

## COMMUNITY BANK SHARES OF INDIANA, INC.

## CONSOLIDATED BALANCE SHEETS

December 31

(In thousands, except share amounts)

	2008	2007
<b>ASSETS</b>		
Cash and due from financial institutions	\$ 19,724	\$ 14,570
Interest-bearing deposits in other financial institutions	45,749	13,943
Securities available for sale	121,659	99,465
Loans held for sale	308	757
Loans, net of allowance for loan losses of \$9,478 and \$6,316	623,103	629,732
Federal Home Loan Bank and Federal Reserve stock	8,472	8,096
Accrued interest receivable	3,163	3,537
Premises and equipment, net	15,128	15,147
Company owned life insurance	17,745	16,911
Goodwill	15,335	15,335
Other intangible assets	2,492	2,899
Other assets	4,485	3,176
	<u>\$ 877,363</u>	<u>\$ 823,568</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits		
Non interest-bearing	\$ 92,467	\$ 79,856
Interest-bearing	510,718	493,490
Total deposits	603,185	573,346
Other borrowings	78,983	72,796
Federal Home Loan Bank advances	111,943	91,376
Subordinated debentures	17,000	17,000
Accrued interest payable	1,705	1,956
Other liabilities	1,948	2,629
Total liabilities	814,764	759,103
Commitments and contingent liabilities (Note 16)	-	-
Shareholders' equity		
Preferred stock, without par value; 5,000,000 shares authorized; none issued	-	-
Common stock, \$.10 par value per share; 10,000,000 shares authorized; 3,863,942 shares issued; 3,242,577 and 3,260,904 outstanding in 2008 and 2007, respectively	386	386
Additional paid-in capital	45,313	45,035
Retained earnings	28,268	29,723
Accumulated other comprehensive loss	(640)	(239)
Treasury stock, at cost (2008- 621,365 shares, 2007- 603,038 shares)	(10,728)	(10,440)
Total shareholders' equity	<u>62,599</u>	<u>64,465</u>
	<u>\$ 877,363</u>	<u>\$ 823,568</u>

## COMMUNITY BANK SHARES OF INDIANA, INC.

## CONSOLIDATED STATEMENTS OF INCOME

Years ended December 31

(In thousands, except per share amounts)

	2008	2007	2006
Interest and dividend income			
Loans, including fees	\$ 38,833	\$ 46,030	\$ 41,360
Taxable securities	4,798	4,711	4,738
Tax-exempt securities	697	510	467
Federal Home Loan Bank and Federal Reserve dividends	338	381	397
Interest-bearing deposits in other financial institutions	241	144	132
	44,907	51,776	47,094
Interest expense			
Deposits	13,529	18,783	16,933
Other borrowings	1,403	2,824	3,054
Federal Home Loan Bank advances	5,605	5,492	5,066
Subordinated debentures	916	1,296	942
	21,453	28,395	25,995
Net interest income	23,454	23,381	21,099
Provision for loan losses	6,857	1,296	262
Net interest income after provision for loan losses	16,597	22,085	20,837
Non-interest income			
Service charges on deposit accounts	3,356	3,187	2,954
Commission income	194	172	107
Net gain (loss) on sales of available for sale securities	364	(41)	-
Mortgage banking income	167	236	322
Earnings on company owned life insurance	734	678	573
Change in fair value and cash settlement of interest rate swaps	180	(1,248)	(1,061)
Interchange income	811	704	533
Gain on disposition of equity stock	-	-	18
Other income	281	439	287
	6,087	4,127	3,733
Non-interest expense			
Salaries and employee benefits	12,125	11,466	10,345
Occupancy	2,169	1,760	1,479
Equipment	1,535	1,446	1,188
Data processing	1,931	2,183	2,162
Marketing and advertising	738	583	527
Legal and professional service fees	1,153	1,383	1,097
Other expense	2,903	2,983	2,318
	22,554	21,804	19,116
Income before income taxes	130	4,408	5,454
Income tax (benefit) expense	(691)	905	1,343
Net income	\$ 821	\$ 3,503	\$ 4,111
Earnings per share:			
Basic	\$ 0.25	\$ 1.05	\$ 1.36
Diluted	\$ 0.25	\$ 1.04	\$ 1.35

See accompanying notes.

## COMMUNITY BANK SHARES OF INDIANA, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY  
Years ended December 31  
(In thousands except per share amounts)

	Common Stock		Additional	Retained	Accumulated	Treasury	Total
	Shares	Amount	Paid-In	Earnings	Other	Stock	Shareholders'
	Outstanding		Capital		Comprehensive		Equity
					Loss		
Balance at January 1, 2006	2,605,544	300	24,971	26,329	(2,838)	(5,987)	42,775
Comprehensive income:							
Net income	-	-	-	4,111	-	-	4,111
Change in securities available for sale, net of reclassification and tax effects	-	-	-	-	631	-	631
Change in unrealized gains (losses), interest rate swap net of reclassification and tax effects	-	-	-	-	390	-	390
Change in minimum pension liability, net of tax effects	-	-	-	-	76	-	76
Total comprehensive income							5,208
Cash dividends declared (\$.640 per share)	-	-	-	(1,921)	-	-	(1,921)
Purchase of treasury stock	(30,000)	-	-	-	-	(685)	(685)
Acquisition of The Bancshares, Inc.	862,875	86	19,722	-	-	-	19,808
Stock award expense	-	-	261	-	-	-	261
Stock options exercised	1,100	-	(2)	-	-	17	15
Tax benefit for stock options exercised	-	-	80	-	-	-	80
Balance at December 31, 2006	3,439,519	386	45,032	28,519	(1,741)	(6,655)	65,541
Comprehensive income:							
Net income	-	-	-	3,503	-	-	3,503
Change in securities available for sale, net of reclassification and tax effects	-	-	-	-	752	-	752
Change in unrealized gains (losses), interest rate swap net of reclassification and tax effects	-	-	-	-	632	-	632

COMMUNITY BANK SHARES OF INDIANA, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY  
Years ended December 31  
(In thousands except per share amounts)

	Common Stock		Additional	Retained	Accumulated	Treasury	Total
	Shares	Amount	Paid-In	Earnings	Other	Stock	Shareholders'
	Outstanding		Capital		Comprehensive		Equity
Unrealized loss on pension benefits, net of tax effects	-	-	-	-	(36)	-	(36)
Total comprehensive income							4,851
Reclassification of unrealized loss on interest rate swap, net of tax effect (see Note 14 to the Consolidated Financial Statements)	-	-	-	-	154	-	154
Cash dividends declared (\$.685 per share)	-	-	-	(2,299)	-	-	(2,299)
Purchase of treasury stock	(186,090)	-	-	-	-	(3,904)	(3,904)
Stock award expense	-	-	122	-	-	-	122
Issuance of performance unit shares	7,475	-	(119)	-	-	119	-
Balance at December 31, 2007	3,260,904	\$ 386	\$ 45,035	\$ 29,723	\$ (239)	\$ (10,440)	\$ 64,465
Comprehensive income:							
Net income	-	-	-	821	-	-	821
Change in securities available for sale, net of reclassification and tax effects	-	-	-	-	(261)	-	(261)
Unrealized loss on pension benefits, net of tax effects	-	-	-	-	(140)	-	(140)
Total comprehensive income							420
Cash dividends declared (\$.70 per share)	-	-	-	(2,276)	-	-	(2,276)
Purchase of treasury stock	(24,817)	-	-	-	-	(400)	(400)
Issuance of treasury stock under dividend reinvestment plan	6,490	-	(31)	-	-	112	81
Stock award expense	-	-	309	-	-	-	309
Balance at December 31, 2008	3,242,577	\$ 386	\$ 45,313	\$ 28,268	\$ (640)	\$ (10,728)	\$ 62,599

See accompanying notes.

COMMUNITY BANK SHARES OF INDIANA, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended December 31

(In thousands)

	2008	2007	2006
<b>Cash flows from operating activities</b>			
Net income	\$ 821	\$ 3,503	\$ 4,111
Adjustments to reconcile net income to net cash from operating activities:			
Provision for loan losses	6,857	1,296	262
Depreciation and amortization	1,863	1,660	1,287
Net accretion of securities	(120)	(106)	9
Net (gain) loss on sales of available for sale securities	(364)	41	-
Mortgage loans originated for sale	(13,589)	(12,032)	(17,418)
Proceeds from mortgage loan sales	14,235	12,370	18,466
Net gain on sales of mortgage loans	(197)	(187)	(262)
Earnings on company owned life insurance	(734)	(678)	(573)
FHLB stock dividends	(16)	-	(37)
Share based compensation expense	309	122	332
Net (gain) loss on sale of other real estate	22	48	(20)
Gain on disposition of equity stock	-	-	(18)
Net (gain) loss on disposition of premises and equipment	(4)	19	-
Net change in			
Accrued interest receivable	374	431	(503)
Accrued interest payable	(251)	(222)	862
Other assets	(438)	(415)	484
Other liabilities	(893)	(890)	(351)
Net cash from operating activities	7,875	4,960	6,631
<b>Cash flows from investing activities</b>			
Acquisition of The Bancshares, Inc., net	-	-	(795)
Net change in interest-bearing deposits	(31,806)	(12,733)	164
Available for sale securities:			
Sales	19,098	10,937	2,990
Purchases	(65,381)	(21,868)	(18,980)
Maturities, prepayments and calls	24,181	34,100	18,969
Loan originations and payments, net	(3,149)	(23,387)	(7,914)
Purchase of premises and equipment, net	(1,524)	(1,504)	(2,248)
Proceeds from the sale of premises and equipment	10	-	-
Proceeds from the sale of other real estate	2,318	252	416
Purchase of FHLB and Federal Reserve stock	(376)	(769)	-
Redemption of FHLB and Federal Reserve stock	16	91	2,011
Investment in cash surrender value of life insurance	(100)	-	(2,050)
Net cash from investing activities	(56,713)	(14,881)	(7,437)

See accompanying notes.

## COMMUNITY BANK SHARES OF INDIANA, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended December 31

(In thousands)

	2008	2007	2006
<b>Cash flows from financing activities</b>			
Net change in deposits	\$ 29,900	\$ 23,509	\$ (18,784)
Net change in other borrowings	6,187	(11,539)	36,600
Proceeds from Federal Home Loan Bank advances	77,000	113,000	128,300
Repayment of Federal Home Loan Bank advances	(56,500)	(114,500)	(143,800)
Proceeds from issuance of subordinated debentures	-	-	10,000
Exercise of stock options	-	-	15
Purchase of treasury stock	(400)	(3,904)	(685)
Tax benefit of stock options exercised	-	-	80
Cash dividends paid	(2,195)	(2,299)	(1,921)
Net cash from financing activities	53,992	4,267	9,805
Net change in cash and due from banks	5,154	(5,654)	8,999
Cash and due from banks at beginning of year	14,570	20,224	11,225
<b>Cash and due from banks at end of year</b>	<b>\$ 19,724</b>	<b>\$ 14,570</b>	<b>\$ 20,224</b>
<b>Supplemental cash flow information:</b>			
Interest paid	\$ 21,704	\$ 28,617	\$ 25,133
Income taxes paid, net of refunds	334	1,274	1,145
<b>Supplemental noncash disclosures:</b>			
Transfers from loans to foreclosed assets	3,292	592	506
Sale and financing of foreclosed assets	286	167	249
Issuance of treasury shares under dividend reinvestment plan	81	-	-

See accompanying notes.

COMMUNITY BANK SHARES OF INDIANA, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2008, 2007 and 2006

**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Nature of Operations and Principles of Consolidation: The consolidated financial statements include Community Bank Shares of Indiana, Inc. and its wholly owned subsidiaries, Your Community Bank (YCB) and The Scott County State Bank (SCSB), collectively referred to as “the Company”. YCB utilizes three wholly-owned subsidiaries to manage its investment portfolio. CBSI Holdings, Inc. and CBSI Investments, Inc. are Nevada corporations which jointly own CBSI Investment Portfolio Management, LLC, a Nevada limited liability corporation which holds and manages the Bank’s investment securities. YCB established a new Community Development Entity (CDE) subsidiary in July 2002 named CBSI Development Fund, Inc. The CDE enables YCB to participate in the federal New Markets Tax Credit (NMTC) Program. The NMTC Program is administered by the Community Development Financial Institutions Fund of the United States Treasury and is designed to promote investment in low-income communities by providing a tax credit over seven years for equity investments in CDE’s. During June 2004 and June 2006, the Company completed placements of floating rate subordinated debentures through Community Bank Shares (IN) Statutory Trust I and Trust II (Trusts), trusts formed by the Company. Because the Trusts are not consolidated with the Company, pursuant to FASB Interpretation No. 46, the financial statements reflect the subordinated debt issued by the Company to the Trusts. Intercompany balances and transactions are eliminated in consolidation. On July 1, 2006, the Company completed its acquisition of The Bancshares, Inc. and its wholly-owned subsidiary SCSB; subsequently, the Company liquidated The Bancshares, Inc.

The Company provides financial services through its offices in Floyd, Clark and Scott counties in Indiana, and Jefferson and Nelson counties in Kentucky. Its primary deposit products are checking, savings, and term certificate accounts, and its primary lending products are residential mortgage, commercial, and installment loans. Substantially all loans are secured by specific items of collateral including business assets, consumer assets, and commercial and residential real estate. Commercial loans are expected to be repaid from cash flow from operations of businesses. There are no significant concentrations of loans to any one industry or customer. However, the customers’ ability to repay their loans is dependent on the real estate and general economic conditions in the area.

Use of Estimates: To prepare financial statements in conformity with the United States generally accepted accounting principles 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 actual results could differ. The allowance for loan losses, valuation of goodwill and other intangible assets, fair value of securities and deferred tax assets are particularly subject to change.

Cash Flows: Cash and cash equivalents include cash and non-interest bearing deposits with other financial institutions with maturities less than 90 days. Net cash flows are reported for interest-bearing deposits in other financial institutions, loans, deposits, and short-term borrowings.

Interest-bearing Deposits in Other Financial Institutions: Interest-bearing deposits in other financial institutions mature within one year, are carried at cost.

Securities: 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 other comprehensive income, net of tax.



COMMUNITY BANK SHARES OF INDIANA, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2008, 2007 and 2006

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

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

Declines in the fair value of securities below their cost that are other than temporary are reflected as realized losses. In estimating other-than-temporary losses, management considers: the length of time and extent that fair value has been less than cost, the financial condition and near term prospects of the issuer, the Company's ability and intent to hold the security for a period sufficient to allow for any anticipated recovery in fair value, and whether there has been an adverse change in expected cash flows.

**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. To deliver closed loans to the secondary market and to control its interest rate risk prior to sale, the Company enters into agreements to sell loans. The aggregate market value of mortgage loans held for sale considers the price of the sales contracts. Loan commitments related to the origination of mortgage loans held for sale and the corresponding sales contracts are considered derivative instruments. The Company's commitments are for fixed rate mortgage loans, generally lasting 60 days and are at market rates when initiated. The Company had commitments to originate \$480,000 and \$231,000 in loans and an equal amount of corresponding sales contracts at December 31, 2008 and 2007. The impact of accounting for these instruments as derivatives was not material and substantially all of the gain on sale generated from mortgage banking activities continues to be recorded when closed loans are delivered into the sales contracts. The adoption of SAB 109 was not material to the Company's accounting for mortgage banking income.

The Company sells loans on a servicing released basis. The Company sold loans previous to 2006 on a servicing retained basis. Servicing assets were recorded on loans sold with servicing retained and were capitalized in other assets and expensed into other income against service fee income in proportion to, and over the period of, estimated net servicing revenues. Impairment is evaluated based on the fair value of the assets, using groupings of the underlying loans as to interest rates and then, secondarily, as to geographic and prepayment characteristics. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Any impairment of a grouping is reported as a valuation allowance, to the extent that fair value is less than the capitalized amount for a grouping.

Servicing fee income, which is reported on the income statement as mortgage banking income, is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal. The amortization of mortgage servicing rights is netted against mortgage servicing fee income. Servicing fees, net of amortization, totaled \$39,000, \$49,000 and \$60,000 for the years ended December 31, 2008, 2007 and 2006. The Company recorded an impairment charge of \$69,000, \$0, and \$0 for the years ended December 31, 2008, 2007 and 2006. Late fees and ancillary fees related to loan servicing are not material.

**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 and an allowance for loan losses.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

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

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 on commercial, mortgage and consumer loans is discontinued at the time the loan is 90 days delinquent. Consumer loans are typically charged-off no later than 120 days past due. In all cases, loans are placed on non-accrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. All interest accrued but not received for loans placed on non-accrual is 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.

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 or loans otherwise classified as substandard, doubtful, or loss. The general component covers non-classified loans and is based on historical loss experience adjusted for current factors.

A loan is impaired when full payment under the loan terms is not expected. 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. Smaller balance homogeneous loans, such as consumer and residential real estate, are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosure.

Premises and Equipment: Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Buildings and related components are depreciated using the straight-line method with useful lives ranging from 7 to 40 years. Furniture, fixtures, and equipment are depreciated using the straight-line method with useful lives ranging from 2 to 10 years. Leasehold improvements are amortized over the shorter of their economic lives or the term of the lease.

Federal Home Loan Bank (FHLB) and Federal Reserve Stock: FHLB and Federal Reserve stock are required investments for institutions that are members of the Federal Reserve and FHLB systems. The required investment in the common stock is based on a predetermined formula. Federal Reserve and FHLB stock are carried at cost, classified as restricted securities, and are periodically evaluated for impairment. Because the stocks are viewed as long term investments, impairment is based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

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

Company Owned Life Insurance: The Company has purchased life insurance policies on certain key executives. In accordance with EITF 06-5, Company owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

Goodwill and Other Intangible Assets: Goodwill results from business acquisitions and represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is assessed at least annually for impairment and any such impairment is recognized in the period identified.

Other intangible assets consist of core deposit intangible and loan customer intangible assets arising from bank acquisitions. They are initially measured at fair value and then are amortized on an accelerated method over their estimated useful lives of 10 years.

Long-term Assets: Premises and equipment, core deposit intangibles, loan customer intangibles 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.

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, a valuation allowance is recorded through expense. Costs after acquisition are expensed. Foreclosed assets amounted to \$1.2 million and \$575,000 at year-end 2008 and 2007, respectively, and are included in other assets in the consolidated balance sheets.

Repurchase Agreements: Repurchase agreement liabilities, included in other borrowings, represent amounts advanced by various customers. Securities are pledged to cover these liabilities, which are not covered by federal deposit insurance.

Equity: Stock dividends in excess of 20% are reported by transferring the par value of the stock issued from retained earnings to common stock. Stock dividends of 20% or less are reported by transferring the fair value, as of the ex-dividend date, of the stock issued from retained earnings to common stock and additional paid-in capital. Fractional share amounts are paid in cash with a reduction in retained earnings. Treasury stock is carried at cost.

Benefit Plans: Pension expense is the net of service and interest cost, return on plan assets, and amortization of gains and losses not immediately recognized. The Company adopted FAS 158 in 2006, and accordingly, recognizes the overfunded or underfunded status of its defined benefit postretirement plan as an asset or liability in its balance sheet and recognizes changes in the funded status in the year in which the changes occur through comprehensive income. Profit sharing and 401k plan expense is the amount contributed determined by formula.

COMMUNITY BANK SHARES OF INDIANA, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2008, 2007 and 2006

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

Stock-Based Compensation: Compensation cost is recognized for stock options and restricted stock awards issued to employees, based on the fair value of these awards at the date of grant. Compensation cost for performance unit awards is based on both the fair market value of the shares at the grant date and the Company's stock price at the end of the reporting cycle. A Black-Scholes model is utilized to estimate the fair value of stock options, while the market price of the Company's common stock at the date of grant is used for restricted stock and sixty-five percent of the performance unit awards. The remaining thirty-five percent of the total performance unit awards are paid in cash and is therefore classified as a liability, with total compensation cost changing as the Company's stock price changes. 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.

Income Taxes: Income tax expense 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.

The Company adopted FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes* ("FIN 48"), as of January 1, 2007. 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 adoption had no effect on the Company's financial statements.

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

Loan Commitments and Related 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 when they are funded.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

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

Derivatives: Derivative financial instruments are recognized as assets or liabilities at fair value. The Company's derivatives consist mainly of interest rate swap agreements, which are used as part of its asset liability management to help manage interest rate risk. The Company does not use derivatives for trading purposes.

At the start of a derivative contract, the Company designates the derivative as one of three types based on the Company's intentions and belief as to likely effectiveness as a hedge. These three types are a hedge of the fair value of a recognized asset or liability of an unrecognized firm commitment ("fair value hedge"), a hedge of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability ("cash flow hedge"), or an instrument with no hedging designation ("stand-alone derivative"). For a fair value hedge, the gain or loss on the derivative, as well as the offsetting loss or gain on the hedged item, are recognized in current earnings as fair values change. For a cash flow hedge, the gain or loss on the derivative is reported in other comprehensive income and is reclassified into earnings in the same periods during which the hedged transaction affects earnings. For both types of hedges, derivative gains and losses that are not effective in hedging the changes in fair value or expected cash flows of the hedged item are recognized immediately in current earnings. Changes in the fair value of stand-alone derivatives that do not qualify for hedge accounting are reported currently in earnings, as noninterest income.

Net cash settlements on derivatives that qualify for hedge accounting are recorded in interest income or interest expense, based on the item being hedged. Net cash settlements on derivatives that do not qualify for hedge accounting are reported in noninterest income. Cash flows on hedges are classified in the cash flow statement the same as the cash flows of the items being hedged.

The Company formally documents the relationship between derivatives and hedged items, as well as the risk-management objective and the strategy for undertaking hedge transactions. This documentation includes linking fair value or cash flow hedges to specific assets and liabilities on the balance sheet or to specific firm commitments or forecasted transactions. The Company also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivative instruments that are used are highly effective in offsetting changes in fair values or cash flows of the hedged items. The Company discontinues hedge accounting when it determines that the derivative is no longer effective in offsetting changes in the fair value or cash flows of the hedged item, the derivative is settled or terminates, a hedged forecasted transaction is no longer probable, a hedged firm commitment is no longer firm, or treatment of the derivative as a hedge is no longer appropriate or intended.

When hedge accounting is discontinued, later changes in fair value of the derivative are recorded as noninterest income. When a fair value hedge is discontinued, the hedged asset or liability is no longer adjusted for changes in fair value and the existing basis adjustment is amortized or accreted over the remaining life of the asset or liability. When a cash flow hedge is discontinued but the hedged cash flows or forecasted transaction is still expected to occur, gains or losses that were accumulated in other comprehensive income are amortized into earnings over the same periods which the hedged transactions will affect earnings.

During 2007, the Company determined that its use of hedge accounting for its interest rate swap was in error. See Note 14 for additional details.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

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

Earnings Per Common Share: Basic earnings per common share is net income divided by the weighted average number of common shares outstanding during the period. Diluted earnings per common share include the dilutive effect of additional potential common shares issuable under stock options. Earnings and dividends per share are restated for stock splits and dividends through the date of issuance of the financial statements.

Comprehensive Income: Comprehensive income consists of net income and other comprehensive income. Other comprehensive income, recognized as separate components of equity, includes changes in the following items: unrealized gains and losses on securities available for sale, unrealized gains and losses on interest rate swaps that qualify for hedge accounting (cash flow hedges), and a minimum pension liability.

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 there are such matters that will have a material effect on the consolidated financial statements.

Restrictions on Cash: Cash on hand or on deposit with the Federal Reserve Bank of \$1.4 million was required to meet regulatory reserve and clearing requirements at year-end 2008 and 2007. Beginning in October 2008, balances on deposit with the Federal Reserve began earning interest.

Dividend Restriction: Banking regulations require maintaining certain capital levels and may limit the dividends paid by the bank subsidiaries to the holding company or by the holding company to shareholders, as more fully described in a separate note.

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.

Operating Segments: While the chief decision-makers monitor the revenue streams of the various products and services, the identifiable segments are not material and operations are managed and financial performance is evaluated on a Company-wide basis. Accordingly, all of the financial service operations are considered by management to be aggregated in one reportable operating segment.

COMMUNITY BANK SHARES OF INDIANA, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2008, 2007 and 2006

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

Adoption of New Accounting Standards:

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements* (FAS 157). This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This Statement establishes a fair value hierarchy about the assumptions used to measure fair value and clarifies assumptions about risk and the effect of a restriction on the sale or use of an asset. The standard was effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued Staff Position (FSP) 157-2, *Effective Date of FASB Statement No. 157*. This FSP delays the effective date of FAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The impact of adoption was not material. In October 2008, the FASB issued Staff Position (FSP) 157-3, *Determining the Fair Value of a Financial Asset when the Market for That Asset Is Not Active*. This FSP clarifies the application of FAS 157 in a market that is not active. FSP 157-3 was used to determine the fair value of trust preferred securities (see Footnote 2).

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. The standard provides companies with an option to report selected financial assets and liabilities at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The new standard was effective for the Company on January 1, 2008. The Company did not elect the fair value option for any financial assets or financial liabilities as of January 1, 2008 or subsequently.

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*. This issue requires that a liability be recorded during the service period when a split-dollar life insurance agreement continues after participants' employment or retirement. The required accrued liability will be based on either the post-employment benefit cost for the continuing life insurance or based on the future death benefit depending on the contractual terms of the underlying agreement. This issue was effective for fiscal years beginning after December 15, 2007. The impact of adoption was not material.

On November 5, 2007, the SEC issued Staff Accounting Bulletin No. 109, *Written Loan Commitments Recorded at Fair Value through Earnings* ("SAB 109"). Previously, SAB 105, *Application of Accounting Principles to Loan Commitments*, stated that in measuring the fair value of a derivative loan commitment, a company should not incorporate the expected net future cash flows related to the associated servicing of the loan. SAB 109 supersedes SAB 105 and indicates that the expected net future cash flows related to the associated servicing of the loan should be included in measuring fair value for all written loan commitments that are accounted for at fair value through earnings. SAB 105 also indicated that internally-developed intangible assets should not be recorded as part of the fair value of a derivative loan commitment, and SAB 109 retains that view. SAB 109 was effective for derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The impact of adoption was not material.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

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

In December 2007, the SEC issued SAB No. 110, which expresses the views of the SEC regarding the use of a “simplified” method, as discussed in SAB No. 107, in developing an estimate of expected term of “plain vanilla” share options in accordance with SFAS No. 123(R), Share-Based Payment. The SEC concluded that a company could, under certain circumstances, continue to use the simplified method for share option grants after December 31, 2007. The Company does not use the simplified method for share options and therefore SAB No. 110 has no impact on the Company’s consolidated financial statements.

On January 12, 2009, the FASB issued FSP No. EITF 99-20-1, *Amendments to the Impairment and Interest Income Measurement Guidance of EITF Issue No. 99-20*. FSP EITF 99-20-1 changed the guidance for the determination of whether an impairment of certain non-investment grade, beneficial interests in securitized financial interests assets is considered other-than-temporary. The adoption of FSP EITF 99-20-1, effective December 31, 2008, did not have a material impact on the Company’s consolidated financial statements.

Effect of Newly Issued But Not Yet Effective Accounting Standards:

In December 2007, the FASB issued FAS No. 141 (revised 2007), Business Combinations (“FAS 141(R)”), which establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in an acquiree, including the recognition and measurement of goodwill acquired in a business combination. FAS No. 141(R) is effective for fiscal years beginning on or after December 15, 2008. Earlier adoption is prohibited. The adoption of this standard is not expected to have a material effect on the Corporation’s results of operations or financial position.

In December 2007, the FASB issued SFAS No. 160, “*Noncontrolling Interest in Consolidated Financial Statements, an amendment of ARB No. 51*” (“SFAS No. 160”), which will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity within the consolidated balance sheets. FAS No. 160 is effective as of the beginning of the first fiscal year beginning on or after December 15, 2008. Earlier adoption is prohibited and the Corporation does not expect the adoption of FAS No. 160 to have a significant impact on its results of operations or financial position.

In March 2008, the FASB issued SFAS No. 161, “Disclosures about Derivative Instruments and Hedging Activities, an amendment of SFAS No. 133”. FAS No. 161 amends and expands the disclosure requirements of SFAS No. 133 for derivative instruments and hedging activities. FAS No. 161 requires qualitative disclosure about objectives and strategies for using derivative and hedging instruments, quantitative disclosures about fair value amounts of the instruments and gains and losses on such instruments, as well as disclosures about credit-risk features in derivative agreements. FAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The adoption of this standard is not expected to have a material effect on the Corporation’s results of operations or financial position.

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



**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 2 – SECURITIES**

The fair value of available for sale securities and the related gross unrealized gains and losses recognized in accumulated other comprehensive loss were as follows.

	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses
		(In thousands)	
<u>2008</u>			
State and municipal	\$ 20,542	\$ 174	\$ (558)
Mortgaged-backed agencies	97,588	2,430	(12)
Corporate bonds, including trust preferred securities	3,285	-	(2,411)
Mutual funds	244	-	(6)
Total	<u>\$ 121,659</u>	<u>\$ 2,604</u>	<u>\$ (2,987)</u>

	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses
		(In thousands)	
<u>2007</u>			
U.S. Government and federal agency	\$ 6,077	\$ 83	-
State and municipal	13,312	281	(1)
Mortgaged-backed agencies	73,252	519	(568)
Corporate bonds, including trust preferred securities	6,583	-	(297)
Mutual funds	241	-	(9)
Total	<u>\$ 99,465</u>	<u>\$ 883</u>	<u>\$ (875)</u>

Sales of available for sale securities were as follows.

	2008	2007	2006
		(In thousands)	
Proceeds	\$ 19,098	\$ 10,937	\$ 2,990
Gross gains	364	2	-
Gross losses	-	(43)	-

The tax provision (benefit) applicable to these net realized gains (losses) amounted to \$ 124,000, \$(14,000) and \$0, respectively.

COMMUNITY BANK SHARES OF INDIANA, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2008, 2007 and 2006

**NOTE 2 – SECURITIES (Continued)**

Contractual maturities of available for sale securities at year-end 2008 were as follows. Mortgage-backed agency securities and mutual funds which do not have a single maturity date are shown separately.

	Fair Value (In thousands)
Due in one year or less	\$ 594
Due from one to five years	2,177
Due from five to ten years	3,493
Due after ten years	17,563
Mortgage-backed agencies	97,588
Mutual Funds	244
<b>Total</b>	<b>\$ 121,659</b>

Securities pledged at year-end 2008 and 2007 had a carrying amount of \$81.5 million and \$76.0 million to secure public deposits, repurchase agreements and Federal Home Loan Bank advances.

At year end 2008 and 2007, there were no holdings of securities of any one issuer, other than the U.S. Government and its agencies, in an amount greater than 10% of shareholders' equity.

Securities with unrealized losses at year end 2008 and 2007, aggregated by investment category and length of time that individual securities have been in a continuous loss position are as follows (in thousands):

	Less than 12 Months		12 Months or More		Total	
	(In thousands)					
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
2008						
State and municipal	\$ 13,174	\$ (558)	\$ -	\$ -	\$ 13,174	\$ (558)
Mortgaged-backed agencies	2,241	(8)	560	(4)	2,801	(12)
Corporate bonds, including trust preferred securities	-	-	3,285	(2,411)	3,285	(2,411)
Mutual funds	-	-	244	(6)	244	(6)
Total temporarily impaired	\$ 15,415	\$ (566)	\$ 4,089	\$ (2,421)	\$ 19,504	\$ (2,987)

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 2 – SECURITIES (Continued)**

NOTE 2 – SECURITIES (Continued)

	Less than 12 Months		12 Months or More		Total	
	(In thousands)					
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
2007						
State and municipal	\$ 886	\$ (1)	\$ -	\$ -	\$ 886	\$ (1)
Mortgaged-backed agencies	1,796	(1)	39,934	(567)	41,730	(568)
Corporate bonds, including trust preferred securities	5,589	(290)	995	(7)	6,584	(297)
Mutual funds	-	-	241	(9)	241	(9)
Total temporarily impaired	\$ 8,271	\$ (292)	\$ 41,170	\$ (583)	\$ 49,441	\$ (875)

All unrealized losses are reviewed on at least a quarterly basis to determine whether the losses are other than temporary and are reviewed more frequently when economic or market concerns warrant such evaluation. Consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and our intent and ability to retain the investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. In analyzing an issuer's financial condition, we may consider whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, the results of reviews of the issuer's financial condition, and, in the case of our trust preferred securities, the present value of the estimated remaining cash flows.

A significant portion of the Company's unrealized losses at December 31, 2008 were related to six trust preferred securities. The decrease in the fair value of these securities is due primarily to the lack of transactions for these types of securities as market participants are currently unwilling to conduct transactions unless forced to do so. Management reviewed these securities in accordance with FSP EITF 99-20-1, "Amendments to the Impairment and Interest Income Measurement Guidance of EITF Issue No. 99-20" ("FSP EITF 99-20-1"), which requires the Company to determine whether the fair value of the beneficial interest has declined below the reference amount and if the decline is other than temporary. If the holder's determination of the expected cash flows has adversely changed, an other-than-temporary impairment is considered to have occurred.

Management utilized a discounted cash flow analysis to determine if there was other-than-temporary impairment related to these 6 securities. The cash flow models were provided by our investment advisors and were used to determine if the expected cash flows as of December 31, 2008 were consistent with the expected cash flows at the date of purchase. The cash flow models included assumptions related to prepayments and anticipated deferrals and defaults for the underlying issuers comprising each issuance. The results of the analysis indicated there had not been an adverse change in the expected cash flows for each of the trust preferred securities we own. Management also reviewed other relevant information in our assessment including: multiple broker quotes, the duration of the unrealized loss, the severity of the decline in fair value, financial information of the underlying issuers within each trust preferred security, and the ability and intent of the Company to hold the security until recovery. Also, the Company reviewed known and anticipated deferrals and defaults of the underlying issues within the trust preferred securities as of December 31, 2008 and subsequent to year-end. Based on review of the cash flow analyses and the other factors identified above, management determined the Company's trust preferred security were not other-than-temporarily impaired and therefore did not recognize a loss into income.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 2 – SECURITIES (Continued)**

Certain securities within the Company's state and municipal portfolio have unrealized losses as of December 31, 2008 which have not been recognized into earnings. Management has reviewed the municipal portfolio and determined that a majority maintain investment grade ratings while five of the remaining securities have not been graded by a rating agency due to downgrades of the companies insuring the issuance which did not impact management's estimate of credit worthiness of the issuer. In addition, the duration of the unrealized losses in the state and municipal portfolio have all been less than twelve months. Management has the intent and the ability to hold the securities until recovery and is unaware of any other circumstances which may indicate other-than-temporary impairment.

**NOTE 3 – LOANS**

Loans at year-end were as follows:

	2008	2007
	(In thousands)	
Commercial	\$ 95,365	\$ 88,353
Real Estate:		
Residential	177,230	186,831
Commercial	206,973	191,774
Construction	73,936	87,364
Home Equity	60,539	60,380
Loans secured by deposit accounts	1,242	1,322
Consumer	17,296	20,024
Subtotal	632,581	636,048
Less: Allowance for loan losses	(9,478)	(6,316)
Loans, net	<u>\$ 623,103</u>	<u>\$ 629,732</u>

During 2008 and 2007, substantially all of the Company's residential and commercial real estate loans were pledged as collateral to the Federal Home Loan Bank to secure advances.

Activity in the allowance for loan losses was as follows:

	2008	2007	2006
	(In thousands)		
Beginning balance	\$ 6,316	\$ 5,654	\$ 5,920
Acquired allowance of SCSB, July 1, 2006	-	-	754
Provision for loan losses	6,857	1,296	262
Loans charged-off	(3,813)	(801)	(1,354)
Recoveries	118	167	72
Ending balance	<u>\$ 9,478</u>	<u>\$ 6,316</u>	<u>\$ 5,654</u>

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 3 – LOANS (Continued)**

Information about impaired loans is presented below. There were no impaired loans for the periods presented without an allowance allocation.

	2008	2007	2006
	(In thousands)		
Impaired loans at year-end	\$ 20,189	\$ 9,295	\$ 4,399
Amount of the allowance for loan losses allocated	4,413	1,593	865
Average of impaired loans during the year	8,107	4,628	4,783
Interest income recognized and received during impairment	4	75	1
Nonperforming loans at year-end were as follows.			
Loans past due over 90 days still on accrual	\$ -	\$ 244	\$ -
Non-accrual loans	20,702	11,134	5,566

Nonperforming loans includes both smaller balance homogenous loans that are collectively evaluated for impairment and individually classified impaired loans.

Related Party Loans: Loans to principal officers, directors, and their affiliates were as follows.

	2008
	(In thousands)
Beginning loans	\$ 22,655
New loans	10,715
Effect of changes in related parties	413
Repayments	(9,976)
Ending loans	\$ 23,807

Off-balance-sheet commitments (including commitments to make loans, unused lines of credit, and letters of credit) to principal officers, directors, and their affiliates as of December 31, 2008 and 2007 were \$12.6 million and \$7.7 million.

Mortgage Banking Activities: Mortgage loans serviced for others are not included in the accompanying consolidated balance sheets. The unpaid principal balances of mortgage loans serviced for others were approximately \$14.4 million and \$17.3 million at year-end 2008 and 2007. Custodial escrow balances maintained in connection with the foregoing loan servicing, and included in non-interest bearing deposits, were approximately \$79,000 and \$62,000 at year-end 2008 and 2007. Servicing assets related to these loans, included in other assets, were \$69,000 and \$147,000 at year-end 2008 and 2007. The servicing asset valuation allowance was \$69,000 and \$0 at year-end 2008 and 2007. Amortization expense was \$8,000, \$8,000 and \$9,000 at year-end 2008, 2007, and 2006. The company recorded impairment charges of \$69,000, \$0, and \$0 in 2008, 2007, and 2006. The fair value for mortgage servicing rights were \$69,000 and \$158,000 at year-end 2008 and 2007. Fair value at year-end 2008 was determined using a discount rate of 12.0%, prepayment speeds ranging from 18.00% to 45.00%, depending on the stratification of the specific right, and a default rate of 0.00%. Fair value at year-end 2007 was determined using a discount rate of 9.50%, prepayment speeds ranging from 8.50% to 40.00%, depending on the stratification of the specific right, and a default rate of 0.00%.

The weighted average amortization period is 5.4 years. Estimated amortization expense for each of the next five years is approximately \$12,800 per year.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 4- PREMISES AND EQUIPMENT**

Year-end premises and equipment were as follows.

	2008	2007
	(In thousands)	
Land and land improvements	\$ 2,766	\$ 2,629
Buildings	13,176	13,225
Furniture, fixtures and equipment	11,085	10,818
Leasehold improvements	1,384	1,198
	28,411	27,870
Less: Accumulated depreciation	(13,283)	(12,723)
	<u>\$ 15,128</u>	<u>\$ 15,147</u>

Depreciation expense was \$1.5 million, \$1.3 million, and \$1.2 million for 2008, 2007, and 2006.

Branch location rent expense was \$672,000, \$512,000 and \$409,000 for 2008, 2007, and 2006, respectively. Rent commitments under noncancelable operating leases (in thousands) were as follows, before considering renewal options that generally are present.

2009	\$ 626
2010	554
2011	546
2012	532
2013	404
Thereafter	1,355
Total	<u>\$ 4,017</u>

**NOTE 5 – GOODWILL AND INTANGIBLE ASSETS**

**Goodwill**

The change in balance for goodwill during the year is as follows (in thousands):

	2008	2007
Beginning of year	\$ 15,335	\$ 15,983
Acquisition adjustments	-	(648)
End of year	<u>\$ 15,335</u>	<u>\$ 15,335</u>

The adjustments to goodwill in 2007 resulted from the finalization of the fair value of assets acquired with the purchase of TBI on July 1, 2006.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 5 – GOODWILL AND INTANGIBLE ASSETS (Continued)**

**Acquired Intangible Assets**

Acquired intangible assets were as follows at year end (in thousands):

	2008		2007	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortized intangible assets:				
Core deposit intangibles (see Note 2)	\$ 3,069	\$ 930	\$ 3,069	\$ 581
Other customer relationship intangibles	443	90	443	32
Total	<u>\$ 3,512</u>	<u>\$ 1,020</u>	<u>\$ 3,512</u>	<u>\$ 613</u>

Aggregate amortization expense was \$407,000, \$438,000 and \$176,000 for 2008, 2007 and 2006.

Estimated amortization expense for each of the next five years (in thousands):

2009	\$ 395
2010	389
2011	377
2012	356
2013	332

**NOTE 6 – DEPOSITS**

Time deposits of \$100,000 or more were \$118.0 million and \$101.0 million at year-end 2008 and 2007. Brokered deposits were \$5.9 million at year-end 2008 and 2007.

Scheduled maturities of time deposits for the next five years (in thousands) were as follows:

2009	\$ 238,867
2010	41,441
2011	4,965
2012	2,406
2013	828

Deposits from principal officers, directors and their affiliates at year-end 2008 and 2007 were approximately \$28.7 million and \$22.2 million.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 7 – OTHER BORROWINGS**

Other borrowings consist of retail repurchase agreements representing overnight borrowings from deposit customers, federal funds purchased representing overnight borrowings from other financial institutions, lines of credit with other financial institutions and a structured repurchase agreement. The debt securities sold under the repurchase agreements were under the control of the subsidiary banks during 2008 and 2007.

The Company has available a revolving line of credit with a bank for \$10.0 million. The line of credit expires on June 30, 2009 and bears interest at LIBOR plus 1.25% (2.97% at December 31, 2008). Payments are due quarterly and are interest only. The line of credit is collateralized by 500 shares of Your Community Bank common stock. The outstanding balance on the line of credit was \$9.2 million and \$8.6 million at December 31, 2008 and 2007.

Information concerning 2008 and 2007 other borrowings is summarized as follows.

	2008	2007
	(Dollars in thousands)	
<b>Repurchase agreements at year-end</b>		
Balance	\$ 60,011	\$ 54,443
Weighted average interest rate	0.42%	3.36%
<b>Repurchase agreements during the year</b>		
Average daily balance	\$ 50,260	\$ 48,547
Maximum month-end balance	60,011	54,443
Weighted average interest rate	1.30%	4.10%
<b>Federal funds purchased and lines of credit at year-end</b>		
Balance	\$ 9,172	\$ 8,553
Weighted average interest rate	2.97%	6.01%
<b>Federal funds purchased and lines of credit during the year</b>		
Average daily balance	\$ 10,631	\$ 13,687
Maximum month-end balance	28,367	32,139
Weighted average interest rate	4.22%	5.78%
<b>Structured repurchase agreement at year-end</b>		
Balance	\$ 9,800	\$ 9,800
Weighted average interest rate	4.90%	2.79%
<b>Structured repurchase agreement during the year</b>		
Average daily balance	\$ 9,800	\$ 1,128
Maximum month-end balance	9,800	9,800
Weighted average interest rate	3.05%	2.72%



**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 8 - FEDERAL HOME LOAN BANK ADVANCES**

At year-end, advances from the Federal Home Loan Bank (FHLB) were as follows.

	2008		2007	
	Weighted Average Rate	Amount	Weighted Average Rate	Amount
	(Dollars in thousands)			
Fixed rate	4.90%	\$ 111,943	5.63%	\$ 91,376

The advances were collateralized by \$320.1 million and \$335.6 million of first mortgage and commercial real estate loans under a blanket lien arrangement and certain available for sale securities at year-end 2008 and 2007. Based on this collateral and the Company's holdings of FHLB stock, the Company is eligible to borrow an additional \$46.7 million at year-end 2008.

The contractual maturities of advances outstanding as of December 31, 2008 are as follows:

	(In thousands)
2009	\$ 31,991
2010	64,952
2011	10,000
2012	-
2013	5,000
	<u>\$ 111,943</u>

The fixed rate advances include of \$67.0 million in convertible advances. The FHLB has the quarterly right to require the Company to choose either conversion of the fixed rate to a variable rate tied to the three month LIBOR index or prepayment of the advance without penalty. There is a substantial penalty if the Company prepays the advances before FHLB exercises its right.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 9 - SUBORDINATED DEBENTURES**

On June 15, 2006, a trust formed by the Company, Community Bank Shares (IN) Statutory Trust II (Trust II), issued \$10.0 million of floating rate trust preferred securities as part of a pooled offering of such securities. On June 17, 2004, a trust formed by the Company, Community Bank Shares (IN) Statutory Trust I (Trust I), issued \$7.0 million of floating rate trust preferred securities as part of a pooled offering of such securities. The Company issued subordinated debentures to Trusts I and II in exchange for the proceeds of each offering; the debentures and related debt issuance costs represent the sole assets of Trusts I and II. Distributions on the trust preferred securities are payable quarterly in arrears at the annual rate (adjusted quarterly) of three-month LIBOR plus 1.70% (3.70% as of the last adjustment) for Trust II and three-month LIBOR plus 2.65% (4.52% as of the last adjustment) for Trust I and are included in interest expense.

The maturity dates of the subordinated debentures are June 15, 2036 for Trust II and June 17, 2034 for Trust I. The subordinated debentures may be redeemed by the Company, in whole or in part, at any distribution payment date on or after the distribution payment date in June 2011 for Trust II and June 2009 for Trust I, at the redemption price. The subordinated debentures have variable rates, adjusted quarterly, which are identical to the trust preferred securities. In addition, the subordinated debentures are redeemable in whole or in part from time to time, upon the occurrence of specific events defined within the trust debenture. The Company has the option to defer interest payments on the subordinated debt from time to time for a period not to exceed five consecutive years. Should interest payments be deferred, the Company is restricted from paying dividends until all deferred payments have been made.

Subordinated debentures are considered as Tier I capital for the Company under current regulatory guidelines.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 10 – BENEFIT PLANS**

**Defined Benefit Plans:** The Company sponsors a defined benefit pension plan. The benefits are based on years of service and the employees' highest average of total compensation for five consecutive years of employment. In 1997, the plan was amended such that there can be no new participants or increases in benefits to the participants. The Company uses December 31<sup>st</sup> as its measurement date for its pension plan.

A reconciliation of the projected benefit obligation and the value of plan assets follow.

	2008	2007
	(In thousands)	
<b>Change in projected benefit obligation</b>		
Balance, beginning of year	\$ 991	\$ 933
Interest cost	56	53
Actuarial (gain) loss	(47)	52
Benefits paid to participants	(33)	(47)
Ending benefit obligation	967	991
<b>Change in plan assets</b>		
Fair value, beginning of year	702	659
Actual return on plan assets	(211)	18
Employer contributions	128	72
Benefits paid to participants	(33)	(47)
Fair value, end of year	586	702
<b>Funded status</b>	<b>\$ (381)</b>	<b>\$ (289)</b>

Amounts recognized in accumulated other comprehensive loss consisted of a net actuarial loss of \$584,000 and \$372,000 at year-end 2008 and 2007. The accumulated benefit obligation was \$967,000 and \$991,000 at year-end 2008 and 2007. The funded status of the plan as of the years ended 2008 and 2007 is reported in other liabilities in the Company's consolidated financial statements.

**Components of Net Periodic Benefit Cost and Other Amounts Recognized in Other Comprehensive Loss**

	2008	2007	2006
	(Dollars in thousands)		
Interest cost	\$ 56	\$ 53	\$ 52
Expected return on plan assets	(56)	(53)	(49)
Amortization of unrecognized loss	8	27	43
Net periodic benefit cost	8	27	46
Net loss	212	60	-
Total recognized in other comprehensive loss	212	60	-
<b>Total recognized in net periodic benefit cost and other comprehensive loss</b>	<b>\$ 220</b>	<b>\$ 87</b>	<b>\$ 46</b>

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 10 – BENEFIT PLANS (Continued)**

The estimated net loss for the defined benefit pension plan that will be amortized from accumulated other comprehensive loss into net periodic benefit cost over the next fiscal year is \$16,000.

Assumptions

	2008	2007	2006
Discount rate on benefit obligation	6.00%	5.75%	5.75%
Rate of expected return on plan assets	8.00%	8.00%	8.00%
Discount rate for periodic benefit costs	5.75%	5.75%	5.50%

Plan Assets: The Company's target allocation for 2009, pension plan asset allocation at year-end 2008 and 2007, and expected long-term rate of return by asset category are as follows:

Asset Category	Target Allocation 2009	Percentage of Plan Assets at Year-end 2008	2007	Weighted-Average Expected Long-Term Rate of Return
Mutual funds	85%	98%	99%	9.0%
Money market	15	2	1	4.0
Total	100%	100%	100%	8.0%

The expected long-term return is based on a periodic review and modeling of the plan's asset allocation and liability structure over a long-term horizon. Expectations of returns on each asset class are the most important of the assumptions used in the review and modeling and are based on reviews of historical data. The expected long-term rate of return on assets was selected from within the reasonable range of rates determined by (a) historical real returns, net of inflation, for the asset classes covered by the investment policy, and (b) projections of inflation over the long-term period during which benefit are payable to plan participants.

Estimated Future Payments: The following benefit payments, which reflect expected future service, are expected (in thousands):

	Pension Benefits
2009	\$ 32
2010	32
2011	32
2012	32
2013	32
Years 2014-2018	260

The Company expects to contribute approximately \$44,000 to its pension plan in 2009.

Your Community Bank is a participant in the Financial Institutions Retirement Fund, a multi-employer defined benefit pension plan covering two of its employees. Employees are fully vested at the completion of five years of participation in the plan. No contributions were required during the three-year period ended December 31, 2008. There have been no new enrollments since 1998.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 10 – BENEFIT PLANS (Continued)**

Defined Benefit Plans - SCSB:

The Company acquired a defined benefit retirement plan upon the purchase of SCSB. Per the merger agreement, the plan was curtailed. The Company settled this plan in the fourth quarter of 2007 which resulted in a gain of \$49,000.

Employee Stock Ownership Plan: In the fourth quarter of 2007, the Company terminated the ESOP and distributed all the shares held in the ESOP trust to participants. Contributions to the ESOP and expense were \$0 for 2008, 2007 and 2006.

Deferred Compensation Arrangements: The Company has entered into deferred compensation arrangements with certain directors and officers. The liability for such arrangements is fully accrued during the service period, with benefits paid monthly upon retirement until death, or date specified by the agreement. The liability was \$295,000 and \$360,000 at December 31, 2008 and 2007, respectively, and was included in other liabilities in the Company's consolidated financial statements. Expense related to these arrangements for 2008, 2007 and 2006 was \$(11,000), \$15,000 and \$17,000.

Defined Contribution Plans: The 401(k) benefit plan matches employee contributions equal to 100% of the first 3% plus 50% of the next 2% of the compensation contributed. Expense for 2008, 2007 and 2006 was \$274,000, \$213,000 and \$206,000.

**NOTE 11 – STOCK-BASED COMPENSATION PLANS**

The Company has three share based compensation plans as described below. Total compensation cost that has been charged against income for those plans was \$325,000, \$122,000, and \$332,000 for 2008, 2007, and 2006. The total income tax benefit was \$68,000, \$1,000, and \$82,000.

Stock Options: The Company's stock option plan provides for the granting of both incentive and nonqualified stock options for up to 400,000 shares of common stock at exercise prices not less than the fair market value of the common stock on the date of grant and expiration dates of up to ten years. Terms of the options are determined by the Board of Directors at the date of grant and generally vest over periods of three to four years. Non-employee directors are eligible to receive only nonqualified stock options. As of December 31, 2008, the plan allows for additional option grants of up to 217,550 shares.

The fair value of each option award is estimated on the date of grant using the Black-Scholes model that uses the assumptions noted in the table below. Expected volatilities are based on historical volatilities of the Company's common stock. The Company uses historical data to estimate option exercise and post-vesting termination behavior. 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, which takes 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.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 11 – STOCK-BASED COMPENSATION PLANS (Continued)**

The fair value of options granted was determined using the following weighted-average assumptions as of grant date. The Company did not grant options during 2008.

	2007	2006
Risk-free interest rate	5.10%	5.07%
	5.7	5.7
Expected term	years	years
Expected stock price volatility	15.38%	16.09%
Dividend yield	3.24%	2.91%

A summary of the activity in the stock option plan for 2008 follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
	(In thousands)		(In thousands)	
Outstanding at beginning of year	301	\$ 20.40		
Granted	-	-		
Exercised	-	-		
Forfeited	(5)	21.98		
Expired	(33)	18.88		
Outstanding at end of year	263	\$ 20.56	7.1	\$ -
Vested and expected to vest	263	\$ 20.56	7.1	\$ -
Exercisable at end of year	150	\$ 19.35	4.5	\$ -

Information related to the stock option plan during each year follows (in thousands, except for weighted fair value of options granted):

	2008	2007	2006
Intrinsic value of options exercised	\$ -	\$ -	\$ 9
Cash received from option exercises	-	-	15
Tax benefit realized from option exercises	-	-	80
Weighted average fair value of options granted	-	2.76	3.61

As of December 31, 2008, there was \$116,000 of total unrecognized compensation cost related to nonvested stock options granted under the Plan. The cost is expected to be recognized over a weighted-average period of 1.18 years.

**Performance Units Awards:** The Company may grant performance unit awards to employees for up to 275,000 shares of common stock. The level of performance shares eventually distributed is contingent upon the achievement of specific performance criteria within a specified award period set at the grant date. The Company estimates the progress toward achieving these objectives when estimating the number of awards expected to vest and correspondingly, periodic compensation expense.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 11 – STOCK-BASED COMPENSATION PLANS (Continued)**

The compensation cost attributable to these restricted performance units awards is based on both the fair market value of the shares at the grant date and the Company's stock price at the end of a reporting cycle. Thirty-five percent of the total award will be paid in cash and is therefore classified as a liability, with total compensation cost changing as the Company's stock price changes. The remaining sixty-five percent is classified as an equity award; total compensation cost is based on the fair market value of sixty-five percent of the total award on the date of grant. The compensation expense is recognized over the specified performance period.

A summary of changes in the Company's nonvested units for the year follows:

Nonvested Units	Units (In thousands)	Weighted- Average Grant-Date Fair Value
Nonvested at January 1, 2008	29	\$ 22.45
Granted	23	18.68
Vested	(29)	22.45
Forfeited	-	-
Nonvested at December 31, 2008	<u>23</u>	<u>\$ 18.68</u>

As of December 31, 2008, there was \$70,000 of total unrecognized compensation cost related to nonvested units granted under the Plan. The cost is expected to be recognized over a weighted-average period of 1.0 years. The total fair value of units vested during the years ended December 31, 2008, 2007 and 2006 was \$335,000, \$0 and \$259,000. There were no modifications or cash paid to settle performance unit awards during the three year period ending December 31, 2008.

**Restricted Share Awards:** The Company may grant restricted share awards to employees for up to 400,000 shares of common stock. Compensation expense is recognized over the vesting period of the awards based on the fair value of the stock at issue date. The fair value of the stock was determined using the market value of the Company's stock on the grant date. The restricted shares fully vest on the third anniversary of the grant date.

A summary of changes in the Company's nonvested shares for the year follows:

Nonvested Shares	Shares (In thousands)	Weighted- Average Grant-Date Fair Value
Nonvested at January 1, 2008	-	\$ -
Granted	20	18.72
Vested	-	-
Forfeited	-	-
Nonvested at December 31, 2008	<u>20</u>	<u>\$ 18.72</u>

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 11 – STOCK-BASED COMPENSATION PLANS (Continued)**

As of December 31, 2008, there was \$259,000 of total unrecognized compensation cost related to nonvested shares granted under the Plan. The cost is expected to be recognized over a weighted-average period of 2.1 years. There were no shares that vested during the years ended December 31, 2008, 2007 and 2006. There were no modifications or cash paid to settle restricted share awards during the three year period ended December 31, 2008.

**NOTE 12 - INCOME TAXES**

Income tax expense (benefit) was as follows.

	2008	2007	2006
		(In thousands)	
Current	\$ 383	\$ 1,221	\$ 1,177
Deferred	(1,458)	(393)	81
Change in valuation allowance	384	77	85
Total	<u>\$ (691)</u>	<u>\$ 905</u>	<u>\$ 1,343</u>

Effective tax rates differ from federal statutory rates applied to financial statement income due to the following.

	2008		2007		2006	
			(Dollars in thousands)			
Federal statutory rate times financial statement income	\$ 44	34.0%	\$ 1,499	34.0%	\$ 1,854	34.0%
Effect of:						
Tax-exempt income	(381)	(292.6)	(253)	(5.7)	(222)	(4.1)
State taxes, net of federal benefit	(384)	(294.7)	(77)	(1.7)	(85)	(1.6)
Change in valuation allowance	384	294.7	77	1.7	85	1.6
Nontaxable earnings on company owned insurance policies	(250)	(191.5)	(231)	(5.2)	(195)	(3.6)
New markets tax credit	(180)	(138.1)	(180)	(4.1)	(150)	(2.8)
Incentive stock options expense	43	32.8	40	0.9	31	0.6
Other, net	33	25.3	30	0.6	25	0.5
Total	<u>\$ (691)</u>	<u>(530.1)%</u>	<u>\$ 905</u>	<u>20.5%</u>	<u>\$ 1,343</u>	<u>24.6%</u>



**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 12 - INCOME TAXES** (Continued)

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

	2008	2007
	(In thousands)	
Deferred tax assets:		
Allowance for loan losses	\$ 3,222	\$ 2,528
Employee benefit plans	100	229
Minimum pension liability	198	126
Net unrealized loss on securities available for sale	126	-
Net unrealized depreciation on interest rate swap	-	80
Net operating loss carryforward	806	422
Other	142	46
	4,594	3,431
Deferred tax liabilities:		
Premises and equipment	(407)	(489)
FHLB stock	(308)	(362)
Deferred loan fees and costs	(254)	(169)
Mortgage servicing rights	(23)	(59)
Net unrealized gain on securities available for sale	-	(7)
Fair value adjustments from acquisitions	(238)	(266)
Intangible assets	(847)	(1,159)
Prepaid pension expense	-	(32)
Prepaid expenses	(102)	(173)
Other	(143)	(106)
	(2,322)	(2,822)
Valuation allowance on net deferred tax assets	(806)	(422)
Net deferred tax asset	\$ 1,466	\$ 187

The Company incurred net operating losses for state income taxes during years 2002 through 2008 which will be carried forward and applied to future state taxable income. Due to the uncertainty of the Company's ability to use this benefit, a valuation allowance has been recorded. The cumulative state net operating loss is \$7.1 million and can be carried forward for 15 years with expiration beginning in 2017.

Retained earnings of Your Community Bank includes approximately \$3.7 million for which no deferred income tax liability has been recognized. This amount represents an allocation of income to bad debt deductions as of December 31, 1987 for tax purposes only. Reduction of amounts so allocated for purposes other than tax bad debt losses including redemption of bank stock or excess dividends, or loss of "bank" status would create income for tax purposes only, which would be subject to the then-current corporate income tax rate. The unrecorded deferred income tax liability on the above amount for Your Community Bank at December 31, 2008 was approximately \$1.3 million.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 12- INCOME TAXES (Continued)**

Unrecognized Tax Benefits

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

	2008	2007
	(In thousands)	
Balance at January 1	\$ 55	\$ 51
Additions based on tax positions related to the current year	-	24
Reductions due to statute of limitations	-	(20)
Reductions for tax positions of prior years	(55)	-
Balance at December 31	<u>\$ -</u>	<u>\$ 55</u>

As of December 31, 2007, the Company's 2004 and 2005 federal tax returns were being audited by the Internal Revenue Service. In the first quarter of 2008, the Company received notification the Internal Revenue Service had completed their audits and had determined adjustments were not required for tax positions taken in those returns. Accordingly, the Company reduced its reserve for unrecognized tax benefits in 2008 by \$55,000.

The total amount of interest and penalties recorded in the income statement for the years ended December 31, 2008 and 2007 were \$0 and \$(3,000), and the amount accrued for interest and penalties at December 31, 2008 and 2007 were \$0 and \$17,000.

The Company and its subsidiaries are subject to U.S. federal income tax as well as income tax of the states of Indiana and Kentucky. The Company is no longer subject to examination by taxing authorities for years before 2005.

**NOTE 13 - CAPITAL REQUIREMENTS AND RESTRICTIONS ON RETAINED EARNINGS**

Banks and bank holding companies are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, 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.

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, 2008 and 2007, the most recent regulatory notifications categorized YCB and SCSB as well capitalized under the regulatory framework for prompt corrective action. There are no considerations or events since December 31, 2008 that management believes have changed the institution's classification as well capitalized.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 13 - CAPITAL REQUIREMENTS AND RESTRICTIONS ON RETAINED EARNINGS (Continued)**

YCB currently has a regulatory agreement with the FDIC that requires YCB to maintain a Tier 1 capital ratio of 8%. YCB is currently in compliance with the Tier 1 capital requirement.

Actual and required capital amounts and ratios are presented below at year-end.

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in millions)						
<u>2008</u>						
Total Capital (to Risk Weighted Assets):						
Consolidated	\$ 70.7	10.7%	\$ 52.7	8.0%	N/A	N/A
Your Community Bank	65.5	11.5	45.4	8.0	56.8	10.0%
Scott County State Bank	13.4	14.1	7.6	8.0	9.5	10.0
Tier I Capital (to Risk Weighted Assets):						
Consolidated	\$ 62.4	9.5%	\$ 26.3	4.0%	N/A	N/A
Your Community Bank	58.3	10.3	22.7	4.0	34.1	6.0%
Scott County State Bank	12.7	13.3	3.8	4.0	5.7	6.0
Tier I Capital (to Average Assets):						
Consolidated	\$ 62.4	7.6%	\$ 33.1	4.0%	N/A	N/A
Your Community Bank	58.3	8.2	28.3	4.0	35.4	5.0%
Scott County State Bank	12.7	9.4	5.4	4.0	6.7	5.0
<u>2007</u>						
Total Capital (to Risk Weighted Assets):						
Consolidated	\$ 69.8	10.9%	\$ 51.1	8.0%	N/A	N/A
Your Community Bank	62.6	11.2	44.6	8.0	55.8	10.0%
Scott County State Bank	13.7	15.9	6.9	8.0	8.6	10.0
Tier I Capital (to Risk Weighted Assets):						
Consolidated	\$ 63.5	9.9%	\$ 25.6	4.0%	N/A	N/A
Your Community Bank	56.9	10.2	22.3	4.0	33.5	6.0%
Scott County State Bank	13.1	15.2	3.4	4.0	5.2	6.0
Tier I Capital (to Average Assets):						
Consolidated	\$ 63.5	8.0%	\$ 31.9	4.0%	N/A	N/A
Your Community Bank	56.9	8.6	26.5	4.0	33.1	5.0%
Scott County State Bank	13.1	9.5	5.5	4.0	6.9	5.0

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 13 - CAPITAL REQUIREMENTS AND RESTRICTIONS ON RETAINED EARNINGS (Continued)**

Dividend Restrictions: The Company's principal source of funds for dividend payments is dividends received from the Banks. 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 retained net profits, combined with the retained net profits of the preceding two years, subject to the capital requirements described above. During 2009, the YCB and SCSB could, without prior approval, declare dividends of approximately \$799,000 and \$0 plus any 2009 net profits retained to the date of the dividend declaration, respectively.

**NOTE 14 – INTEREST RATE SWAPS**

On August 30, 2002, the Company entered into a \$25,000,000 notional amount interest rate swap arrangement to exchange variable payments of interest tied to Prime for receipt of fixed rate payments of 6.51% which matured on August 30, 2007. An additional \$25,000,000 notional amount interest rate swap was entered into on June 19, 2003 to exchange variable payments of interest tied to Prime for receipt of fixed rate payments of 5.22% which matured on June 19, 2008. The variable rate of the swaps reset daily, with net interest being settled monthly. The notional amount of the swaps did not represent amounts exchanged by the parties. The amounts exchanged were determined by reference to the notional amount and other terms of the swaps.

Prior to December 31, 2007, these interest rate swap agreement were reported, and had been since their inception, as cash flow hedges as the Company believed the critical terms of the swap agreements matched the critical terms of the variable rate loans and concluded that interest rate swap agreements were effective cash flow hedges. As of December 31, 2007, the Company determined that accounting for these agreements as cash flows hedges was in error because a critical term did not match. The Company did not designate the swap agreements to pools of variable rate loans with like spreads to prime rate, such as prime plus .25%, prime plus .50%, etc., but did so only in total. Therefore, fluctuations in the fair value of the interest rate swaps should have been recorded in other non-interest income instead of in other comprehensive loss. As of December 31, 2007, the remaining interest rate swap had a fair value of \$234,000, which amount was reversed out of other comprehensive loss and reported in other non-interest income. The Company reported a gain of \$234,000 on the maturation of the swap for the year-ended December 31, 2008. During the 12 months ended December 31, 2008, 2007 and 2006, respectively, the Company recognized expense of \$54,000, \$1,014,000 and \$1,061,000, respectively. The fair value of the swap was a liability of \$234,000 as of year-end 2007 and was reported in other liabilities in the Company's consolidated financial statements.

**NOTE 15 - OFF-BALANCE-SHEET ACTIVITIES**

Some financial instruments, such as commitments to make loans for the Company's portfolio, credit lines and letters of credit, 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, and usually have expiration dates. 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 exercise of the commitment.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 15 - OFF-BALANCE-SHEET ACTIVITIES (Continued)**

The contractual amount of financial instruments with off-balance-sheet risk was as follows at year-end.

	2008		2007	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
	(In thousands)			
Commitments to make loans	\$ 1,734	\$ 350	\$ 858	\$ 13,731
Unused lines of credit	2,493	119,803	8,043	127,959
Letters of credit	-	5,737	-	6,914

Commitments to make loans are generally made for periods of 30 days or less and are at market rates. The fixed rate loan commitments have interest rates ranging from approximately 4.88% to 8.88% and maturities ranging from 3 years to 15 years.

**NOTE 16 - FAIR VALUE**

FASB Statement No. 157 establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

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, and other inputs that are observable or can be corroborated by observable market data.

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

The Company used the following methods and significant assumptions to estimate fair value.

Securities: The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). In instances where broker quotes are used, these quotes are obtained from market makers or broker-dealers recognized to be market participants. These valuation methods are classified as Level 2 in the fair value hierarchy.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 16 - FAIR VALUE (Continued)**

Collateralized debt obligations which are issued by financial institutions and insurance companies were historically priced using Level 2 inputs, the decline in the level of observable inputs and market activity in this class of investments by the measurement date has been significant and resulted in unreliable external pricing. Broker pricing and bid/ask spreads, when available, vary widely. The once active market has become comparatively inactive. As such, these investments are now priced using Level 3 inputs. The fair values of our collateralized debt obligations are determined by capital market traders of our bond accountant using a base discount margin driven by current market fundamentals adjusted for characteristics unique to each security and the security's discounted projected cash flows.

Impaired Loans: The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are typically significant and result in a Level 3 classification of the inputs for determining fair value.

Servicing Rights: The fair value of servicing rights is based on a valuation model that calculates the present value of estimated net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income. The Company is able to compare the valuation model inputs and results to widely available published industry data for reasonableness (Level 2 inputs).

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

Assets at Fair Value at December 31, 2008	Fair Value Measurements at December 31, 2008, Using		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(in thousands)	
<u>Assets:</u>			
Available for sale securities	\$ 121,659	\$ —	\$ 118,374 \$ 3,285

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 16 - FAIR VALUE** (Continued)

The rollforward of activity for the Company's significant unobservable inputs (Level 3) is as follows:

	Twelve Months Ended December 31, 2008 (in thousands)
Balance, January 1, 2008	\$ —
Transfer into level 3, April 1, 2009	5,189
Net unrealized loss	(1,756)
Principal paydowns	(148)
Balance, December 31, 2008	<u>\$ 3,285</u>

Assets measured at fair value on a nonrecurring basis are summarized below.

	Assets at Fair Value at December 31, 2008	Fair Value Measurements at December 31, 2008, Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
			(in thousands)	
<b>Assets:</b>				
Impaired loans	\$ 15,776	\$ —	\$ —	\$ 15,776
Mortgage servicing rights	69	—	69	—

The Company measures for impairment using the fair value of the collateral for collateral-dependent loans. The Company's impaired loans totaled \$20.2 million as of December 31, 2008, which included collateral-dependent loans with a carrying value of \$15.8 million. As of December 31, 2008, the Company's collateral dependent loans had a valuation allowance of \$4.4 million, resulting in an additional provision for loan losses of \$3.7 million during the twelve months ended December 31, 2008.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 16 - FAIR VALUE** (Continued)

**Fair value of Financial Instruments**

Carrying amount and estimated fair values of financial instruments, not previously presented, were as follows at year-end.

	2008		2007	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(In thousands)			
<b>Financial assets</b>				
Cash and due from financial institutions	\$ 19,724	\$ 19,724	\$ 14,570	\$ 14,570
Interest-bearing deposits in other financial institutions	45,749	45,749	13,943	13,943
Loans held for sale	308	312	757	767
Loans, net	623,103	615,501	629,732	636,433
Accrued interest receivable	3,163	3,163	3,537	3,537
Federal Home Loan Bank and Federal Reserve Stock	8,472	n/a	8,096	n/a
<b>Financial liabilities</b>				
Deposits	603,185	589,537	573,346	565,741
Other borrowings	78,983	80,158	72,796	72,796
Federal Home Loan Bank Advances	111,943	116,007	91,376	94,431
Subordinated debentures	17,000	12,699	17,000	16,220
Accrued interest payable	1,705	1,705	1,956	1,956
Interest rate swap	-	-	234	234

The methods and assumptions used to estimate fair value are described as follows:

The estimated fair value equals the carrying amount for cash and due from banks, interest-bearing deposits in other financial institutions, accrued interest receivable and payable, demand deposits, other borrowings, and variable rate loans or deposits that reprice frequently and fully. Interest rate swap fair values are based on market prices or dealer quotes. For fixed rate loans or deposits and for variable rate loans or deposits 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 loans held for sale is based on market quotes. It is not practical to determine the fair value of FHLB and Federal Reserve stock due to restrictions placed on transferability. Fair value of FHLB advances and subordinated debentures are based on current rates for similar financing. The fair value of off-balance-sheet items is based on current fees or costs that would be charged to enter into or terminate such arrangements and is not material.



**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 17- PARENT COMPANY ONLY CONDENSED FINANCIAL INFORMATION**

Condensed financial information for Community Bank Shares of Indiana, Inc. is as follows:

**CONDENSED BALANCE SHEETS**

	December 31,	
	2008	2007
	(In thousands)	
<b>ASSETS</b>		
Cash and due from financial institutions	\$ 826	\$ 7
Interest-bearing deposits in other financial institutions	5	-
Investment in subsidiaries	88,583	88,217
Other assets	799	2,656
Total assets	<u>\$ 90,213</u>	<u>\$ 90,880</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Other borrowings	\$ 9,172	\$ 8,554
Subordinated debentures	17,000	17,000
Accrued expenses and other liabilities	1,442	861
Total liabilities	27,614	26,415
Total shareholders' equity	62,599	64,465
	<u>\$ 90,213</u>	<u>\$ 90,880</u>

**CONDENSED STATEMENTS OF INCOME**

	Years ended December 31,		
	2008	2007	2006
	(In thousands)		
Income			
Dividends from subsidiaries	\$ 4,000	\$ 4,500	\$ 950
Expense			
Operating expenses	2,669	3,171	2,057
Income (loss) before income taxes and equity			
in undistributed net income of subsidiaries	1,331	1,329	(1,107)
Income tax benefit	864	1,037	668
Income (loss) before equity in undistributed net			
income of subsidiaries	2,195	2,366	(439)
Equity in undistributed net income (loss) of subsidiaries	(1,374)	1,137	4,550
Net Income	<u>\$ 821</u>	<u>\$ 3,503</u>	<u>\$ 4,111</u>

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 17 - PARENT COMPANY ONLY CONDENSED FINANCIAL INFORMATION** (Continued)

**CONDENSED STATEMENTS OF CASH FLOWS**

	Years ended December 31,		
	2008	2007	2006
<b>Cash flows from operating activities</b>	(In thousands)		
Net income	\$ 821	\$ 3,503	\$ 4,111
Adjustments to reconcile net income to net cash from operating activities			
Equity in undistributed net (income) loss of subsidiaries	1,374	(1,137)	(4,550)
Share-based compensation expense	309	122	332
Net change in other assets and liabilities	2,297	(1,415)	63
Net cash from operating activities	4,801	1,073	(44)
<b>Cash flows from investing activities</b>			
Acquisition of The Bancshares, Inc.	-	-	(11,001)
Net change in interest-bearing deposits with banks	(5)	-	-
Investment in subsidiary	(2,000)	-	-
Net cash from investing activities	(2,005)	-	(11,001)
<b>Cash flows from financing activities</b>			
Net change in short-term borrowings	618	5,074	3,480
Proceeds from issuance of subordinated debenture	-	-	10,000
Exercise of stock options	-	-	15
Purchase of treasury stock	(400)	(3,904)	(685)
Tax benefit of stock options exercised	-	-	80
Cash dividends paid	(2,195)	(2,299)	(1,921)
Net cash from financing activities	(1,977)	(1,129)	10,969
Net change in cash	819	(56)	(76)
Cash at beginning of year	7	63	139
<b>Cash at end of year</b>	<b>\$ 826</b>	<b>\$ 7</b>	<b>\$ 63</b>

COMMUNITY BANK SHARES OF INDIANA, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2008, 2007 and 2006

**NOTE 18 – EARNINGS PER SHARE**

The factors used in the earnings per share computation follows.

	2008	2007	2006
	(In thousands, except share and per share amounts)		
<b>Basic</b>			
Net Income	\$ 821	\$ 3,503	\$ 4,111
Average shares:			
Common shares issued	3,863,942	3,863,942	3,436,051
Less: Treasury stock	(615,157)	(514,521)	(413,004)
Average shares outstanding	3,248,785	3,349,421	3,023,047
Net income per common share, basic	\$ 0.25	\$ 1.05	\$ 1.36
<b>Diluted</b>			
Net Income	\$ 821	\$ 3,503	\$ 4,111
Average shares:			
Common shares outstanding for basic	3,248,785	3,349,421	3,023,047
Add: Dilutive effects of outstanding options	10,376	24,802	32,610
Average shares and dilutive potential common shares	3,259,161	3,374,223	3,055,657
Net income per common share, diluted	\$ 0.25	\$ 1.04	\$ 1.35

Stock options of 241,000, 197,000, and 138,000 common shares were excluded from 2008, 2007, and 2006 diluted earnings per share because they were anti-dilutive.

Performance units of 22,500, 28,500, and 30,500 were excluded from 2008, 2007, and 2006 diluted earnings per share because all the conditions required for issuance at those dates had not been met.

**COMMUNITY BANK SHARES OF INDIANA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2008, 2007 and 2006**

**NOTE 19 – OTHER COMPREHENSIVE INCOME (LOSS)**

Other comprehensive income (loss) components and related taxes were as follows.

	2008	2007	2006
	(In thousands)		
Unrealized holding gains (losses) on available for sale securities	\$ (27)	\$ 1,216	\$ 958
Less reclassification adjustments for (gains) losses recognized in income	(364)	41	-
Net unrealized gain (loss) on securities available for sale, net of reclassifications	(391)	1,257	958
Unrealized holding gain (loss) on interest rate swaps	-	44	(473)
Amounts reclassified to interest income	-	1,014	1,061
Net unrealized gain (loss) on interest rate swaps, net of reclassifications	-	1,058	588
Change in minimum pension liability	-	-	125
Unrealized loss on pension benefits	(212)	(60)	-
Other comprehensive income (loss) before tax effects	(603)	2,255	1,671
Tax effect	202	(907)	(574)
Other comprehensive income (loss)	\$ (401)	\$ 1,348	\$ 1,097

**NOTE 20 – QUARTERLY FINANCIAL DATA (UNAUDITED)**

	Interest Income	Net Interest Income	Net Income (Loss)	Earnings (Loss) Per Share	
				Basic	Diluted
	(In thousands, except per share amounts)				
<u>2008</u>					
First quarter	\$ 11,802	\$ 5,782	\$ 1,036	\$ 0.32	\$ 0.32
Second quarter	11,088	5,886	218	0.07	0.06
Third quarter	11,280	5,946	919	0.28	0.28
Fourth quarter	10,737	5,840	(1,352)	(0.42)	(0.42)
<u>2007</u>					
First quarter	\$ 12,638	\$ 5,517	\$ 1,015	\$ 0.30	\$ 0.29
Second quarter	12,797	5,669	915	0.27	0.27
Third quarter	12,881	5,593	1,088	0.33	0.33
Fourth quarter	12,446	5,588	485	0.15	0.15

Net income for the second and fourth quarters of 2008 and the fourth of 2007 were substantially impacted by increased provision for loan losses in those periods as compared to other periods in those years. The provision for loan losses for the second and fourth quarters of 2008 and the fourth quarter of 2007 were \$1.9 million, \$3.5 million, and \$892,000, respectively.

## Part II

### **Item 9. Changes In And Disagreements With Accountants On Accounting And Financial Disclosures**

There has been no change in the Company's principal independent accountant during the Company's two most recent fiscal years.

### **Item 9A. Controls And Procedures**

Company management, including the Chief Executive Officer (serving as the principal executive officer) and Chief Financial Officer (serving as the principal financial officer), have conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Securities Exchange Act of 1934 Rule 13a-14. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the disclosure controls and procedures are effective in timely alerting them to material information required to be included in this report. There has been no change in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that has materially affected or is reasonable likely to materially affect the Company's internal control over financial reporting.

## MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Community Bank Shares of Indiana's (the Company's) management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) or 15d-15(f) under the Securities Exchange Act of 1934 as a process designed by, or under the supervision of, the Company's principal executive and principal financial officers and effected by the Company's Board of Directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the Company's assets;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. 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.

Our management, including our principal executive officer and principal financial officer, assessed the effectiveness of our internal control over financial reporting as of the end of the fiscal year covered by this annual report on Form 10-K. In making this assessment, our management used the criteria set forth in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on our management's assessment, management concluded that, as of December 31, 2008, our Company's internal control over financial reporting is effective based on the COSO criteria.

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 temporary rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this annual report.

/s/ James D. Rickard

James D. Rickard  
President and Chief Executive Officer

/s/ Paul A. Chrisco

Paul A. Chrisco  
Executive Vice President and  
Chief Financial Officer

**Item 9B. Other Information**

There was no information to be disclosed by the Company on a Form 8-K during the fourth quarter of 2008 but not reported.

**Part III**

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

The information regarding Company directors required by this item is incorporated herein by reference to information under the headings “Corporate Governance and Board Matters” and “Proposal No. 1 – Election of Directors” in our definitive proxy statement, to be filed with the SEC, relating to our 2009 annual meeting of shareholders (“2009 Proxy Statement”)the 2009 Proxy Statement. Information regarding the members of the Audit Committee, the Company’s code of business conduct and ethics, the identification of the Audit Committee Financial Expert and stockholder nominations of directors is also incorporated by reference to the information under the aforesaid headings. The information regarding our executive officers required by this item is incorporated by reference to the information in the 2009 Proxy Statement.

**Section 16(a) Beneficial Ownership Reporting Compliance**

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires the Company’s directors and executive officers and person who own more than 10% of the Company’s common stock to file reports of ownership and changes in ownership with the SEC. Based solely upon a review of the Forms 3, 4 and 5 filed during 2008, and written representations from certain reporting persons that no Forms 5 were required, the Company reasonably believes that all required reports were timely filed.

**Item 11. Executive Compensation**

Information concerning executive compensation is incorporated herein by reference to the information under the heading “EXECUTIVE COMPENSATION” in the 2009 Proxy Statement.

**Item 12. Security Ownership Of Certain Beneficial Owners And Management And Related Stockholder Matters**

Information concerning security ownership of management is incorporated herein by reference to the information under the heading “STOCK OWNERSHIP BY DIRECTORS AND EXECUTIVE OFFICERS” in the 2009 Proxy Statement.

**Item 13. Certain Relationships And Related Transactions, And Director Independence**

Information concerning relationships and related transactions, and director independence is incorporated herein by reference to the information under the headings “COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION”, “CORPORATE GOVERNANCE AND BOARD MATTERS” and “CERTAIN RELATIONSHIPS AND RELATED PERSON TRANSACTIONS” in the 2009 Proxy Statement.

**Item 14. Principal Accountant Fees And Services**

Information concerning principal accountant fees and services is incorporated herein by reference to the information under the headings “REPORT OF THE AUDIT COMMITTEE” and “RATIFICATION OF APPOINTMENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM” in the 2009 Proxy Statement.

## Part IV

### **Item 15. Exhibits And Financial Statement Schedules**

#### (a)(1) Financial Statements

The following financial statements are included in Item 8 of this Form 10-K:

Report of Independent Registered Public Accounting Firm  
Consolidated Balance Sheets  
Consolidated Statements of Income  
Consolidated Statements of Changes in Shareholders' Equity  
Consolidated Statements of Cash Flows  
Notes to Consolidated Financial Statements

#### (a)(2) Financial Statement Schedules

All financial statement schedules have been omitted as the required information is inapplicable or the required information has been included in the Consolidated Financial Statements or notes thereto.

#### (a) (3) Exhibits

Reference is made to the Exhibit Index beginning on Page E-1 hereof.



## 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.

### COMMUNITY BANK SHARES OF INDIANA, INC.

March 31, 2009

By: /s/ James D. Rickard  
James D. Rickard  
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange 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.

<u>/s/ James D. Rickard</u> James D. Rickard	President, Chief Executive Officer, and Director (Principal Executive Officer)	March 31, 2009
<u>/s/ Paul A. Chrisco</u> Paul A. Chrisco	Senior Vice-President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 31, 2009
<u>/s/ Timothy T. Shea</u> Timothy T. Shea	Chairman of the Board of Directors and Director	March 31, 2009
<u>/s/ Gary L. Libs</u> Gary L. Libs	Director	March 31, 2009
<u>/s/ R. Wayne Estopinal</u> R. Wayne Estopinal	Director	March 31, 2009
<u>/s/ George M. Ballard</u> George M. Ballard	Director	March 31, 2009
<u>/s/ Gordon L. Huncilman</u> Gordon L. Huncilman	Director	March 31, 2009
<u>/s/ Kerry M. Stemler</u> Kerry M. Stemler	Director	March 31, 2009
<u>/s/ Steven R. Stemler</u> Steven R. Stemler	Director	March 31, 2009
<u>/s/ Norman E. Pfau</u> Norman E. Pfau	Director	March 31, 2009

**Exhibit Index**

## Incorporated By Reference

Exhibit Number	Document	Filed with this Form 10-K	Form	File No.	Date Filed
2.1	Agreement and Plan of Merger between Community Bank Shares of Indiana, Inc., The Bancshares, Inc., and CBIN Subsidiary, Inc.				
			8-K	000-25766	02/16/2006
3.1	Articles of Incorporation		8-K	000-25766	07/27/2007
3.2	Bylaws		8-K	000-25766	07/27/2007
4.0	Common Stock Certificate		8-K	000-25766	07/27/2007
10.1	Employment Agreement with Dale Orem *		10-K	000-25766	04/02/2002
10.2	Employment Agreement with Robert E. Yates*		10-K	000-25766	04/02/2002
10.3	Employment Agreement James D. Rickard *		10-Q	000-25766	11/14/2000
10.4	Community Bank Shares of Indiana, Inc. 1997 Stock Incentive Plan *				07/29/1998
			S-8	333- 60089	
10.5	Community Bank Shares of Indiana, Inc. Dividend Reinvestment Plan *		S-3D	333-40211	11/14/1997
			S-3D	333-130721	12/28/2005
10.6	Employment Agreement with Christopher L. Bottorff *		10-K	000-25766	03/31/2003
10.7	Employment Agreement with Kevin J. Cecil *		10-K	000-25766	03/31/2004
10.8	Employment Agreement with Paul A. Chrisco *		10-K	000-25766	03/31/2004
10.9	Consulting Agreement with Dale L. Orem *		10-K	000-25766	03/31/2004
10.10	Community Bank Shares of Indiana, Inc. and Affiliates Business Ethics Policy				
			8-K	000-25766	04/24/2007
10.11	Community Bank Shares of Indiana, Inc. 2005 Stock Award Plan		Exh. B to DEF 14A	000-25766	11/06/2006
10.12	Amendment to Employment Agreement with James D. Rickard *				
			8-K	000-25766	11/06/2006
10.13	Amendment to Employment Agreement with Christopher L. Bottorff *				
			8-K	000-25766	11/06/2006
10.14	Amendment to Employment Agreement with Kevin J. Cecil *				
			8-K	000-25766	11/06/2006
10.15	Amendment to Employment Agreement with Paul A. Chrisco *				
			8-K	000-25766	11/06/2006
10.16	Amendment to Community Bank Shares of Indiana, Inc. Performance Units Plan				
			8-K	000-25766	10/23/2006
11.1	Computation of Earnings Per Share	X			
21.0	Subsidiaries of Registrant	X			
23.1	Consent of Crowe Horwath LLP	X			
31.1	Certification of Principal Executive Officer Pursuant to 18 U.S.C. Section 1350 (As Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002)				
		X			
31.2	Certification of Principal Financial Officer Pursuant to 18 U.S.C. Section 1350 (As Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002)				
		X			
32.1	Certification of Principal Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	X			
		X			
32.2	Certification of Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	X			

\* Management contract or compensatory plan or arrangement required to be filed as an exhibit to this Report pursuant to Item 601 of Regulation S-K.



---

**Exhibit 11.1 - Computation of Earnings Per Share**

See note 18 to the Consolidated Financial Statements.

**Exhibit 21 - Subsidiaries of Registrant**

<u>Name of Subsidiary</u>	<u>State of Incorporation or Organization</u>
Your Community Bank	Indiana
CBSI Holdings, Inc.	Nevada
CBSI Investments, Inc.	Nevada
CBSI Investment Portfolio Management, LLC	Nevada
CBSI Development Fund, Inc.	Indiana
First Community Service Corporation	Indiana
Nelson Service Corporation	Kentucky
The Scott County State Bank	Indiana

---

**Exhibit 23.1****CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We consent to the incorporation by reference in the Registration Statements (Forms S-3D Registration Statement Nos. 333-40211 and 333-130721) and in the Registration Statements (Forms S-8 Registration Statements Nos. 333-60089, 333-128278, and 333-109018) pertaining to certain stock award, stock option, stock incentive and stock bonus plans of Community Bank Shares of Indiana, Inc., of our report dated March 30, 2009, appearing in this annual report Form 10-K for Community Bank Shares of Indiana, Inc. for the year ended December 31, 2008.

/s/ Crowe Horwath LLP

Louisville, Kentucky  
March 30, 2009

CERTIFICATIONS PURSUANT TO  
SECTION 302 OF  
THE SARBANES-OXLEY ACT OF 2002

CERTIFICATION

I, James D. Rickard, certify that:

- 1) I have reviewed this annual report on Form 10-K of Community Bank Shares of Indiana, Inc.;
- 2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
- 3) Based on my knowledge, the financial statements and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of and for the periods presented in this report;
- 4) The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f)) for the registrant and have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared; and
  - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
- 5) The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting, which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 31, 2009

/s/ James D. Rickard  
James D. Rickard  
President and Chief Executive Officer

CERTIFICATIONS PURSUANT TO  
SECTION 302 OF  
THE SARBANES-OXLEY ACT OF 2002

CERTIFICATION

I, Paul A. Chrisko, certify that:

- 1) I have reviewed this annual report on Form 10-K of Community Bank Shares of Indiana, Inc.;
- 2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
- 3) Based on my knowledge, the financial statements and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of and for the periods presented in this report;
- 4) The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f)) for the registrant and have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared; and
  - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fourth fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
- 5) The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting, which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 31, 2009

/s/ Paul A. Chrisko  
Paul A. Chrisko  
Executive Vice President and  
Chief Financial Officer



---

**Exhibit 32.1**

CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the accompanying Form 10-K of Community Bank Shares of Indiana, Inc. (the "Company") for the year ended December 31, 2008, I, James D. Rickard, Chief Executive Officer of Community Bank Shares of Indiana, Inc., hereby certify pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

- (1) Such Form 10-K for the year ended December 31, 2008 fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in such Form 10-K for the year ended December 31, 2008 fairly presents, in all material respects, the financial condition and results of operation of the Company.

By: /s/ James D. Rickard  
James D. Rickard  
President and  
Chief Executive Officer

Date: March 31, 2009

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

This certification shall not be deemed filed by the Company for purposes of §18 of the Securities Exchange Act of 1934, as amended.

---

**Exhibit 32.2**

CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the accompanying Form 10-K of Community Bank Shares of Indiana, Inc. (the "Company") for the year ended December 31, 2008, I, Paul A Chrisco, Chief Financial Officer of Community Bank Shares of Indiana, Inc., hereby certify pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

- (1) Such Form 10-K for the year ended December 31, 2008 fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in such Form 10-K for the year ended December 31, 2008 fairly presents, in all material respects, the financial condition and results of operation of the Company.

By: /s/ Paul A. Chrisco  
Paul A. Chrisco  
Executive Vice President,  
Chief Financial Officer

Date: March 31, 2009

A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

This certification shall not be deemed filed by the Company for purposes of §18 of the Securities Exchange Act of 1934, as amended.