FIRST MID ILLINOIS BANCSHARES INC
Form 10-Q
August 07, 2007

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 June 30, 2007

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 0-13368

FIRST MID-ILLINOIS BANCSHARES, INC.
(Exact name of Registrant as specified in its charter)

Delaware	**37-1103704**
(State or other jurisdiction of incorporation or organization)	(I.R.S. employer identification no.)
1515 Charleston Avenue, Mattoon, Illinois	**61938**
(Address of principal executive offices)	(Zip code)

(217) 234-7454
(Registrant's telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (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. (Check one):

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

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

As of August 7, 2007, 6,373,495 common shares, $4.00 par value, were outstanding.

PART I

ITEM 1. FINANCIAL STATEMENTS				
Condensed Consolidated Balance Sheets		**(Unaudited)**		
(In thousands, except share data)		**June 30, 2007**		**December 31, 2006**
Assets				
Cash and due from banks:				
Non-interest bearing	$	18,964	$	20,266
Interest bearing		270		200
Federal funds sold		100		1,370
Cash and cash equivalents		19,334		21,836
Investment securities:				
Available-for-sale, at fair value		185,366		184,266
Held-to-maturity, at amortized cost (estimated fair value of $1,212 and $1,346 at June 30, 2007 and December 31, 2006, respectively)		1,198		1,323
Loans held for sale		1,817		2,234
Loans		729,986		721,334
Less allowance for loan losses		(6,158)		(5,876)
Net loans		723,828		715,458
Interest receivable		6,731		8,417
Premises and equipment, net		15,904		16,293
Goodwill, net		17,363		17,363
Intangible assets, net		4,715		5,148
Other assets		9,240		8,221
Total assets	$	985,496	$	980,559
Liabilities and Stockholders' Equity				
Deposits:				
Non-interest bearing	$	110,415	$	121,405
Interest bearing		655,759		649,190
Total deposits		766,174		770,595
Securities sold under agreements to repurchase		45,520		66,693
Interest payable		2,507		2,445
Other borrowings		68,000		37,800
Junior subordinated debentures		20,620		20,620
Other liabilities		5,508		6,620
Total liabilities		908,329		904,773
Stockholders' Equity				
Common stock, $4 par value; authorized 18,000,000 shares; issued 7,120,368 shares in 2007 and 8,552,886 shares in 2006		28,481		22,808
Additional paid-in capital		23,045		21,261
Retained earnings		45,931		68,625
Deferred compensation		2,496		2,629
Accumulated other comprehensive income (loss)		(900)		19
Less treasury stock at cost, 746,874 shares in 2007				

and 2,121,269 shares in 2006		(21,886)		(39,556)
Total stockholders' equity		77,167		75,786
Total liabilities and stockholders' equity	$	985,496	$	980,559

See accompanying notes to unaudited condensed consolidated financial statements.

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Condensed Consolidated Statements of Income (unaudited)

(In thousands, except per share data)

	Three months ended June 30,		Six months ended June 30,	
	2007	**2006**	**2007**	**2006**
Interest income:				
Interest and fees on loans	$ 12,422	$ 11,514	$ 24,594	$ 21,800
Interest on investment securities	2,212	2,031	4,481	3,584
Interest on federal funds sold	62	88	143	105
Interest on deposits with other financial institutions	4	18	8	21
Total interest income	14,700	13,651	29,226	25,510
Interest expense:				
Interest on deposits	5,402	4,381	10,692	7,830
Interest on securities sold under agreements to repurchase	592	530	1,169	1,011
Interest on other borrowings	658	671	1,245	1,270
Interest on subordinated debentures	388	304	783	494
Total interest expense	7,040	5,886	13,889	10,605
Net interest income	7,660	7,765	15,337	14,905
Provision for loan losses	209	211	395	404
Net interest income after provision for loan losses	7,451	7,554	14,942	14,501
Other income:				
Trust revenues	618	600	1,335	1,209
Brokerage commissions	140	204	252	296
Insurance commissions	427	498	1,126	1,074
Service charges	1,444	1,334	2,714	2,484
Securities gains (losses), net	17	-	156	(1)
Mortgage banking revenue, net	133	94	254	161
Other	767	685	1,541	1,325
Total other income	3,546	3,415	7,378	6,548
Other expense:				
Salaries and employee benefits	4,008	3,884	8,084	7,447
Net occupancy and equipment expense	1,197	1,198	2,414	2,334
Amortization of intangible assets	216	191	433	329
Stationery and supplies	138	130	283	265
Legal and professional	380	344	854	631
Marketing and promotion	63	244	269	420
Other	1,352	1,146	2,548	2,240
Total other expense	7,354	7,137	14,885	13,666
Income before income taxes	3,643	3,832	7,435	7,383
Income taxes	1,236	1,310	2,434	2,457

Net income	$	2,407	$	2,522	$	5,001	$	4,926
Per share data:								
Basic earnings per share	$	0.38	$	0.39	$	0.78	$	0.75
Diluted earnings per share	$	0.37	$	0.38	$	0.77	$	0.74
Cash dividends per share	$	0.19	$	0.17	$	0.19	$	0.17

See accompanying notes to unaudited condensed consolidated financial statements.

Condensed Consolidated Statements of Cash Flows (unaudited)	**Six months ended June 30,**	
(In thousands)	**2007**	**2006**
Cash flows from operating activities:		
Net income	$ 5,001	$ 4,926
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	395	404
Depreciation, amortization and accretion, net	907	853
Stock-based compensation expense	26	92
(Gains) losses on sale of securities, net	(156)	1
(Gains) losses on sale of other real property owned, net	(16)	38
Gains on sale of loans held for sale, net	(294)	(197)
Origination of loans held for sale	(26,212)	(14,864)
Proceeds from sale of loans held for sale	26,923	14,186
Decrease in other assets	903	584
Increase (decrease) in other liabilities	71	(36)
Net cash provided by operating activities	7,548	5,987
Cash flows from investing activities:		
Proceeds from sales of securities available-for-sale	9,043	5,336
Proceeds from maturities of securities available-for-sale	24,284	35,139
Proceeds from maturities of securities held-to-maturity	125	120
Purchases of securities available-for-sale	(35,433)	(24,981)
Net increase in loans	(8,765)	(23,642)
Purchases of premises and equipment	(429)	(753)
Proceeds from sales of other real property owned	923	274
Payment related to acquisition, net of cash and cash equivalents acquired	-	(12,060)
Net cash used in investing activities	(10,252)	(20,567)
Cash flows from financing activities:		
Net (decrease) increase in deposits	(4,421)	23,202
Decrease in federal funds purchased	(3,300)	-
Decrease in repurchase agreements	(21,173)	(14,802)
Proceeds from short term FHLB advances	34,000	65,600
Repayment of short term FHLB advances	(21,000)	(79,600)
Proceeds from long term FHLB advances	15,000	10,000
Proceeds from short term debt	-	500
Proceeds from long term debt	6,000	15,000
Repayment of short term debt	-	(6,000)
Repayment of long term debt	(500)	-
Issuance of junior subordinated debentures	-	10,310
Proceeds from issuance of common stock	592	475
Purchase of treasury stock	(3,484)	(4,238)
Dividends paid on common stock	(1,512)	(1,514)
Net cash provided by financing activities	202	18,933
Increase (decrease) in cash and cash equivalents	(2,502)	4,353
Cash and cash equivalents at beginning of period	21,836	19,557
Cash and cash equivalents at end of period	$ 19,334	23,910

Supplemental disclosures of cash flow information

Cash paid during the period for:

Interest	$	13,827	$	9,815
Income taxes		2,653		2,360
Supplemental disclosures of noncash investing and financing activities				
Loans transferred to real estate owned		53		346
Dividends reinvested in common stock		791		757
Net tax benefit related to option and deferred compensation plans		556		147

See accompanying notes to unaudited condensed consolidated financial statements.

Notes to Consolidated Financial Statements
(unaudited)

Basis of Accounting and Consolidation

The unaudited condensed consolidated financial statements include the accounts of First Mid-Illinois Bancshares, Inc. ("Company") and the following wholly-owned subsidiaries: Mid-Illinois Data Services, Inc. ("MIDS"), The Checkley Agency, Inc. ("Checkley"), and First Mid-Illinois Bank & Trust, N.A. ("First Mid Bank"). All significant intercompany balances and transactions have been eliminated in consolidation. The financial information reflects all adjustments which, in the opinion of management, are necessary for a fair presentation of the results of the interim periods ended June 30, 2007 and 2006, and all such adjustments are of a normal recurring nature. Certain amounts in the prior year's consolidated financial statements have been reclassified to conform to the June 30, 2007 presentation and there was no impact on net income or stockholders' equity. The results of the interim period ended June 30, 2007 are not necessarily indicative of the results expected for the year ending December 31, 2007. The Company operates as a one-segment entity for financial reporting purposes.

The 2006 year-end consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles.

The unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X and do not include all of the information required by U.S. generally accepted accounting principles for complete financial statements and related footnote disclosures although the Company believes that the disclosures made are adequate to make the information not misleading. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's 2006 Annual Report on Form 10-K.

Stock Plans

At the Annual Meeting of Stockholders held May 23, 2007, the stockholders approved the First Mid-Illinois Bancshares, Inc. 2007 Stock Incentive Plan ("SI Plan"). The SI Plan was implemented to succeed the Company's 1997 Stock Incentive Plan, which has a ten-year term that expires October 21, 2007. The SI Plan is intended to provide a means whereby directors, employees, consultants and advisors of the Company and its Subsidiaries may sustain a sense of proprietorship and personal involvement in the continued development and financial success of the Company and its Subsidiaries, thereby advancing the interests of the Company and its stockholders. Accordingly, directors and selected employees, consultants and advisors may be provided the opportunity to acquire shares of Common Stock of the Company or otherwise participate in the financial success of the Company, on the terms and conditions established herein.

A maximum of 200,000 shares may be issued under the SI Plan. As of June 30, 2007, no shares have been awarded.

Stock Split

On June 29, 2007, the Company effected a three-for-two stock split in the form of a 50% stock dividend for all shareholders of record as of June 18, 2007. Accordingly, an entry was made for $9,493,000 to the common stock and retained earnings accounts. Par value remained at $4 per share. All current and prior period share and per share amounts have been restated giving retroactive recognition to the stock split.

Treasury Stock

On May 23, 2007, the Company retired 1,500,000 shares of its treasury stock, of which cost was determined using the first-in, first-out method. Accordingly, an entry was made to the treasury stock account for $21,021,000, the common stock account for $4,000,000 and the retained earnings account for $17,021,000. Treasury stock and retained earnings at June 30, 2007 are $5,350,700 lower than originally reported in the Current Report on Form 8-K filed July 26, 2007, as a result of the correction of a mathematical error in computing the effect of the retirement.

Website

The Company maintains a website at www.firstmid.com. All periodic and current reports of the Company and amendments to these reports filed with the Securities and Exchange Commission ("SEC") can be accessed, free of charge, through this website as soon as reasonably practicable after these materials are filed with the SEC.

Comprehensive Income

The Company's comprehensive income for the three and six-month periods ended June 30, 2007 and 2006 was as follows (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2007	**2006**	**2007**	**2006**
Net income	$ 2,407	$ 2,522	$ 5,001	$ 4,926
Other comprehensive loss:				
Unrealized losses during the period	(1,651)	(1,174)	(1,350)	(1,417)
Less realized gain (loss) during the period	(17)	-	(156)	1
Tax effect	650	458	587	552
	(1,018)			
	91,018			
Total other comprehensive loss	0	(716)	(919)	(864)
Comprehensive income	$ 1,389	$ 1,806	$ 4,082	$ 4,062

New Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board ('FASB") issued Statement of Financial Accounting Standards No. 157 (FAS 157), "Fair Value Measurements," which provides enhanced guidance for using fair value to measure assets and liabilities. FAS 157 establishes a common definition of fair value, provides a framework for measuring fair value under U.S. Generally Accepted Accounting Principles and expands disclosures requirements about fair value measurements. FAS 157 is effective for financial statements issued in fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the impact, if any, the adoption of FAS 157 will have on its financial reporting and disclosures.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158 (FAS 158), "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)," which requires recognition of a net liability or asset to report the funded status of defined benefit pension and other postretirement plans on the balance sheet and recognition (as a component of other comprehensive income) of changes in the funded status in the year in which the changes occur. Additionally, FAS 158 requires measurement of a plan's assets and obligations as of the balance sheet date and additional disclosures in the notes to the financial statements. The recognition and disclosure provisions of FAS 158 are effective for fiscal years ending after December 15, 2006, while the requirement to measure a plan's assets and obligations as of the balance sheet date is effective for fiscal years ending after December 15, 2008. There was no material impact in regard to adoption of the recognition and disclosure provisions of FAS 158. The Company is currently evaluating the impact the adoption of the remaining provisions of FAS 158 will have on its financial reporting and disclosures.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159 (FAS 159), "The Fair Value Option for Financial Assets and Financial Liabilities - Including amendment of FASB Statement No. 115." FAS 159 allows companies to report selected financial assets and liabilities at fair value. The changes in fair value are recognized in earnings and the assets and liabilities measured under this methodology are required to be displayed separately in the balance sheet. The main intent of FAS 159 is to mitigate the difficulty in determining reported earnings caused by a "mixed-attribute model" (or reporting some assets at fair value and others using a different valuation attribute such as amortized cost). The project is separated into two phases. This first phase addresses the creation of a fair value option for financial assets and liabilities. A second phase will address creating a fair value option for selected non- financial items. FAS 159 is effective for all financial statements issued for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact, if any, the adoption of FAS 159 will have on its financial reporting and disclosures.

Earnings Per Share

A three-for-two common stock split was effected on June 29, 2007, in the form of a 50% stock dividend for the stockholders of record at the close of business on June 18, 2007. Accordingly, information with respect to shares of common stock and earnings per share has been restated for current and prior periods presented to fully reflect the stock split. Basic earnings per share ("EPS") is calculated as net income divided by the weighted average number of common shares outstanding. Diluted EPS is computed using the weighted average number of common shares outstanding, increased by the assumed conversion of the Company's stock options, unless anti-dilutive.

The components of basic and diluted earnings per common share for the three and six-month periods ended June 30, 2007 and 2006 were as follows:

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
Basic Earnings per Share:				
Net income	$ 2,407,000	$ 2,522,000	$ 5,001,000	$ 4,926,000
Weighted average common shares outstanding	6,368,388	6,507,963	6,394,746	6,541,619
Basic earnings per common share	$ .38	$ .39	$ .78	$ 0.75
Diluted Earnings per Share:				
Weighted average common shares outstanding	6,368,388	6,507,963	6,394,746	6,541,619
Assumed conversion of stock options	136,371	130,241	136,574	131,775
Diluted weighted average common shares outstanding	6,504,759	6,638,204	6,531,320	6,673,394
Diluted earnings per common share	$ .37	$ .38	$ .77	$ 0.74

Acquisition

On May 1, 2006, the Company completed the acquisition, for $24 million in cash, of all of the outstanding common stock of Mansfield Bancorp, Inc. (“Mansfield”) and its wholly-owned subsidiary, Peoples State Bank of Mansfield (“Peoples State Bank”), located in Mansfield, Mahomet and Weldon, Illinois, in order to expand its market presence in this area. The Company financed the purchase price through a dividend of $5 million from First Mid Bank, an issuance of $10 million of trust preferred securities and a $9.5 million draw on the Company’s line of credit with The Northern Trust Company. Following the completion of the acquisition during the third quarter of 2006, Mansfield merged with and into Peoples State Bank and Peoples State Bank merged with and into First Mid Bank. Following the completion of these mergers, Mansfield and Peoples State Bank ceased to exist and Peoples State Bank’s operations were merged into First Mid Bank’s.

The transaction has been accounted for as a purchase, and the results of operations of Mansfield and Peoples since the acquisition date have been included in the consolidated financial statements. The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of this transaction (in thousands):

Cash and cash equivalents	$ 12,193
Investment securities	52,740
Loans	55,770
Less allowance for loan losses	(1,405)
Premises and equipment	1,465
Goodwill	8,329
Core deposit intangibles	3,132
Other asset	1,636
Total assets acquired	133,860
Deposits	108,114
Deferred income taxes	869
Other liabilities	622

Total liabilities assumed		109,605
Net assets acquired	$	24,255

Transaction costs related to the completion of the transaction were approximately $255,000. The fair value of deposits acquired in the transaction exceeded the book value, resulting in a core deposit intangible asset of $3,132,000, which is being amortized over 10 years. The total fair value of the assets and liabilities acquired exceeded the book value, resulting in goodwill of $8,329,000, which is not subject to amortization. The core deposit intangibles and goodwill are not deductible for tax purposes.

The following unaudited pro forma condensed combined financial information presents the results of operations of the Company, including the effects of the purchase accounting adjustments, issuance of trust preferred securities and bank loan, had the acquisition taken place at the beginning of 2006 (in thousands):

	For the three months ended June 30, 2006	For the six months ended June 30, 2006
Net interest income	$ 8,018	$ 15,871
Provision for loan losses	221	444
Non-interest income	3,472	6,773
Non-interest expense	7,277	14,574
Income before income taxes	3,992	7,626
Income tax expense	1,504	2,659
Net income	$ 2,488	$ 4,967
Earnings per share		
Basic	$ 0.38	$ 0.76
Diluted	$ 0.38	$ 0.75
Basic weighted average shares outstanding	6,507,963	6,541,619
Diluted weighted average shares outstanding	6,638,204	6,673,694

The unaudited pro forma condensed combined financial statements do not reflect any anticipated cost savings and revenue enhancements. Additionally, the income statement for the first three months of 2006 includes merger-related expenses. Accordingly, the pro forma results of operations of the Company as of and after the merger may not be indicative of the results that actually would have occurred if the merger had been in effect during the period presented or of the results that may be attained in the future.

Goodwill and Intangible Assets

The Company has goodwill from business combinations, intangible assets from branch acquisitions, and identifiable intangible assets assigned to core deposit relationships and customer lists of Checkley.

The following table presents gross carrying value and accumulated amortization by major intangible asset class as of June 30, 2007 and December 31, 2006 (in thousands):

	June 30, 2007		December 31, 2006	
	Gross Carrying Value	Accumulated Amortization	Gross Carrying Value	Accumulated Amortization
Goodwill not subject to amortization (effective 1/1/02)	$ 21,123	$ 3,760	$ 21,123	$ 3,760
	3,015	2,061	3,015	1,961

Intangibles from branch acquisition				
Core deposit intangibles	5,936	3,048	5,936	2,810
Customer list intangibles	1,904	1,031	1,904	936
	$ 31,978	$ 9,900	$ 31,978	$ 9,467

Total amortization expense for the six months ended June 30, 2007 and 2006 was as follows (in thousands):

	June 30,	
	2007	**2006**
Intangibles from branch acquisition	$ 100	$ 100
Core deposit intangibles	238	134
Customer list intangibles	95	95
	$ 433	$ 329

Aggregate amortization expense for the current year and estimated amortization expense for each of the five succeeding years is shown in the table below (in thousands):

Aggregate amortization expense:	
For period 01/01/07-6/30/07	$ 433
Estimated amortization expense:	
For period 7/01/07-12/31/07	$ 379
For year ended 12/31/08	$ 765
For year ended 12/31/09	$ 735
For year ended 12/31/10	$ 704
For year ended 12/31/11	$ 704
For year ended 12/31/12	$ 380

In accordance with the provisions of SFAS 142, the Company performed testing of goodwill for impairment as of September 30, 2006 and determined that, as of that date, goodwill was not impaired. Management also concluded that the remaining amounts and amortization periods were appropriate for all intangible assets.

Repurchase Agreements and Other Borrowings

Securities sold under agreements to repurchase had seasonal declines of $21.2 million during the first six months of 2007. Other borrowings increased $30.2 million during the six-month period ended June 30, 2007. This increase was primarily due to an increase of $28 million in Federal Home Loan Bank advances which were used to offset the decline in repurchase agreement balances.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis is intended to provide a better understanding of the consolidated financial condition and results of operations of the Company and its subsidiaries as of, and for the periods ended, June 30, 2007 and 2006. This discussion and analysis should be read in conjunction with the consolidated financial statements, related notes and selected financial data appearing elsewhere in this report.

Forward-Looking Statements

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), such as discussions of the Company's pricing and fee trends, credit quality and outlook, liquidity, new business results, expansion plans, anticipated expenses and planned schedules. The Company intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995, and is including this statement for purposes of these safe harbor provisions. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies and expectations of the Company, are identified by use of the words "believe", "expect", "intend", "anticipate", "estimate", "projec or similar expressions. Actual results could differ materially from the results indicated by these statements because the realization of those results is subject to many risks and uncertainties including: changes in interest rates, general economic conditions, legislative/regulatory changes, monetary and fiscal policies of the U.S. government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality or composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Company's market area and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Further information concerning the Company and its business, including a discussion of these and additional factors that could materially affect the Company's financial results, is included in the Company's 2006 Annual Report on Form 10-K under the headings "Item 1. Business" and "Item 1A. Risk Factors."

New Accounting Standards Adopted During 2007

The Company adopted the provisions of FASB Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes," on January 1, 2007. The implementation of FIN 48 did not impact the Company's financial statements. The Company files U.S. federal and state of Illinois income tax returns. The Company is no longer subject to U.S. federal or state income tax examinations by tax authorities for years before 2003.

Overview

This overview of management's discussion and analysis highlights selected information in this document and may not contain all of the information that is important to you. For a more complete understanding of trends, events, commitments, uncertainties, liquidity, capital resources, and critical accounting estimates which have an impact on the Company's financial condition and results of operations you should carefully read this entire document.

Net income was $5,001,000 and $4,926,000 and diluted earnings per share was $.77 and $.74 for the six months ended June 30, 2007 and 2006, respectively. The following table shows the Company's annualized performance ratios for the six months ended June 30, 2007 and 2006, compared to the performance ratios for the year ended December 31, 2006:

	Six months ended		Year ended
	June 30, 2007	June 30, 2006	December 31, 2006
Return on average assets	1.03%	1.10%	1.07%
Return on average equity	13.06%	13.42%	13.31%
Average equity to average assets	7.89%	8.23%	8.01%

Total assets at June 30, 2007 and December 31, 2006 were $985.5 million and $980.6 million, respectively. The increase in net assets was primarily due to an increase in available-for-sale securities and commercial and agricultural operating loans. Net loan balances were $723.8 million at June 30, 2007, an increase of $8.4 million, or 1.2%, from $715.4 million at December 31, 2006. Total deposit balances decreased to $766.2 million at June 30, 2007 from $770.6 million at December 31, 2006.

Net interest margin, defined as net interest income divided by average interest-earning assets, was 3.39% for the six months ended June 30, 2007, down from 3.58% for the same period in 2006. The decrease in the net interest margin is attributable to a greater increase in borrowing and deposit rates compared to the increase in interest-earning asset rates. Net interest income before the provision for loan losses was $15.3 million compared to net interest income of $14.9 million for the same period in 2006. This increase was due to growth in average earning assets of $70.2 million for the six months ended June 30, 2007.

Noninterest income increased $830,000, or 12.7%, to $7.4 million for the six months ended June 30, 2007 compared to $6.5 million for the six months ended June 30, 2006. The increase in income is primarily due to the acquisition of Mansfield accounts that led to increased service charges and greater ATM and debit card fees.

Noninterest expense increased 8.9%, or $1.2 million, to $14.9 million for the six months ended June 30, 2007 compared to $13.7 million during the same period in 2006. In addition to increases in noninterest expense due to the acquisition of Mansfield, other factors in the expense increase were increased salaries and benefits expense that resulted from merit increases for continuing employees and an increase in legal and professional expenses.

Following is a summary of the factors that contributed to the changes in net income (in thousands):

	Change in Net Income 2007 versus 2006	Change in Net Income 2007 versus 2006
	Three months ended June 30	Six months ended June 30
Net interest income	$ (105)	$ 432
Provision for loan losses	2	9
Other income, including securities transactions	131	830
Other expenses	(217)	(1,219)
Income taxes	74	23
Increase (decrease) in net income	$ (115)	$ 75

Credit quality is an area of importance to the Company. Total nonperforming loans were $7.6 million at June 30, 2007, compared to $3.7 million at June 30, 2006 and $3.7 million at December 31, 2006. This increase was primarily due to insufficient cash flow on commercial real estate loans to one borrower which totaled $3.9 million. The Company's provision for loan losses for the six months ended June 30, 2007 and 2006 was $395,000 and $404,000, respectively. At June 30, 2007, the composition of the loan portfolio remained similar to the same period last year. During the six months ended June 30, 2007, net charge-offs were .03% of average loans compared to .07% for the same period in 2006. Loans secured by both commercial and residential real estate comprised 70% of the loan portfolio as of June 30, 2007 and 2006.

The Company's capital position remains strong and the Company has consistently maintained regulatory capital ratios above the "well-capitalized" standards. The Company's Tier 1 capital to risk weighted assets ratio calculated under the regulatory risk-based capital requirements at June 30, 2007 and 2006 was 10.37% and 9.72%, respectively. The Company's total capital to risk weighted assets ratio calculated under the regulatory risk-based capital requirements at June 30, 2007 and 2006 was 11.21% and 10.49%, respectively.

The Company's liquidity position remains sufficient to fund operations and meet the requirements of borrowers, depositors, and creditors. The Company maintains various sources of liquidity to fund its cash needs. See discussion under the heading "Liquidity" for a full listing of sources and anticipated significant contractual obligations. The Company enters into financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include lines of credit, letters of credit and other commitments to extend credit. The total outstanding commitments at June 30, 2007 and 2006 were $159.4 million and $118.8 million, respectively. This increase is primarily attributable to increases in commercial real estate lines of credit.

Critical Accounting Policies

The Company has established various accounting policies that govern the application of U.S. generally accepted accounting principles in the preparation of the Company's financial statements. The significant accounting policies of the Company are described in the footnotes to the consolidated financial statements included in the Company's 2006 Annual Report on Form 10-K. Certain accounting policies involve significant judgments and assumptions by management that have a material impact on the carrying value of certain assets and liabilities; management considers such accounting policies to be critical accounting policies. The judgments and assumptions used by management are based on historical experience and other factors, which are believed to be reasonable under the circumstances. Because of the nature of the judgments and assumptions made by management, actual results could differ from these judgments and assumptions, which could have a material impact on the carrying values of assets and liabilities and the results of operations of the Company.

The Company believes the allowance for loan losses is the critical accounting policy that requires the most significant judgments and assumptions used in the preparation of its consolidated financial statements. In estimating the allowance for loan losses, management utilizes historical experience, as well as other factors, including the effect of changes in the local real estate market on collateral values, the effect on the loan portfolio of current economic indicators and their probable impact on borrowers, and increases or decreases in nonperforming and impaired loans. Changes in these factors may cause management's estimate of the allowance for loan losses to increase or decrease and result in adjustments to the Company's provision for loan losses. See heading "Loan Quality and Allowance for Loan Losses" for a more detailed description of the Company's estimation process and methodology related to the allowance for loan losses.

Results of Operations

Net Interest Income

The largest source of revenue for the Company is net interest income. Net interest income represents the difference between total interest income earned on earning assets and total interest expense paid on interest-bearing liabilities. The amount of interest income is dependent upon many factors, including the volume and mix of earning assets, the general level of interest rates and the dynamics of changes in interest rates. The cost of funds necessary to support earning assets varies with the volume and mix of interest-bearing liabilities and the rates paid to attract and retain such funds. The Company's average balances, interest income and expense and rates earned or paid for major balance sheet categories are set forth in the following table (dollars in thousands):

	Six months ended June 30, 2007			Six months ended June 30, 2006		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
ASSETS						
Interest-bearing deposits	$ 303	$ 8	5.16%	$ 978	$ 21	4.33%
Federal funds sold	5,592	143	5.18%	6,340	105	3.34%
Investment securities						
Taxable	167,196	4,138	4.95%	150,221	3,225	4.29%
Tax-exempt (1)	16,668	343	4.12%	16,659	359	4.31%
Loans (2)(3)	716,429	24,594	6.92%	661,783	21,800	6.64%
Total earning assets	906,188	29,226	6.50%	835,981	25,510	6.15%
Cash and due from banks	18,838			17,635		
Premises and equipment	16,061			15,702		
Other assets	35,963			28,041		
Allowance for loan losses	(6,041)			(5,247)		
Total assets	$ 971,009			$ 892,112		
LIABILITIES AND STOCKHOLDERS' EQUITY						
Interest-bearing deposits						
Demand deposits	$ 263,384	$ 3,107	2.38%	$ 233,133	$ 2,213	1.91%
Savings deposits	62,030	169	.55%	61,252	143	.47%
Time deposits	330,137	7,416	4.53%	298,978	5,474	3.69%
Securities sold under agreements to repurchase	51,065	1,169	4.62%	50,906	1,011	4.00%
FHLB advances	28,856	695	4.86%	42,321	954	4.55%
Federal funds purchased	3,704	101	5.50%	5,851	95	3.27%
Junior subordinated debt	20,620	783	7.66%	14,069	494	7.08%
Other debt	13,616	449	6.65%	7,392	221	6.03%
	773,412	13,889	3.62%	713,902	10,605	3.00%

Total interest-bearing liabilities						
Non interest-bearing demand deposits	113,710			98,897		
Other liabilities	7,286			5,913		
Stockholders' equity	76,601			73,400		
Total liabilities & equity	$ 971,009			$ 892,112		
Net interest income		$ 15,337			$ 14,905	
Net interest spread			2.88%			3.15%
Impact of non-interest bearing funds			.51%			.43%
Net yield on interest-earning assets			3.39%			3.58%

(1) The tax-exempt income is not recorded on a tax equivalent basis.

(2) Nonaccrual loans have been included in the average balances.

(3) Includes loans held for sale.

Changes in net interest income may also be analyzed by segregating the volume and rate components of interest income and interest expense. The following table summarizes the approximate relative contribution of changes in average volume and interest rates to changes in net interest income for the six months ended June 30, 2007, compared to the same period in 2006 (in thousands):

	For the six months ended June 30, 2007 compared to 2006 Increase / (Decrease)		
	Total Change	Volume (1)	Rate (1)
Earning Assets:			
Interest-bearing deposits	$ (13)	$ (23)	$ 10
Federal funds sold	38	(35)	73
Investment securities:			
Taxable	913	387	526
Tax-exempt (2)	(16)	-	(16)
Loans (3)	2,794	1,849	945
Total interest income	3,716	2,178	1,538
Interest-Bearing Liabilities:			
Interest-bearing deposits			
Demand deposits	894	309	585
Savings deposits	26	2	24
Time deposits	1,942	610	1,332
Securities sold under agreements to repurchase	158	3	155
FHLB advances	(259)	(429)	170
Federal funds purchased	6	(89)	95
Junior subordinated debt	289	246	43
Other debt	228	203	25
Total interest expense	3,284	855	2,429
Net interest income	$ 432	$ 1,323	$ (891)

(1) Changes attributable to the combined impact of volume and rate have been allocated proportionately to the change due to volume and the change due to rate.
(2) The tax-exempt income is not recorded on a tax-equivalent basis.
(3) Nonaccrual loans have been included in the average balances.

Net interest income increased $.4 million, or 2.9%, to $15.3 million for the six months ended June 30, 2007, from $14.9 million for the same period in 2006. The increase in net interest income was due to growth in earning assets, primarily composed of loan growth, partially offset by a reduction in the net interest margin.

For the six months ended June 30, 2007, average earning assets increased by $70.2 million, or 8.4%, and average interest-bearing liabilities increased $59.5 million, or 8.3%, compared with average balances for the same period in 2006. The changes in average balances for these periods are shown below:

- Average loans increased by $54.6 million or 8.3%.

- Average securities increased by $17 million or 10.2%.
- Average interest-bearing deposits increased by $62.2 million or 10.5%.
- Average securities sold under agreements to repurchase increased by $.2 million or .4%.
- Average borrowings and other debt decreased by $2.8 million or 4%.
- Net interest margin decreased to 3.39% for the first six months of 2007 from 3.58% for the first six months of 2006.

To compare the tax-exempt yields on interest-earning assets to taxable yields, the Company also computes non-GAAP net interest income on a tax equivalent basis (TE) where the interest earned on tax-exempt securities is adjusted to an amount comparable to interest subject to normal income taxes assuming a federal tax rate of 34% (referred to as the tax equivalent adjustment). The net yield on interest-earning assets (TE) was 3.46% for the first six months of 2007 and 3.62% for the first six months of 2006. The TE adjustments to net interest income for June 30, 2007 and 2006 were $177,000 and $185,000, respectively.

Provision for Loan Losses

The provision for loan losses for the six months ended June 30, 2007 and 2006 was $395,000 and $404,000, respectively. Nonperforming loans were $7.6 million and $3.7 million as of June 30, 2007 and 2006, respectively. Net charge-offs were $113,000 for the six months ended June 30, 2007 compared to $234,000 during the same period in 2006. For information on loan loss experience and nonperforming loans, see discussion under the "Nonperforming Loans" and "Loan Quality and Allowance for Loan Losses" sections below.

Other Income

An important source of the Company's revenue is derived from other income. The following table sets forth the major components of other income for the three and six months ended June 30, 2007 and 2006 (in thousands):

	Three months ended June 30,			Six months ended June 30,		
	2007	**2006**	**$ Change**	**2007**	**2006**	**$ Change**
Trust	$ 618	$ 600	$ 18	$ 1,335	$ 1,209	$ 126
Brokerage	140	204	(64)	252	296	(44)
Insurance commissions	427	498	(71)	1,126	1,074	52
Service charges	1,444					