GREENVILLE FIRST BANCSHARES INC
Form 10-Q
November 13, 2006

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

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended September 30, 2006

OR

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

For the Transition Period from__________ to __________

Commission file number 000-27719

Greenville First Bancshares, Inc.
(Exact name of registrant as specified in its charter)

South Carolina	58-2459561
(State or other jurisdiction of incorporation)	(I.R.S. Employer Identification No.)
112 Haywood Road Greenville, S.C.	29607
(Address of principal executive offices)	(Zip Code)

864-679-9000
(Registrant's telephone number, including area code)

Not Applicable
(Former name, former address, and former fiscal year, if changed since last report)

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

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

Large accelerated filer [ ] Accelerated filer [ ]
Non-accelerated filer [X]

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 2,933,868 shares of common stock, $.01 par value per share, were issued and outstanding as of October 25, 2006.

GREENVILLE FIRST BANCSHARES, INC.
PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

The financial statements of Greenville First Bancshares, Inc. and Subsidiary are set forth in the following pages.

GREENVILLE FIRST BANCSHARES, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

	September 30, 2006 (Unaudited)	December 31, 2005 (Audited)
Assets		
Cash and due from banks	$ 10,270,282	$ 6,223,397
Federal funds sold	5,113,284	19,380,755
Investment securities available for sale	49,440,232	11,310,956
Investment securities held to maturity-		
(fair value $16,887,932 and $18,709,112)	17,518,379	19,345,016
Other investments, at cost	6,880,100	5,475,400
Loans, net	385,739,546	334,040,776
Property and equipment, net	6,340,911	5,576,882
Accrued interest receivable	2,272,331	1,694,648
Bank owned life insurance	8,055,000	-
Other real estate owned	779,218	-
Other assets	2,730,162	2,264,713
Total assets	$ 495,139,445	$ 405,312,543
Liabilities		
Deposits	$ 339,959,604	$ 254,148,041
Official checks outstanding	770,595	7,786,468
Federal funds purchased and repurchase agreements	-	14,680,000
Federal Home Loan Bank advances	104,500,000	79,500,000
Junior subordinated debentures	13,403,000	13,403,000
Accrued interest payable	2,173,939	1,510,635
Accounts payable and accrued expenses	998,686	3,811,652
Total liabilities	461,805,824	374,839,796
Commitments and contingencies		
Shareholders' equity		
Preferred stock, par value $.01 per share, 10,000,000 shares authorized, no shares issued	-	-
Common stock, par value $.01		
Authorized, 10,000,000 shares, issued and outstanding 2,933,868 and 2,659,719 at September 30, 2006 and December 31, 2005, respectively	29,339	26,597
Additional paid-in capital	30,820,044	25,626,740

Accumulated other comprehensive loss		(170,538)		(150,602)
Retained earnings		2,654,776		4,970,012
Total shareholders' equity		33,333,621		30,472,747
Total liabilities and shareholders' equity	$	495,139,445	$	405,312,543

See notes to consolidated financial statements that are an integral part of these consolidated statements.

GREENVILLE FIRST BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME

	For the three months ended September 30, 2006 (Unaudited)	2005
Interest income		
Loans	$ 7,266,867	$ 5,234,626
Investment securities	766,990	416,249
Federal funds sold	100,211	18,436
Total interest income	8,134,068	5,669,311
Interest expense		
Deposits	3,068,681	1,629,321
Borrowings	1,371,967	935,121
Total interest expense	4,440,648	2,564,442
Net interest income	3,693,420	3,104,869
Provision for loan losses	400,000	225,000
Net interest income after provision for loan losses	3,293,420	2,879,869
Noninterest income		
Loan fee income	29,683	42,000
Service fees on deposit accounts	66,772	58,446
Other real estate owned activity	(88,903)	-
Other income	105,375	101,405
Total noninterest income	112,927	201,851
Noninterest expenses		
Compensation and benefits	1,085,922	837,851
Professional fees	126,386	67,895
Marketing	108,067	104,834
Insurance	48,068	39,188
Occupancy	161,981	211,813
Data processing and related costs	225,558	229,167
Telephone	20,540	11,391
Other	77,654	83,903
Total noninterest expenses	1,854,176	1,586,042
Income before income taxes expense	1,552,171	1,495,678
Income tax expense	532,494	568,357
Net income	$ 1,019,677	$ 927,321
Earnings per common share		
Basic	$ .35	$ .32
Diluted	$ .32	$ .29
Weighted average common shares outstanding		
Basic	2,933,721	2,925,698
Diluted	3,231,605	3,224,499

See notes to consolidated financial statements that are an integral part of these consolidated statements.

GREENVILLE FIRST BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME

	For the nine months ended September 30, 2006	2005
	(Unaudited)	
Interest income		
Loans	$ 20,210,226	$ 14,176,899
Investment securities	1,855,836	1,251,114
Federal funds sold	192,007	51,756
Total interest income	22,258,069	15,479,769
Interest expense		
Deposits	7,696,917	4,237,255
Borrowings	3,945,043	2,535,716
Total interest expense	11,641,960	6,772,971
Net interest income	10,616,109	8,706,798
Provision for loan losses	1,200,000	835,000
Net interest income after provision for loan losses	9,416,109	7,871,798
Noninterest income		
Loan fee income	89,145	138,369
Service fees on deposit accounts	195,031	194,583
Other real estate owned activity	(103,392)	-
Other income	221,716	299,768
Total noninterest income	402,500	632,720
Noninterest expenses		
Compensation and benefits	3,176,784	2,428,499
Professional fees	308,250	231,821
Marketing	350,192	313,142
Insurance	135,776	112,749
Occupancy	495,587	582,123
Data processing and related costs	622,147	676,972
Telephone	59,818	34,425
Other	264,564	239,099
Total noninterest expenses	5,413,118	4,618,830
Income before income taxes expense	4,405,491	3,885,688
Income tax expense	1,573,955	1,476,561
Net income	$ 2,831,536	$ 2,409,127
Earnings per common share		
Basic	$ .97	$ .82
Diluted	$ .87	$ .75

Weighted average common shares outstanding		
Basic	2,930,898	2,921,304
Diluted	3,237,901	3,217,858

See notes to consolidated financial statements that are an integral part of these consolidated statements.

GREENVILLE FIRST BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
AND COMPREHENSIVE INCOME
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005
(Unaudited)

	Common stock Shares	Common stock Amount	Additional paid-in capital	Accumulated other comprehensive income (loss)	Retained earnings	Total share-holders' equity
December 31, 2004	2,647,994	$ 26,480	$ 25,546,259	$ 49,989	$ 2,455,860	$ 28,078,588
Net income	-	-	-	-	2,409,127	2,409,127
Comprehensive income, net of tax -						
Unrealized holding loss on securities available for sale	-	-	-	(106,731)	-	(106,731)
Comprehensive income	-	-	-	-	-	2,302,396
Proceeds from exercise of stock options and warrants	11,731	117	80,481	-	-	80,598
September 30, 2005	2,659,725	$ 26,597	$ 25,626,740	$ (56,742)	$ 4,864,987	$ 30,461,582
December 31, 2005	2,659,719	$ 26,597	$ 25,626,740	$ (150,602)	$ 4,970,012	$ 30,472,747
Net income	-	-	-	-	2,831,536	2,831,536
Comprehensive income, net of tax -						
Unrealized holding loss on securities available for sale	-	-	-	(19,936)	-	(19,936)
Comprehensive income	-	-	-	-	-	2,811,600
Proceeds from exercise of stock options	7,500	75	49,645	-	-	49,720
Stock dividend (10%), net of cash in lieu of fractional shares	266,649	2,667	5,143,659	-	(5,146,772)	(446)
September 30, 2006	2,933,868	$ 29,339	$ 30,820,044	$ (170,538)	$ 2,654,776	$ 33,333,621

See notes to consolidated financial statements that are an integral part of these consolidated statements.

GREENVILLE FIRST BANCSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS

		For the nine months ended September 30, 2006		2005
		(Unaudited)		
Operating activities				
Net income	$	2,831,536	$	2,409,127
Adjustments to reconcile net income to cash provided by (used for) operating activities:				
Provision for loan losses		1,200,000		835,000
Depreciation and other amortization		259,626		187,569
Accretion and amortization of securities discounts and premium, net		80,005		96,280
Gain on sale of real estate owned		(1,065)		-
Increase in deferred tax asset		(402,413)		(124,447)
Increase in other assets, net		(630,448)		(286,791)
Increase (decrease) in other liabilities, net		(9,165,535)		1,157,295
Net cash provided by (used for) operating activities		(5,828,294)		4,274,033
Investing activities				
Increase (decrease) in cash realized from:				
Origination of loans, net		(55,017,192)		(43,932,332)
Purchase of property and equipment		(1,023,655)		(1,910,389)
Purchase of investment securities:				
Available for sale		(41,828,730)		-
Held to maturity		-		(10,258,021)
Other investments		(5,567,200)		(3,944,250)
Payments and maturity of investment securities:				
Available for sale		3,624,315		1,424,652
Held to maturity		1,791,564		2,921,643
Other investments		4,162,500		2,459,700
Purchase of bank owned life insurance		(8,055,000)		-
Proceeds from sale of real estate acquired in settlement of loans		1,340,269		28,000
Net cash used for investing activities		(100,573,129)		(53,210,997)
Financing activities				
Increase in deposits, net		85,811,563		32,019,790
Increase (decrease) in short-term borrowings		(14,680,000)		3,132,001
Proceeds from the exercise of stock options		49,720		80,598
Increase in Federal Home Loan Bank advances		25,000,000		20,840,000
Cash in lieu of fractional shares		(446)		-
Net cash provided by financing activities		96,180,837		56,072,389
Net increase (decrease) in cash and cash equivalents		(10,220,586)		7,135,425
Cash and cash equivalents at beginning of the period		25,604,152		5,338,336
Cash and cash equivalents at end of the period	$	15,383,566	$	12,473,761
Supplemental information				
Cash paid for				
Interest	$	10,978,656	$	6,088,475
Income taxes	$	1,976,369	$	1,982,000
Schedule of non-cash transactions				
Foreclosure of real estate	$	2,118,421	$	-
Unrealized loss on securities, net of income taxes	$	(19,936)	$	(106,731)

See notes to consolidated financial statements that are an integral part of these consolidated statements.

GREENVILLE FIRST BANCSHARES, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - Nature of Business and Basis of Presentation

Business activity

Greenville First Bancshares, Inc. is a South Carolina corporation that owns all of the capital stock of Greenville First Bank, N.A. and all of the stock of Greenville First Statutory Trust I and Trust II (collectively the "Trusts"). The bank is a national bank organized under the laws of the United States located in Greenville County, South Carolina. The bank is primarily engaged in the business of accepting demand deposits and savings deposits insured by the Federal Deposit Insurance Corporation, and providing commercial, consumer and mortgage loans to the general public. The bank owns all of the capital stock of JB Properties. This subsidiary is for the purpose of owning real estate acquired in loan foreclosures. The Trusts are special purpose subsidiaries for the sole purpose of issuing trust preferred securities.

Basis of Presentation

The accompanying financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine month periods ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. For further information, refer to the consolidated financial statements and footnotes thereto included in the company's Form 10-K for the year ended December 31, 2005 (Registration Number 000-27719) as filed with the Securities and Exchange Commission. The consolidated financial statements include the accounts of Greenville First Bancshares, Inc., and its wholly owned subsidiary Greenville First Bank, N.A. The financial statements related to the special purpose subsidiaries, Greenville First Statutory Trust I and Trust II, have not been consolidated in accordance with Financial Accounting Standards Board ("FASB") Interpretation No. 46.

Cash and Cash Equivalents

For purposes of the Consolidated Statements of Cash Flows, cash and federal funds sold are included in "cash and cash equivalents." These assets have contractual maturities of less than three months.

Note 2 - Stock Dividend

On June 20, 2006, the company's Board of Directors approved a 10 percent stock dividend to the company's shareholders. The record date was July 24, 2006 and the distribution date was August 14, 2006. Earnings per share and average shares outstanding have been adjusted to reflect the stock dividend in the Consolidated Statements of Income and in Note 4.

Note 3 - Line of Credit

The company has an unused $4.5 million revolving line of credit with another bank that matures on March 20, 2007. The line of credit bears interest at a rate of three-month libor plus 2.00%, which at September 30, 2006 was 7.37%. The company has pledged the stock of the bank as collateral for this line of credit. The line of credit agreement contains various covenants related to net income and asset quality. As of September 30, 2006, the company believes it is in compliance with all covenants.

Note 4 - Earnings per Share

The following schedule reconciles the numerators and denominators of the basic and diluted earnings per share computations for the three months and nine months ended September 30, 2006 and 2005. Dilutive common shares arise from the potentially dilutive effect of the company's stock options and warrants that are outstanding. The assumed conversion of stock options and warrants can create a difference between basic and dilutive net income per common share. The average dilutive shares have been computed utilizing the "treasury stock" method.

	Three months ended September 30,			
		2006		**2005**
Basic Earnings Per Share				
Average common shares		2,933,721		2,925,698
Net income	$	1,019,677	$	927,321
Earnings per share	$	0.35	$	0.32
Diluted Earnings Per Share				
Average common shares		2,933,721		2,925,698
Average dilutive common shares		297,884		298,801
Adjusted average common shares		3,231,605		3,224,499
Net income	$	1,019,677	$	927,321
Earnings per share	$	0.32	$	0.29

	Nine months ended September 30,			
		2006		**2005**
Basic Earnings Per Share				
Average common shares		2,930,898		2,921,304
Net income	$	2,831,536	$	2,409,127
Earnings per share	$	0.97	$	0.82
Diluted Earnings Per Share				
Average common shares		2,930,898		2,921,304
Average dilutive common shares		307,003		296,554
Adjusted average common shares		3,237,901		3,217,858
Net income	$	2,831,536	$	2,409,127
Earnings per share	$	0.87	$	0.75

Note 5 - Stock Based Compensation

The company has a stock-based employee compensation plan. On January 1, 2006, the company adopted the fair value recognition provisions of Financial Accounting Standards Board Statement of Financial Accounting Standards ("SFAS") No. 123(R), *Accounting for Stock-Based Compensation*, to account for compensation costs under its stock option plan. The company previously utilized the intrinsic value method under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees (as amended)* ("APB 25"). Under the intrinsic value method prescribed by APB 25, no compensation costs were recognized for the company's stock options because the option exercise price in its plans equals the market price on the date of grant. Prior to January 1, 2006, the company only disclosed the pro forma effects on net income and earnings per share as if the fair value recognition provisions of SFAS No. 123(R) had been utilized. On December 20, 2005, the Board of Directors approved accelerating the vesting of 45,813 unvested stock options effective December 28, 2005. The decision to accelerate vesting of these options was made so as to reduce compensation expense upon the adoption of SFAS No. 123(R) by approximately $68,000 and $52,000 in the years ended December 31, 2006 and 2007, respectively, and $4,000 in each of the years ended December 31, 2008 and 2009.

In adopting SFAS No. 123, the company elected to use the modified prospective method to account for the transition from the intrinsic value method to the fair value recognition method. Under the modified prospective method, compensation cost is recognized from the adoption date forward for all new stock options granted and for any outstanding unvested awards as if the fair value method had been applied to those awards as of the date of grant. The following table illustrates the effect on net income and earnings per share as if the fair value based method had been applied to all outstanding and unvested awards in each period. All stock options were fully vested at September 30, 2006.

	Three Months Ended September 30			
		2006		**2005**
Net income as reported	$	1,019,677	$	927,321
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects		-		-
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		-		(17,992)
Pro forma net income including stock-based compensation cost based on fair-value method	$	1,019,677	$	909,329
Earnings per share:				
Basic - as reported	$	0.35	$	0.32
Basic - pro forma	$	0.35	$	0.31
Diluted - as reported	$	0.32	$	0.29
Diluted - pro forma	$	0.32	$	0.28

	Nine Months Ended September 30			
		2006		**2005**
Net income as reported	$	2,831,536	$	2,409,127
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects		-		-
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		-		(53,976)
Pro forma net income including stock-based compensation cost based on fair-value method	$	2,831,536	$	2,355,151
Earnings per share:				
Basic - as reported	$	0.97	$	0.82
Basic - pro forma	$	0.97	$	0.81
Diluted - as reported	$	0.87	$	0.75
Diluted - pro forma	$	0.87	$	0.73

The fair value of the option grant is estimated on the date of grant using the Black-Scholes option-pricing model. The following assumptions were used for grants: expected volatility of 6.76% for 2005, risk-free interest rate of 4.02% for 2005, expected lives of the options 10 years, and the assumed dividend rate was zero. No options were granted during the nine month period ended September 30, 2006.

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

The following discussion reviews our results of operations and assesses our financial condition. You should read the following discussion and analysis in conjunction with the accompanying consolidated financial statements. The commentary should be read in conjunction with the discussion of forward-looking statements, the financial statements and the related notes and the other statistical information included in this report.

DISCUSSION OF FORWARD-LOOKING STATEMENTS

This report contains "forward-looking statements" relating to, without limitation, future economic performance, plans and objectives of management for future operations, and projections of revenues and other financial items that are based on the beliefs of management, as well as assumptions made by and information currently available to management. The words "may," "will," "anticipate," "should," "would," "believe," "contemplate," "expect," "estimate," "continue," and "intend," as well as other similar words and expressions of the future, are intended to identify forward-looking statements. Our actual results may differ materially from the results discussed in the forward-looking statements, and our operating performance each quarter is subject to various risks and uncertainties that are discussed in detail in our filings with the Securities and Exchange Commission, including, without limitation:

significant increases in competitive pressure in the banking and financial services industries;

changes in the interest rate environment which could reduce anticipated or actual margins;

changes in political conditions or the legislative or regulatory environment;

general economic conditions, either nationally or regionally and especially in our primary service area, becoming less favorable than expected resulting in, among other things, a deterioration in credit quality;

changes occurring in business conditions and inflation;

changes in technology;

changes in monetary and tax policies;

the level of allowance for loan loss;

the rate of delinquencies and amounts of charge-offs;

the rates of loan growth and the lack of seasoning of our loan portfolio;

adverse changes in asset quality and resulting credit risk-related losses and expenses;

loss of consumer confidence and economic disruptions resulting from terrorist activities;

changes in the securities markets; and

other risks and uncertainties detailed from time to time in our filings with the Securities and Exchange Commission.

Overview

We were incorporated in March 1999 to organize and serve as the holding company for Greenville First Bank, N.A. Since we opened our bank in January 2000, we have experienced consistent growth in total assets, loans, deposits, and shareholders' equity, which has continued during the first nine months of 2006. To support this growth, we conducted an underwritten public offering of our common stock in 2004. On September 24, 2004 and October 15, 2004, we sold 800,000 and 120,000 shares, respectively, of common stock. The net proceeds from this offering were approximately $15.0 million.

Like most community banks, we derive the majority of our income from interest received on our loans and investments. Our primary source of funds for making these loans and investments is our deposits, on which we pay interest. Consequently, one of the key measures of our success is our amount of net interest income, or the difference between the income on our interest-earning assets, such as loans and investments, and the expense on our interest-bearing liabilities, such as deposits and borrowings. Another key measure is the spread between the yield we earn on these interest-earning assets and the rate we pay on our interest-bearing liabilities, which is called our net interest spread.

There are risks inherent in all loans, so we maintain an allowance for loan losses to absorb probable losses on existing loans that may become uncollectible. We maintain this allowance by charging a provision for loan losses against our operating earnings for each period. We have included a detailed discussion of this process, as well as several tables describing our allowance for loan losses.

In addition to earning interest on our loans and investments, we earn income through fees and other charges to our customers. We have also included a discussion of the various components of this noninterest income, as well as of our noninterest expense.

The following discussion and analysis also identifies significant factors that have affected our financial position and operating results during the periods included in the accompanying financial statements. We encourage you to read this discussion and analysis in conjunction with our financial statements and the other statistical information included in our filings with the Securities and Exchange Commission.

Critical Accounting Policies

We have adopted various accounting policies that govern the application of accounting principles generally accepted in the United States and with general practices within the banking industry in the preparation of our financial statements. Our significant accounting policies are described in the footnotes to our audited consolidated financial statements as of December 31, 2005, as filed in our annual report on Form 10-K.

Certain accounting policies involve significant judgments and assumptions by us that have a material impact on the carrying value of certain assets and liabilities. We consider these accounting policies to be critical accounting policies. The judgment and assumptions we use are based on historical experience and other factors, which we believe to be reasonable under the circumstances. Because of the nature of the judgment and assumptions we make, actual results could differ from these judgments and estimates that could have a material impact on the carrying values of our assets and liabilities and our results of operations.

We believe the allowance for loan losses is the critical accounting policy that requires the most significant judgments and estimates used in preparation of our consolidated financial statements. Some of the more critical judgments supporting the amount of our allowance for loan losses include judgments about the credit worthiness of borrowers, the estimated value of the underlying collateral, the assumptions about cash flow, determination of loss factors for estimating credit losses, the impact of current events, and conditions, and other factors impacting the level of probable inherent losses. Under different conditions, the actual amount of credit losses incurred by us may be different from management's estimates provided in our consolidated financial statements. Refer to the portion of this discussion that addresses our allowance for loan losses for a more complete discussion of our processes and methodology for determining our allowance for loan losses.

Effect of Economic Trends

Beginning in July of 2004 and through the third quarter of 2006, our rates on both short-term or variable rate interest-earning assets and interest-bearing liabilities increased as the Federal Reserve began to increase short-term rates as the economy showed signs of strengthening following an economic decline and historically low interest rates. During this period, the Federal Reserve increased rates 17 times for a total of 425 basis points. Three of these rate increases occurred during the first six months of 2006 for a total of 75 basis points. However, the Federal

Reserve allowed short-term rates to remain unchanged during the third quarter of 2006, leading many economists to believe that the Federal Reserve is nearing the end of this cycle of rate increases. The following discussion includes our analysis of the effect we anticipate changes in interest rates will have on our financial condition. However, no assurance can be given related to future actions that the Federal Reserve may choose to take or that the results we anticipate will actually occur.

Results of Operations

Income Statement Review

Summary

Three months ended September 30, 2006 and 2005

Our net income was $1.0 million and $927,321 for the three months ended September 30, 2006 and 2005, respectively, an increase of $92,356, or 10.0%. The increase in net income resulted primarily from an increase of $588,551 in net interest income and $35,863 decrease in income tax expense which were partially offset by an increase of $175,000 in the provision for loan losses, a decrease of $88,924 in noninterest income, and $268,134 of additional noninterest expense. Our efficiency ratio was 48.7% and 48.0% for the three months ended September 30, 2006 and 2005, respectively. Our efficiency ratio declined slightly because our net interest income and other income increased at a lower rate than the increases in our overhead expenses.

Nine months ended September 30, 2006 and 2005

Our net income was $2.8 million and $2.4 million for the nine months ended September 30, 2006 and 2005, respectively, an increase of $422,409, or 17.5%. The increase in net income resulted primarily from an increase of $1.9 million in net interest income, partly offset by an increase of $365,000 in the provision for loan losses, a decrease of $230,220 in noninterest income, $794,288 of additional noninterest expense and a $97,394 increase in income tax expense. Our efficiency ratio was 49.1% and 49.5% for the nine months ended September 30, 2006 and 2005, respectively. Our efficiency ratio has improved because our net interest income and other income increased at a higher rate than the increases in our overhead expenses.

Net Interest Income

Our level of net interest income is determined by the level of earning assets and the management of our net interest margin. The continuous growth in our loan portfolio is the primary driver of the increase in net interest income. During the nine months ended September 30, 2006, our average loan portfolio was $65.4 million higher compared to the average for the nine months ended September 30, 2005. The growth in the first nine months of 2006 was $51.8 million. We anticipate the growth in loans will continue to drive our growth in assets and our growth in net interest income. However, no assurance can be given that we will be able to continue to increase loans at the same levels we have experienced in the past.

Our decision to grow the loan portfolio at the current pace created the need to increase deposits and borrowings. This loan growth strategy also resulted in a significant portion of our assets being in higher earning loans than in lower yielding investments. At September 30, 2006, net loans represented 77.9% of total assets. However, as described below, we have also increased our level of deposits significantly. While we plan to continue our focus on increasing the loan portfolio, as rates on investment securities have risen during 2006 and we obtained these additional deposits, we increased the size of the investment portfolio. As a result, net loans as a percentage of total assets has actually decreased from the 84% amount at June 30, 2006. Our investment portfolio increased by $37.7 million in the first nine months of 2006. At September 30, 2006, investments and federal funds sold represented 15.9% of total assets.

The historically low interest rate environment in the last four years allowed us to obtain short-term borrowings and wholesale certificates of deposit generally at rates that were lower than certificate of deposit rates being offered in our local market. Therefore, we decided not to begin our retail deposit office expansion program until the beginning of 2005. This funding strategy allowed us to continue to operate in one location until 2005, maintain a smaller staff, and not incur marketing costs to advertise deposit rates, which in turn allowed us to focus on the fast growing loan portfolio.

In anticipation of rising interest rates, we opened one retail deposit office in March of 2005 and a second in November of 2005. Our focus for these two locations is to obtain low cost transaction accounts that we believe will be less impacted by changing market rates. Our goal is to increase both the percentage of assets being funded by "in market" retail deposits and to increase the percentage of low-cost transaction accounts to total deposits. The two additional retail deposit offices are assisting us in meeting these objectives. We also anticipate that deposit promotions and the opening of the two new offices will continue to have a negative impact on earnings in the year 2006. However, we believe that these two strategies will provide additional clients in our local market and will provide a lower alternative cost of funding. At September 30, 2006, retail deposits represented $247.8 million, or 50.0% of total assets, borrowings represented $117.9 million, or 23.8% of total assets, and wholesale out-of-market deposits represented $92.1 million, or 18.6% of total assets.

As more fully discussed in the - "Market Risk" and - "Liquidity and Interest Rate Sensitivity" sections below, at September 30, 2006, 52.0% of our loans had variable rates. Given our percentage of rate-sensitive loans, our primary focus during the past three years has been to obtain short-term liabilities to fund our asset growth. This strategy improves our ability to manage the impact on our earnings resulting from anticipated changes in market interest rates.

At September 30, 2006, 74.3% of our interest-bearing liabilities had a maturity of less than one year. Therefore, we believe that we are positioned to benefit from future decreases in short-term rates. Conversely, future increases in short-term rates would likely have a negative effect on our earnings. At September 30, 2006, we had $111.5 million more liabilities than assets that reprice within the next twelve months. Based on a review of our deposit portfolio, we believe that the majority of our interest bearing transaction accounts, would only be impacted by a portion of any change in market rates. This key assumption is utilized in our overall evaluation of our level of interest sensitivity.

We intend to maintain a capital level for the bank that exceeds the OCC requirements to be classified as a "well capitalized" bank. To provide the additional capital needed to support our bank's growth in assets, in 2003 we issued $6.2 million in junior subordinated debentures in connection with our trust preferred securities offering. During 2004, we issued 920,000 additional shares of common stock that resulted in $14.9 million of additional capital. In 2005, we issued an additional $7.2 million in junior subordinated debentures in a second trust preferred securities offering. We also have a $4.5 million unused short-term holding company line of credit that could be utilized to provide additional capital for the bank if deemed necessary. As of September 30, 2006, the company's regulatory capital levels were over $12.4 million in excess of the various well capitalized requirements.

In addition to the growth in both assets and liabilities, and the timing of repricing of our assets and liabilities, net interest income is also affected by the ratio of interest-earning assets to interest-bearing liabilities and the changes in interest rates earned on our assets and interest rates paid on our liabilities.

Our net interest income margin was 3.25% and 3.35% for the three months and nine months ended September 3 0, 2006, respectively, while our net interest spread was 2.82% and 2.91% for the same periods, respectively. During these periods, our net interest margin exceeded our net interest spread because we had more interest-earning assets than interest-bearing liabilities. Average interest-earning assets exceeded average interest-bearing liabilities by $44.4 million, and $45.4 million for the three and nine months ended September 30, 2006, respectively.

During the three and nine months ended September 30, 2006, our rates on both short-term or variable rate earning-assets and short-term or variable rate interest-bearing liabilities continued to increase primarily as a result of the actions taken by the Federal Reserve over the last twelve months to raise short-term rates. The impact of the Federal Reserve's actions resulted in an increase in both the yields on our variable rate assets and the rates that we paid for our short-term deposits and borrowings. Our net interest spread declined since more of our rate-sensitive liabilities repriced than our rate-sensitive assets during the 12 month period ending September 30, 2006. Given the fact that the Federal Reserve has increased short-term rates by 425 basis points since July 2004, we believe that short-term interest rates are currently at or near their peak. Therefore, we have chosen to increase the amount of fixed rate loans in our loan portfolio and targeted to have a significant portion of our liabilities to reprice within a twelve-month period.

We have included a number of tables to assist in our description of various measures of our financial performance. For example, the "Average Balances" tables show the average balance of each category of our assets and liabilities as well as the yield we earned or the rate we paid with respect to each category during the three and nine months ended September 30, 2006 and 2005. A review of these tables show that our loans typically provide higher interest yields than do other types of interest-earning assets, which is why we direct a substantial percentage of our earning assets into our loan portfolio. Similarly, the "Rate/Volume Analysis" tables demonstrate the effect of changing interest rates and changing volume of assets and liabilities on our financial condition during the periods shown. A review of these tables shows that the significant portion of the increases in net interest income in both the 2006 and 2005 periods have resulted from the increased levels of assets and liabilities in each period. We also track the sensitivity of our various categories of assets and liabilities to changes in interest rates, and we have included tables to illustrate our interest rate sensitivity with respect to interest-earning accounts and interest-bearing accounts. Finally, we have included various tables that provide detail about our investment securities, our loans, our deposits, and other borrowings.

The following table sets forth information related to our average balance sheets, average yields on assets, and average costs of liabilities. We derived these yields by dividing income or expense by the average balance of the corresponding assets or liabilities. We derived average balances from the daily balances throughout the periods indicated. During the three-month and nine-month periods ended September 30, 2006 and 2005, we had no interest-bearing deposits in other banks or any securities purchased with agreements to resell. All investments were owned at an original maturity of over one year. Nonaccrual loans are included in the following tables. Loan yields have been reduced to reflect the negative impact on our earnings of loans on nonaccrual status. The net of capitalized loan costs and fees are amortized into interest income on loans.

Average Balances, Income and Expenses, and Rates

For the Three Months Ended September 30,

	2006			2005		
	Average Balance	**Income/ Expense**	**Yield/ Rate(1)**	**Average Balance**	**Income/ Expense**	**Yield/ Rate(1)**
	(Dollars in thousands)					
Earnings						
Federal funds sold	$ 7,482	$ 100	5.30%	$ 2,284	$ 18	3.13%
Investment securities	59,694	767	5.10%	37,174	416	4.44%
Loans	383,853	7,267	7.51%	317,680	5,235	6.54%
Total earning-assets	451,029	8,134	7.15%	357,138	5,669	6.30%
Non-earning assets	19,176			7,034		
Total assets	$ 470,205			$ 364,172		
Interest-bearing liabilities						
NOW accounts	$ 30,821	145	1.87%	$ 27,049	97	1.42%
Savings & money market	93,989	828	3.50%	44,305	208	1.86%
Time deposits	169,864	2,096	4.90%	140,273	1,324	3.74%
Total interest-bearing deposits	294,674	3,069	4.13%	211,627	1,629	3.05%
FHLB advances	92,853	1,036	4.43%	75,185	676	3.57%
Other borrowings	19,107	336	6.98%	23,224	259	4.42%
Total interest-bearing liabilities	406,634	4,441	4.33%	310,036	2,564	3.28%
Non-interest bearing liabilities	30,542			23,648		
Shareholders' equity	33,029			30,488		
Total liabilities and shareholders' equity	$ 470,205			$ 364,172		
Net interest spread			2.82%			3.02%
Net interest income / margin		$ 3,693	3.25%		$ 3,105	3.45%

(1) Annualized for the three month period.

Our net interest spread was 2.82% for the three months ended September 30, 2006, compared to 3.02% for the three months ended September 30, 2005. The net interest spread is the difference between the yield we earn on our interest-earning assets and the rate we pay on our interest-bearing liabilities. Because we had more interest-bearing liabilities than interest-earning assets that repriced, our net interest spread decreased 20 basis points in the three months ended September 30, 2006, compared to the same period in 2005.

Our net interest margin is calculated as net interest income divided by average interest-earning assets. Our net interest margin for the three months ended September 30, 2006 was 3.25%, compared to 3.45% for the three months ended September 30, 2005. During the three months ended September 30, 2006, interest-earning assets averaged $451.0 million, compared to $357.1 million in the three months ended September 30, 2005. Interest earning assets exceeded interest bearing liabilities by $44.4 million and $47.1 million for the three month periods ended September 30, 2006 and 2005, respectively.

Our loan yield increased 97 basis points for the three months ended September 30, 2006 compared to the three months ended September 30, 2005 as a result of approximately 52% of the loan portfolio having variable rates, combined with the increase in rates over the twelve months ended September 30, 2006. Offsetting the increase in our loan yield is a 108 basis point increase in the cost of our interest-bearing deposits for the third quarter of 2006 compared to the same period in 2005. The increase in the rate on our time deposits is due to the renewal rates on time deposits being much higher than the original rates as a result of the number of increases in the market rate in the past twenty-four months. In addition, the cost of our savings and money market accounts has increased by 164 basis points as we have increased the rates we offer on these products to stay competitive in response to the increase in short-term market rates. The 86 basis point increase in FHLB advances and the 256 basis point increase in other borrowed funds in the third quarter of 2006 compared to the same period in 2005 resulted primarily from the impact of the 150 basis point increase in short-term market rates over the past twelve months. The rate on other borrowings increased more than the increase in market rates as a result of the additional $7.2 million trust preferred securities that were obtained at a higher cost at the end of 2005. As of September 30, 2006, approximately 48% of our FHLB advances had variable rates, while all of our other borrowings had variable rates.

Net interest income, the largest component of our income, was $3.7 million and $3.1 million for the three months ended September 30, 2006 and 2005, respectively, an increase of $588,551. Average earning assets were $93.9 million higher during the three months ended September 30, 2006 compared to the same period in 2005 and average interest-bearing liabilities increased by $96.6 million during the same period. The higher average balances resulted in $636,000 additional net interest income. Net interest income did not increase by the total impact of higher volumes due to the negative net impact that higher interest rates on both interest-earning assets and interest-bearing liabilities had on earnings.

Interest income for the three months ended September 30, 2006 was $8.1 million, consisting of $7.3 million on loans, $766,990 on investments, and $100,211 on federal funds sold. Interest income for the three months ended September 30, 2005 was $5.7 million, consisting of $5.2 million on loans, $416,249 on investments, and $18,436 on federal funds sold. Interest on loans for the three months ended September 30, 2006 and 2005 represented 89.3% and 92.3%, respectively, of total interest income, while income from investments and federal funds sold represented 10.7% and 7.7% of total interest income. The high percentage of interest income from loans relates to our strategy to maintain a significant portion of our assets in higher earning loans compared to lower yielding investments. Average loans represented 85.1% and 89.0% of average interest-earning assets for the three months ended September 30, 2006 and 2005, respectively. Included in interest income on loans for the three months ended September 30, 2006 and 2005 was $124,731 and $164,185, respectively, related to the net amortization of loan fees and capitalized loan origination costs.

Interest expense for the three months ended September 30, 2006 was $4.4 million, consisting of $3.1 million related to deposits and $1.4 million related to borrowings. Interest expense for the three months ended September 30, 2005 was $2.6 million, consisting of $1.6 million related to deposits and $935,121 related to borrowings. Interest expense on deposits for the three months ended September 30, 2006 and 2005 represented 69.1% and 63.5%, respectively, of total interest expense, while interest expense on borrowings represented 30.9% and 36.5%, respectively, of total interest expense for the same three month periods. During the three months ended September 30, 2006, average interest-bearing deposits increased by $83.1 million over the same period in 2005, while FHLB and other borrowings during the three months ended September 30, 2006 increased $13.6 million over the same period in 2005. Both the short-term borrowings from the FHLB and the sale of securities under agreements to repurchase provide us with the opportunity to obtain low cost funding with various maturities similar to the maturities on our loans and investments.

Average Balances, Income and Expenses, and Rates
For the Nine Months Ended September 30,

	2006 Average Balance	2006 Income/ Expense	2006 Yield/ Rate(1)	2005 Average Balance	2005 Income/ Expense	2005 Yield/ Rate(1)
	(Dollars in thousands)					
Earnings						
Federal funds sold	$ 4,988	$ 192	5.15%	$ 2,275	$ 52	3.06%
Investment securities	49,565	1,856	5.01%	37,412	1,251	4.47%
Loans	369,556	20,210	7.31%	304,201	14,177	6.23%
Total earning-assets	424,109	22,258	7.02%	343,888	15,480	6.02%
Non-earning assets	15,086			6,166		
Total assets	$ 439,195			$ 350,054		
Interest-bearing liabilities						
NOW accounts	$ 36,279	502	1.85%	$ 28,383	296	1.39%
Savings & money market	77,639	1,964	3.38%	46,573	606	1.74%
Time deposits	152,855	5,231	4.58%	126,687	3,335	3.52%
Total interest-bearing deposits	266,773	7,697	3.86%	201,643	4,237	2.81%
FHLB advances	85,937	2,747	4.27%	73,468	1,822	3.32%
Other borrowings	26,041	1,198	6.15%	24,322	714	3.92%
Total interest-bearing liabilities	378,751	11,642	4.11%	299,433	6,773	3.03%
Non-interest bearing liabilities	28,323			21,244		
Shareholders' equity	32,121			29,377		
Total liabilities and shareholders' equity	$ 439,195			$ 350,054		
Net interest spread			2.91%			2.99%
Net interest income / margin		$ 10,616	3.35%		$ 8,707	3.39%

(1) Annualized for the nine month period.

Our net interest spread was 2.91% for the nine months ended September 30, 2006, compared to 2.99% for the nine months ended September 30, 2005. The net interest spread is the difference between the yield we earn on our interest-earning assets and the rate we pay on our interest-bearing liabilities. Because we had more interest-bearing liabilities than interest-earning assets that repriced, our net interest spread decreased 8 basis points in the nine months ended September 30, 2006, compared to the same period in 2005.

Our net interest margin is calculated as net interest income divided by average interest-earning assets. Our net interest margin for the nine months ended September 30, 2006 was 3.35%, compared to 3.39% for the nine months ended September 30, 2005. During the nine months ended September 30, 2006, interest-earning assets averaged $424.1 million, compared to $343.9 million in the nine months ended September 30, 2005. Interest earning assets exceeded interest bearing liabilities by $45.4 million and $44.5 million for the nine month periods ended September 30, 2006 and 2005, respectively.

Our loan yield increased 108 basis points for the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005 as a result of approximately 52% of the loan portfolio having variable rates, combined with the increase in rates over the twelve months ended September 30, 2006. Offsetting the increase in our loan yield is a 105 basis point increase in the cost of our interest-bearing deposits for the first nine months of 2006 compared to the same period in 2005. The increase in the rate on our time deposits is due to the renewal rates on time deposits being much higher than the original rates due to the number of increases in the market rate in the past twenty-four months. In addition, the cost of our savings and money market accounts has increased by 164 basis points as we have increased the rates we offer on these products to stay competitive in response to the increase in short-term market rates. The 95 basis point increase in FHLB advances and the 223 basis point increase in other borrowed funds in the first nine months of 2006 compared to the same period in 2005 resulted primarily from the impact of the 150 basis point increase in short-term market rates over the past twelve months. The rate on other borrowings increased more than the increase in market rates as a result of the additional $7.2 million trust preferred securities that were obtained at a higher cost at the end of 2005. As of September 30, 2006, approximately 48% of our FHLB advances had variable rates, while all of our other borrowings had variable rates.

Net interest income, the largest component of our income, was $10.6 million and $8.7 million for the nine months ended September 30, 2006 and 2005, respectively. Of the $1.9 million increase in net interest income, approximately $1.8 million related to the impact of higher average earning assets and interest-bearing liabilities in the nine months ended September 30, 2006 compared to the same period in 2005. Average earning assets were $80.2 million higher during the nine months ended September 30, 2006 compared to the same period in 2005, and average interest-bearing liabilities increased by $79.3 million during the same period. The remaining increase in net interest income is largely a result of the net impact of higher interest rates on both interest-earning assets and interest-bearing liabilities.

Interest income for the nine months ended September 30, 2006 was $22.3 million, consisting of $20.2 million on loans, $1.9 million on investments, and $192,007 on federal funds sold. Interest income for the nine months ended September 30, 2005 was $15.5 million, consisting of $14.2 million on loans, $1.3 million on investments, and $51,756 on federal funds sold. Interest on loans for the nine months ended September 30, 2006 and 2005 represented 90.8% and 91.6%, respectively, of total interest income, while income from investments and federal funds sold represented only 9.2% and 8.4% of total interest income. The high percentage of interest income from loans relates to our strategy to maintain a significant portion of our assets in higher earning loans compared to lower yielding investments. Average loans represented 87.1% and 88.5% of average interest-earning assets for the nine months ended September 30, 2006 and 2005, respectively. Included in interest income on loans for the nine months ended September 30, 2006 and 2005, was $402,167 and $441,024, respectively, related to the net amortization of loan fees and capitalized loan origination costs.

Interest expense for the nine months ended September 30, 2006 was $11.6 million, consisting of $7.7 million related to deposits and $3.9 million related to borrowings. Interest expense for the nine months ended September 30, 2005 was $6.8 million, consisting of $4.2 million related to deposits and $2.5 million related to borrowings. Interest expense on deposits for the nine months ended September 30, 2006 and 2005 represented 66.1% and 62.6%, respectively, of total interest expense, while interest expense on borrowings represented 33.9% and 37.4%, respectively, of total interest expense for the same periods. During the nine months ended September 30, 2006, average interest-bearing deposits increased by $65.1 million over the same period in 2005, while FHLB and other borrowings during the nine months ended September 30, 2006 increased $14.2 million over the same period in 2005. During the nine months ended September 30, 2006, we pledged additional collateral to the FHLB, allowing us to increase our FHLB borrowings. Both the short-term borrowings from the FHLB and the sale of securities under agreements to repurchase provide us with the opportunity to obtain low cost funding with various maturities similar to the maturities on our loans and investments.

Rate/Volume Analysis

Net interest income can be analyzed in terms of the impact of changing interest rates and changing volume. The following table sets forth the effect which the varying levels of interest-earning assets and interest-bearing liabilities and the applicable rates have had on changes in net interest income for the periods presented.

	Three Months Ended							
	September 30, 2006 vs. 2005 Increase (Decrease) Due to				September 30, 2005 vs. 2004 Increase (Decrease) Due to			
	Volume	Rate	Rate/ Volume	Total	Volume	Rate	Rate/ Volume	Total
	(Dollars in thousands)							
Interest income								
Loans	$ 1,086	$ 776	$ 170	$ 2,032	$ 863	$ 773	$ 195	$ 1,831
Investment securities	252	62	37	351	177	8	6	191
Federal funds sold	41	13	28	82	2	8	2	12
Total interest income	1,379	851	235	2,465	1,042	789	203	2,034
Interest expense								
Deposits	629	581	229	1,439	253	341	91	685
FHLB advances	159	163	38	360	67	221	42	330
Other borrowings	(46)	149	(26)	77	5	97	3	105
Total interest expense	742	893	241	1,876	325	659	136	1,120
Net interest income	**$** 637	$ (42)	$ (6)	$ 589	$ 717	$ 130	$ 67	$ 914

	Nine Months Ended							
	September 30, 2006 vs. 2005 Increase (Decrease) Due to				September 30, 2005 vs. 2004 Increase (Decrease) Due to			
	Volume	Rate	Rate/ Volume	Total	Volume	Rate	Rate/ Volume	Total
	(Dollars in thousands)							
Interest income								
Loans	$ 3,042	$ 2,455	$ 536	$ 6,033	$ 2,673	$ 1,863	$ 549	$ 5,085
Investment securities	406	150	49	605	538	24	19	581
Federal funds sold	62	36	42	140	3	29	5	37
Total interest income	3,510	2,641	627	6,778	3,214	1,916	573	5,703
Interest expense								
Deposits	1,378	1,568	514	3,460	622	885	220	1,727
FHLB advances	310	526	89	925	318	508	204	1,030
Other borrowings	50	405	29	484	47	247	30	324
Total interest expense	1,738	2,499	632	4,869	987	1,640	454	3,081
Net interest income	**$** 1,772	$ 142	$ (5)	$ 1,909	$ 2,227	$ 276	$ 119	$ 2,622

Provision for Loan Losses

We have established an allowance for loan losses through a provision for loan losses charged as an expense on our statement of income. We review our loan portfolio periodically to evaluate our outstanding loans and to measure both the performance of the portfolio and the adequacy of the allowance for loan losses. Please see the discussion below under "Balance Sheet Review - Provision and Allowance for Loan Losses" for a description of the factors we consider in determining the amount of the provision we expense each period to maintain this allowance.

Three and nine months ended September 30, 2006 and 2005

For the three months ended September 30, 2006, we incurred a noncash expense related to the provision for loan losses of $400,000, bringing the allowance for loan losses to $4.6 million, or 1.18% of gross loans, as of September 30, 2006. During the three month period ended September 30, 2006, we charged-off $49,472 in loans and recorded $36,197 of recoveries on loans previously charged-off. In contrast, for the third quarter of 2005, we added $225,000 to the provision for loan losses, resulting in an allowance of $4.6 million at September 30, 2005. As of September 30, 2005, the allowance was at 1.41% of gross loans. This higher than normal level was a result of only $29,661 of charged-off loans during the three months ended September 30, 2005, offset by recoveries of $62,286 for the same period, and other key factors which indicated potential underlying weaknesses in specific loans in the portfolio at the time.

For the nine months ended September 30, 2006, we incurred a noncash expense related to the provision for loan losses of $1.2 million, bringing the allowance for loan losses to $4.6 million, or 1.18% as a percentage of gross loans, as of September 30, 2006. The $1.2 million provision for the nine months ended September 30, 2006 related primarily to the level of charge-offs that occurred during this period. During the nine month period ended September 30, 2006, we charged-off $1.2 million in loans and recorded $119,152 of recoveries on loans previously charged-off. In contrast, for the nine months ended September 30, 2005, we added $835,000 to the provision for loan losses, resulting in an allowance of $4.6 million at September 30, 2005.

The substantial portion, or $1.0 million, of loans charged-off in the nine months ended September 30, 2006 relates to a group of loans with a common interest totaling $2.9 million. These loans were secured by diversified real estate or vehicles, on which we have foreclosed. We charged-off $318,000 related to this group of loans in the first quarter of 2006 and $713,737 in the second quarter of 2006 in order to reduce the carrying value of these loans to what we believe is their fair market value. During the second and third quarters of 2006, we sold $1.3 million of the property which had secured these loans. At September 30, 2006, the remaining $779,218 in property which had secured these loans is recorded at their fair market value as other real estate owned on our consolidated balance sheet.

At September 30, 2006, the allowance for loan losses represented 7.1 times the amount of non-performing loans, compared to 3.8 times at September 30, 2005. As a result of this level of coverage on non-performing loans, we determined that the provisions of $400,000 and $1.2 million for the three and nine months ended September 30, 2006 to be adequate.

Noninterest Income

The following table sets forth information related to our noninterest income.

	Three months ended September 30,		**Nine months ended September 30,**	
	2006	**2005**	**2006**	**2005**
Loan fee income	$ 29,683	$ 42,000	**$** 89,145	$ 138,369
Service fees on deposit accounts	66,772	58,446	195,031	194,583
Other real estate owned activity	(88,903)	-	(103,392)	-
Other income	105,375	101,405	221,716	299,768
Total noninterest income	$ 112,927	$ 201,851	**$** 402,500	$ 632,720

Three months ended September 30, 2006 and 2005

Noninterest income in the three month period ended September 30, 2006 was $112,927, a decrease of 44.1% over noninterest income of $201,851 in the same period of 2005. The $88,924 decrease in noninterest income is related to decreases of $12,317 in loan fee income and a net loss of $88,903 in real estate owned operations, partially offset by an $8,326 increase in service fees on deposit accounts and a $3,970 increase in other income.

Loan fee income consists primarily of late charge fees, fees from issuance of letters of credit and mortgage origination fees we receive on residential loans funded and closed by a third party. Loan fees were $29,683 and $42,000 for the three months ended September 30, 2006 and 2005, respectively. The $12,317 decrease for the three months ended September 30, 2006 compared to the same period in 2005 related primarily to an $9,787 reduction in mortgage origination fees and a $5,617 decrease in fees received from the issuance of letters of credit, offset by an increase of $3,087 in late charge fees. Mortgage origination fees were $0 and $9,787 for the three months ended September 30, 2006 and 2005, respectively, while income related to amortization of fees on letters of credit was $7,465 and $13,082 for the third quarter of 2006 and 2005, respectively. Late charge fees were $22,218 and $19,131 for the three months ended September 30, 2006 and 2005, respectively.

Service fees on deposits were $66,772 and $58,446 for the three months ended September 30, 2006 and 2005, respectively. The $8,326 increase relates primarily to additional NSF fees collected on deposit accounts in the third quarter of 2006. NSF income was $39,402 and $33,267 for the three months ended September 30, 2006 and 2005, respectively, representing 59.0% of total service fees on deposits in the 2006 period compared to 56.9% of total service fees on deposits in the 2005 period. Partially offsetting the increase in NSF fees collected was a $1,969 decrease in service charges on deposit accounts which were $18,298 and $20,267 for the three months ended September 30, 2006 and 2005, respectively.

As a result of loans that were transferred into real estate owned in the first and second quarters of 2006, our cost of owning the real estate exceeded income derived from the property by $88,903 for the three months ended September 30, 2006. We had no income or expenses on real estate owned for the same period in 2005.

Other income consisted primarily of income from bank owned life insurance, fees received on debit card transactions and sale of customer checks. Other income was $105,375 and $101,405 for the three months ended September 30, 2006 and 2005, respectively. A significant portion of the $3,970 increase is related to income earned on bank owned life insurance which we purchased in the third quarter of 2006. Income derived from life insurance was $55,000 for the three months ended September 30, 2006. Offsetting the income from life insurance was a $53,377 decrease in debit card transaction fees due to a change in merchant service providers whereby we now receive a net fee related to the service provided to our merchant clients. In prior years, we received a substantially higher fee, but also incurred additional transaction costs. Debit card transaction fees were $36,661 and $90,038 for the three months ended September 30, 2006 and 2005, respectively and represented 34.8% and 88.8% of total other income for the third quarters of 2006 and 2005, respectively. The corresponding transaction costs associated with debit card transactions are included in noninterest outside service expense. The debit card transaction costs were $21,387 and $75,790 for the three months ended September 30, 2006 and 2005, respectively. The net impact of the fees received and the related cost of the debit card transactions on earnings for the three months ended September 30, 2006 and 2005 was $15,274 and $14,248, respectively.

Nine months ended September 30, 2006 and 2005

Noninterest income in the nine month period ended September 30, 2006 was $402,500, a decrease of 36.4% over noninterest income of $632,720 in the same period of 2005. The $230,220 decrease in noninterest income is related to decreases of $49,224 in loan fee income and $78,052 in other income, and a net loss of $103,392 in real estate owned operations.

Loan fee income consists primarily of late charge fees, fees from issuance of letters of credit and mortgage origination fees we receive on residential loans funded and closed by a third party. Loan fees were $89,145 and $138,369 for the nine months ended September 30, 2006 and 2005, respectively. The $49,224 decrease for the nine months ended September 30, 2006 compared to the same period in 2005 related primarily to a $25,109 reduction in mortgage origination fees and a $29,486 decrease in fees received from the issuance of letters of credit which were offset by a $5,371 increase in late charge fees. Mortgage origination fees were $2,885 and $27,994 for the nine months ended September 30, 2006 and 2005, respectively, while income related to amortization of fees on letters of credit was $24,118 and $53,604 for the first nine months of 2006 and 2005, respectively. Late charge fees were $62,142 and $56,771 for the nine months ended September 30, 2006 and 2005, respectively.

Service fees on deposits were $195,031 and $194,583 for the nine months ended September 30, 2006 and 2005, respectively. While the number of client accounts continues to grow, service fees on deposits increased only slightly due primarily to the amount of NSF fees collected in the first nine months of 2006 compared to the same period in 2005. NSF income decreased $5,722 to $110,493 for the nine months ended September 30, 2006 from $116,215 for the same period in 2005, representing 56.7% of total service fees on deposits in the 2006 period compared to 59.7% of total service fees on deposits in the 2005 period. Partially offsetting the decrease in NSF fees collected was a $1,600 increase in service charges on deposit accounts which were $66,414 for the nine months ended September 30, 2006 compared to $64,814 for the same period ended September 30, 2005.

As a result of loans that were transferred into real estate owned in the first and second quarters of 2006, our cost of owning the real estate exceeded income derived from the property by $103,392 for the nine months ended September 3 0, 2006. We had no income or expenses on real estate owned for the same period in 2005.

Other income consisted primarily of income from bank owned life insurance, fees received on debit card transactions and sale of customer checks. Other income was $221,716 and $299,768 for the nine months ended September 30, 2006 and 2005, respectively. A significant portion of the $78,052 decrease is related to a change in merchant service providers whereby we now receive a net fee related to the service provided to our merchant clients, offset by income from bank owned life insurance which we purchased in the third quarter of 2006. Income derived from life insurance was $55,000 for the nine months ended September 30, 2006. Debit card transaction fees decreased during the nine months ended September 30, 2006, because in prior years, we received a substantially higher fee, but also incurred additional transaction costs. Debit card transaction fees were $106,775 and $262,810 for the nine months ended September 30, 2006 and 2005, respectively and represented 48.2% and 87.7% of total other income for the first nine months of 2006 and 2005, respectively. The corresponding transaction costs associated with debit card transactions are included in noninterest outside service expense. The debit card transaction costs were $60,199 and $218,021 for the nine months ended September 30, 2006 and 2005, respectively. The net impact of the fees received and the related cost of the debit card transactions on earnings for the nine months ended September 30, 2006 and 2005 was $46,576 and $44,789, respectively.

Noninterest expenses

The following table sets forth information related to our noninterest expenses.

	Three months ended September 30,		Nine months ended September 30,	
	2006	**2005**	**2006**	**2005**
Compensation and benefits	$ 1,085,922	$		