TRI COUNTY FINANCIAL CORP /MD/
Form 10-Q
May 11, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended March 31, 2007

OR

o **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 0-18279
Tri-County Financial Corporation
(Exact name of registrant as specified in its charter)

Maryland (State of other jurisdiction of incorporation or organization)	52-1652138 (I.R.S. Employer Identification No.)
3035 Leonardtown Road, Waldorf, Maryland (Address of principal executive offices)	20601 (Zip Code)

(301) 843-0854
(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 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 þ No o

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 o Accelerated filer o Non-accelerated filer þ

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

As of April 26, 2007 the registrant had 2,653,806 shares of common stock outstanding.

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TRI-COUNTY FINANCIAL CORPORATION
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PART I FINANCIAL INFORMATION
ITEM I. FINANCIAL STATEMENTS
TRI-COUNTY FINANCIAL CORPORATION
CONSOLIDATED BALANCE SHEETS MARCH 31, 2007 AND DECEMBER 31, 2006 (UNAUDITED)

	March 31, 2007	December 31, 2006
ASSETS		
Cash and due from banks	$ 2,545,692	$ 3,157,595
Federal Funds sold	608,539	772,351
Interest-bearing deposits with banks	11,453,211	14,260,560
Securities available for sale	9,129,840	9,301,676
Securities held to maturity at amortized cost	95,180,384	97,804,849
Federal Home Loan Bank and Federal Reserve Bank stock at cost	5,400,900	6,100,400
Loans receivable net of allowance for loan losses of $3,984,655 and $3,783,721, respectively	436,331,951	422,479,799
Premises and equipment, net	7,960,344	6,822,461
Foreclosed real estate	460,884	460,884
Accrued interest receivable	2,866,145	2,837,413
Investment in bank owned life insurance	8,845,278	8,762,761
Other assets	2,665,045	2,735,265
TOTAL ASSETS	$ 583,448,213	$ 575,496,014
LIABILITIES AND STOCKHOLDERS EQUITY		
LIABILITIES:		
Noninterest-bearing deposits	$ 48,379,608	$ 43,723,436
Interest-bearing deposits	393,148,950	374,289,966
Total deposits	441,528,558	418,013,402
Short-term borrowings	609,816	6,567,702
Long-term debt	86,035,980	96,045,936
Guaranteed preferred beneficial interest in junior subordinated debentures	12,000,000	12,000,000
Accrued expenses and other liabilities	4,499,240	5,139,637
Total liabilities	544,673,594	537,766,677
STOCKHOLDERS EQUITY:		
Common stock par value $.01; authorized - 15,000,000 shares; issued 2,647,003 and 2,642,288 shares, respectively	26,470	26,423
Additional paid in capital	9,538,076	9,499,946
Retained earnings	29,349,523	28,353,792

Accumulated other comprehensive loss	(42,448)	(53,822)
Unearned ESOP shares	(97,002)	(97,002)
Total stockholders equity	38,774,619	37,729,337
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 583,448,213	$ 575,496,014

See notes to consolidated financial statements

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TRI-COUNTY FINANCIAL CORPORATION
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)
THREE MONTHS ENDED MARCH 31, 2007 AND 2006

	2007	2006
INTEREST INCOME:		
Interest and fees on loans	$ 8,059,141	$ 6,663,527
Taxable interest and dividends on investment securities	1,428,541	1,591,302
Interest on deposits with banks	36,510	45,130
Total interest income	9,524,192	8,299,959
INTEREST EXPENSE:		
Interest on deposits	3,646,103	2,462,742
Interest on short-term borrowings	28,280	228,495
Interest on long-term debt	1,306,649	1,354,579
Total interest expenses	4,981,032	4,045,816
NET INTEREST INCOME	4,543,160	4,254,143
PROVISION FOR LOAN LOSSES	256,526	86,485
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	4,286,634	4,167,658

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TRI-COUNTY FINANCIAL CORPORATION
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)
THREE MONTHS ENDED MARCH 31, 2007 AND 2006

	2007	2006
NONINTEREST INCOME:		
Loan appraisal, credit, and miscellaneous charges	63,588	98,617
Net gain on the sale of foreclosed property	66,428	
Income from bank owned life insurance	82,517	70,772
Gain on the sale of investment securities	16,912	
Service charges	321,248	308,329
Total noninterest income	550,693	477,718
NONINTEREST EXPENSE:		
Salary and employee benefits	1,883,486	1,661,371
Occupancy	311,430	279,307
Advertising	161,123	145,208
Data processing	187,591	220,234
Legal and professional fees	116,605	239,014
Depreciation of furniture, fixtures, and equipment	119,258	112,496
Telephone communications	22,911	22,721
ATM expenses	67,017	57,322
Office supplies	46,461	35,711
Office equipment	11,210	12,793
Other	334,058	344,378
Total noninterest expenses	3,261,150	3,130,555
INCOME BEFORE INCOME TAXES	1,576,177	1,514,821
Income tax expense	566,558	541,684
NET INCOME	1,009,619	973,137
OTHER COMPREHENSIVE INCOME NET OF TAX		
Net unrealized holding gains (losses) arising during period	11,374	(161,787)
COMPREHENSIVE INCOME	$ 1,020,993	$ 811,350
INCOME PER COMMON SHARE		
Basic	$ 0.38	$ 0.37
Diluted	0.36	0.35

See notes to consolidated financial statements

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TRI-COUNTY FINANCIAL CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
THREE MONTHS ENDED MARCH 31, 2007 AND 2006

	Three Months Ended March 31,	
	2007	**2006**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 1,009,619	$ 973,137
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Stock Based Compensation Expense		60,000
Provision for loan losses	256,526	86,485
Gain on sales of investment securities	(16,912)	
Depreciation and amortization	242,766	213,856
Net amortization of premium/discount on investment securities	6,758	(10,502)
Increase in cash surrender of bank owned life insurance	(82,517)	(70,772)
Deferred income tax (benefit) expense	(170,232)	75,883
Increase in accrued interest receivable	(28,732)	(60,021)
Increase (decrease) in deferred loan fees	43,633	(29,261)
Increase (decrease) in accounts payable, accrued expenses, other liabilities	(706,825)	24,228
Decrease in other assets	234,592	98,558
Net cash provided by operating activities	788,676	1,361,591
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of investment securities available for sale	(36,429)	(11,694)
Proceeds from sale, redemption or principal payments of investment securities available for sale	241,903	163,379
Purchase of investment securities held to maturity		(3,500,000)
Proceeds from maturities or principal payments of investment securities held to maturity	2,618,216	5,883,155
Net redemption of FHLB and Federal Reserve stock	699,500	121,100
Loans originated or acquired	(39,525,440)	(36,968,947)
Principal collected on loans	25,373,129	26,803,170
Purchase of Bank Owned Life Insurance		(2,000,000)
Purchase of premises and equipment	(1,380,648)	(230,707)
Proceeds from foreclosed real estate	66,428	
Net cash used in investing activities	(11,943,341)	(9,740,544)

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TRI-COUNTY FINANCIAL CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS(UNAUDITED)
THREE MONTHS ENDED MARCH 31, 2007 AND 2006

	Three Months Ended March 31,	
	2007	**2006**
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in deposits	23,515,156	8,744,990
Proceeds from long-term borrowings		260,000
Payments of long-term borrowings	(10,009,956)	(8,546)
Net decrease in short term borrowings	(5,957,886)	(4,569,387)
Exercise of stock options	38,183	57,344
Redemption of common stock	(13,896)	(144,710)
Net cash provided by financing activities	7,571,601	4,339,691
DECREASE IN CASH AND CASH EQUIVALENTS	(3,583,064)	(4,039,262)
CASH AND CASH EQUIVALENTS JANUARY 1	18,190,506	22,575,240
CASH AND CASH EQUIVALENTS MARCH 31	$ 14,607,442	$ 18,535,978
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid during the three months for:		
Interest	$ 5,018,941	$ 4,068,462
Income taxes	$ 332,600	$ 613,000

See notes to consolidated financial statements

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. **BASIS OF PRESENTATION**

General - The consolidated financial statements of Tri-County Financial Corporation (the Company) and its wholly owned subsidiary, Community Bank of Tri-County (the Bank) included herein are unaudited. However, they reflect all adjustments consisting only of normal recurring accruals that, in the opinion of management, are necessary to present fairly the Company s financial condition, results of operations, and cash flows for the periods presented. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. The Company believes that the disclosures are adequate to make the information presented not misleading. The balances as of December 31, 2006 have been derived from audited financial statements. There have been no significant changes to the Company s accounting policies as disclosed in the 2006 Annual Report. The results of operations for the three months ended March 31, 2007 are not necessarily indicative of the results of operations to be expected for the remainder of the year or any other period. Certain previously reported amounts have been restated to conform to the 2007 presentation.

It is suggested that these consolidated financial statements be read in conjunction with the consolidated financial statements and notes included in the Company s Annual Report for the year ended December 31, 2006.

2. **NATURE OF BUSINESS**

The Company, through its bank subsidiary, provides domestic financial services primarily in southern Maryland. The primary financial services include real estate, commercial and consumer lending, as well as traditional demand deposits and savings products.

3. **INCOME TAXES**

The Company uses the liability method of accounting for income taxes as required by SFAS No. 109, Accounting for Income Taxes. Under the liability method, deferred-tax assets and liabilities are determined based on differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities (i.e., temporary differences) and are measured at the enacted rates that will be in effect when these differences reverse. The Company also adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN48) on January 1, 2007. FIN 48 is an interpretation of FASB Statement No. 109, Accounting for Income Taxes, and seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. In addition, FIN 48 provides guidance on de-recognition, classification, interest and penalties, and accounting in interim periods and requires expanded disclosure with respect to the uncertainty in income taxes. There was no cumulative effect as a result of applying FIN 48. No adjustment was made to our opening balance of retained earnings.

4. **EARNINGS PER SHARE**

Earnings per common share are computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period, including any potential dilutive common shares outstanding, such as options and warrants. As of March 31, 2007, there were no shares excluded from the diluted net income per share computation because inclusion of these options would be anti-dilutive. Basic and diluted earnings per share, have been computed based on weighted-average common and common equivalent shares outstanding as follows:

	Three Months Ended March 31,	
	2007	**2006**
Basic	2,643,950	2,639,962
Diluted	2,829,778	2,811,823

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Share and per share data have been adjusted to reflect the three for two common stock split effected in November 2006 as if it had occurred on January 1, 2006.

5. STOCK-BASED COMPENSATION

The Company has stock option and incentive plans to attract and retain key personnel in order to promote the success of the business. These plans are described in note 12 to the financial statements included in our Annual Report to Stockholders for the year ended December 31, 2006. No compensation related expense related to stock options has been recognized in the quarter ended March 31, 2007 and during 2006.

The Company and the Bank currently maintain incentive plans which provide for payments to be made in either cash or stock options. The Company has accrued the full amounts due under these plans, but currently it is not possible to identify the portion that will be paid out in the form of stock options.

A summary of the Company s stock option plans as of March 31, 2007 and changes during the three-month period then ended is presented below:

	Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted-Average Contractual Life Remaining In Years
Outstanding at December 31, 2006	417,097	$ 13.86		
Granted				
Exercised	(5,301)	7.20		
Expired				
Forfeited				
Outstanding at March 31, 2007	411,796	$ 13.95	$ 5,272,812	5.5
Exercisable at March 31, 2007	411,796	$ 13.95	$ 5,272,812	5.5

Share and per share data have been adjusted to reflect the three for two common stock split effected in November 2006 as if it had occurred on January 1, 2006.

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6. GUARANTEED PREFERRED BENEFICIAL INTEREST IN JUNIOR SUBORDINATED DEBENTURES

On June 15, 2005, Tri County Capital Trust II (Capital Trust II), a Delaware business trust formed, funded and wholly owned by the Company, issued $5,000,000 of capital securities with an interest rate of 5.07% in a private pooled transaction. The rate is based on the 90-day LIBOR rate plus 1.70%. The Trust used the proceeds from this issuance to purchase $5.2 million of the Company s junior subordinated debentures. The interest rate on the debentures and the trust preferred securities is variable and adjusts quarterly. The Company has, through various contractual arrangements, fully and unconditionally guaranteed all of Capital Trust II s obligations with respect to the capital securities. These capital securities qualify as Tier I capital and are presented in the Consolidated Balance Sheets as Guaranteed Preferred Beneficial Interests in Junior Subordinated Debentures. Both the capital securities of Capital Trust II and the junior subordinated debentures are scheduled to mature on June 15, 2035, unless called by the Company not earlier than June 15, 2010.

On July 22, 2004, Tri County Capital Trust I (Capital Trust I), a Delaware business trust formed, funded and wholly owned by the Company, issued $7,000,000 of capital securities with an interest rate of 4.22% in a private pooled transaction. The rate is based on the 90-day LIBOR rate plus 2.60%. The Trust used the proceeds from this issuance to purchase $7.2 million of the Company s junior subordinated debentures. The interest rate on the debentures and the trust preferred securities is variable and adjusts quarterly. The Company has, through various contractual arrangements, fully and unconditionally guaranteed all of Capital Trust I s obligations with respect to the capital securities. These capital securities qualify as Tier I capital and are presented in the Consolidated Balance Sheets as Guaranteed Preferred Beneficial Interests in Junior Subordinated Debentures. Both the capital securities of Capital Trust I and the junior subordinated debentures are scheduled to mature on July 22, 2034, unless called by the Company not earlier than July 22, 2009.

Costs associated with the issuance of the trust-preferred securities were less than $10,000 and were expensed as period costs.

7. NEW ACCOUNTING STANDARDS

In September 2006, the Financial Accounting Standards Board, the (FASB) issued Statements of Financial Accounting Standards (SFAS) 157, Fair Value Measurements. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 applies to existing accounting pronouncements that require or permit fair value measurements in which FASB had previously concluded fair value is the most relevant measurement attribute. Accordingly, SFAS 157 does not require any new fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, with early adoption encouraged. The Company is currently evaluating the impact the adoption of this interpretation will have on its financial condition and results of operations.

SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115. SFAS 159 permits entities to choose to measure eligible items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. The fair value option (i) may be applied instrument by instrument, with certain exceptions, (ii) is irrevocable (unless a new election date occurs) and (iii) is applied only to entire instruments and not to portions of instruments. SFAS 159 is effective for the Corporation on January 1, 2008 and is not expected to have a significant impact on the Corporation s financial statements.

In September 2006, the FASB ratified the consensus reached by the EITF on Issue No. 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. EITF 06-4 requires the recognition of a liability and related compensation costs for endorsement split-dollar life insurance policies that provide a benefit to an employee that extends to postretirement periods as defined in SFAS No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions. The EITF reached a consensus that Bank Owned Life Insurance policies purchased for this purpose do not effectively settle the entity s obligation to the employee in this regard and, thus, the entity must record compensation costs and a related liability. Entities should recognize the effects of applying this Issue through either, (a) a change in

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accounting principle through a cumulative-effective adjustment to retained earnings or to other components of equity or net assets in the balance sheet as of the beginning of the year of adoption, or (b) a change in accounting principle through retrospective application to all prior periods. This Issue is effective for fiscal years beginning after December 15, 2007. Management is currently evaluating the impact of adopting this Issue on the Company s financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN48). FIN 48 is an interpretation of FASB Statement No. 109, Accounting for Income Taxes, and seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. In addition, FIN 48 provides guidance on de-recognition, classification, interest and penalties, and accounting in interim periods and requires expanded disclosure with respect to the uncertainty in income taxes. We adopted the provisions of FIN 48 on January 1, 2007. There was no cumulative effect as a result of applying FIN 48. No adjustment was made to our opening balance of retained earnings.

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

This document contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including discussions of Tri-County Financial Corporation s (the Company) goals, strategies and expected outcomes; estimates of risks and future costs; and reports of the Company s ability to achieve its financial and other goals. Forward-looking statements are generally preceded by terms such as expects, believes, anticipates, intends and similar expressions. These forward-looking statements are subject to significant known and unknown risks and uncertainties because they are based upon future economic conditions, particularly interest rates, competition within and without the banking industry, changes in laws and regulations applicable to the Company, change sin accounting principles, and various other matters. Additional factors that may affect our results are discussed in the Company s Annual Report on Form 10-K (the Form 10-K) and this Quarterly Report on Form 10-Q under Item 1.A. Risk Factors. Because of these uncertainties, there can be no assurance that actual results, performance or achievements of the Company will not differ materially from any future results, performance or achievements expressed or implied by these forward-looking statements. The Company does not undertake and specifically disclaims any obligation to publicly release the result of any revisions that may be made to any forward-looking statement to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

GENERAL

The Company is a bank holding company organized in 1989 under the laws of the State of Maryland. It owns all the outstanding shares of capital stock of Community Bank of Tri-County (the Bank), a Maryland-chartered commercial bank. The Company engages in no significant activity other than holding the stock of the Bank, the payment of its subordinated debt, and directing the business of the Bank. Accordingly, the information set forth in this report, including financial statements and related data, relates primarily to the Bank and its subsidiaries.

The Bank serves the Southern Maryland area through its main office and eight branches located in Waldorf, Bryans Road, Dunkirk, Leonardtown, La Plata, Charlotte Hall, Prince Frederick and California, Maryland. The Bank is engaged in the commercial and retail banking business as authorized by the banking statutes of the State of Maryland and applicable Federal regulations. The Bank accepts demand and time deposits and uses these funds along with borrowings from the Federal Home Loan Bank (the FHLB), to fund loan originations to individuals, associations, partnerships and corporations. The Bank makes real estate loans including residential first and second mortgage loans, home equity lines of credit and commercial mortgage loans. The Bank also makes commercial loans including secured and unsecured loans. The Bank is a member of the Federal Reserve and FHLB Systems. The Federal Deposit Insurance Corporation provides deposit insurance coverage up to applicable limits.

Since its conversion to a state chartered commercial bank in 1997, the Bank has sought to increase its commercial, commercial real estate, construction, second mortgage, home equity, and consumer lending business as well as the level of transactional deposits to levels consistent with similarly sized commercial banks. As a result of this emphasis, the Bank s percentage of assets invested in residential first mortgage lending has declined since 1997. Conversely, targeted loan types have increased. The Bank has also seen an increase in transactional deposit accounts while the percentage of total liabilities represented by certificates of deposits has declined. Management believes that these changes will enhance the Bank s overall long-term financial performance.

Management recognizes that the shift in composition of the Bank s loan portfolio away from residential first mortgage lending will tend to increase its exposure to credit losses. The Bank continues to evaluate its allowance for loan losses and the associated provision to compensate for the increased risk. Any evaluation of the allowance for loan losses is inherently inexact and reflects management s expectations as to future economic conditions in the Southern Maryland area as well as individual borrower s circumstances. Management believes that its allowance for loan losses is adequate. For further information on the Bank s allowance for loan losses see the discussion in the sections captioned Financial Condition and Critical Accounting Policies as well as the relevant discussions in the Form 10-K and Annual Report for the year ended December 31, 2006.

After a series of increases in the Federal Funds rate, the Federal Reserve has not changed the Federal Funds rate since June 2006. The increases enacted up to June 2006 had the effect of pushing short-term rates higher while longer-term rates remained essentially unchanged. The difference between short- and long-term rates has decreased, creating a flat yield curve. For the last several quarters, many market participants have signaled through price expectations that they expect a Federal Funds rate cut in response to their perceptions of a slowing economy and a deflation in housing prices. However, official Federal Reserve documents indicate that the Federal Reserve still believe that consumer price inflation remains a threat. As a result of these and other factors the Federal Reserve has decided to leave the Federal Funds rate unchanged.

SELECTED FINANCIAL DATA

	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006
Condensed Income Statement		
Interest Income	$ 9,524,192	$ 8,299,959
Interest Expense	4,981,032	4,045,816
Net Interest Income	4,543,160	4,254,143
Provision for Loan Losses	256,526	86,485
Noninterest Income	550,693	477,718
Noninterest Expense	3,261,150	3,130,555
Income Before Income Taxes	1,576,177	1,514,821
Income Taxes	566,558	541,684
Net Income	$ 1,009,619	$ 973,137
Per Common Share		
Basic Earnings	$ 0.38	$ 0.37
Diluted Earnings	$ 0.36	$ 0.35

Share and per share data have been adjusted to reflect the three for two common stock split effected in November 2006 as if it had occurred on January 1, 2006.

RESULTS OF OPERATIONS

Net income for the three-month period ended March 31, 2007 totaled $1,009,619 ($0.38 basic and $0.36 diluted earnings per share) compared to $973,137 ($0.37 basic and $0.35 diluted earnings per share) for the same period in the prior year. This increase of $36,482, or 3.75%, was caused by increases in net interest and noninterest income partially offset by increases in provision for loan losses and noninterest expenses.

For the three-month period ended March 31, 2007, interest income increased by $1,224,233, or 14.75%, to $9,524,192. The increase was due to higher average balances of earning assets and higher rates earned on these assets. The Bank continued to increase balances of loans which tend to have higher yields and decrease balances of cash and investment securities which tend to have lower yields. Interest expense increased to $4,981,032 in the three-month period ended March 31, 2007 as compared to $4,045,816 in the same period in the prior year, an increase of $935,216 or 23.12%. The increase was the result of higher average balances and higher rates. Although overall rates paid on interest earning liabilities increased, the Bank s continued shifting from wholesale liabilities to retail deposits helped to control the overall amount of interest expense.

Provision for loan losses increased to $256,526 for the three months ended March 31, 2007 from $86,485 for the three-month period ended March 31, 2006. The increase in the provision was caused by the increases in the Bank s loan portfolio, especially in commercial loans, which tend to have a higher risk of default than one- to four family residential real estate loans. In addition, the Bank experienced $57,325 of loan charge-offs in the current period compared to $6,636 in the corresponding period in 2006. Higher charge-offs were caused by developments in certain individual loans and do not appear to indicate systemic weaknesses in our loan standards. While loan charge-offs have increased in the current period, total delinquency has decreased from December 31, 2006. Management will continue to periodically review its allowance for loan losses and the