SLADES FERRY BANCORP
Form 10-Q
May 12, 2006

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

FORM 10-Q

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

For the quarter ended March 31, 2006

Commission file number 000-23904

SLADE'S FERRY BANCORP.

(Exact name of registrant as specified in its character)

Massachusetts	04-3061936
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
100 Slade's Ferry Avenue Somerset, Massachusetts	02726
(Address of principal executive offices)	(Zip code)

(508)-675-2121

(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, 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 [ ] 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 practical date:

Common stock ($0.01 par value) 4,165,125
outstanding shares as of April 30, 2006.

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Part I

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ITEM 1

FINANCIAL STATEMENTS

SLADE'S FERRY BANCORP. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEET
(Unaudited)

	March 31, 2006	December 31
	(In thousands)	
Assets		

Cash and due from banks	$ 16,116	$ 17,7
Interest-bearing demand deposits with other banks	661	
Federal funds sold	-	2,2
Cash and cash equivalents	16,777	20,0
Interest-bearing certificates of deposit with other banks	100	1
Securities available for sale	92,435	94,2
Securities held to maturity (fair value approximates $27,734 at March 31, 2006 and $28,858 as ofat December 31, 2005)	28,201	29,3
Federal Home Loan Bank stock, at cost	6,304	6,3
Loans, net of allowance for loan losses of $4,372 at March 31, 2006 and $4,333 at December 31, 2005	414,396	409,6
Premises and equipment, net	5,857	5,9
Goodwill	2,173	2,1
Accrued interest receivable	2,354	2,2
Bank-owned life insurance	11,991	11,8
Deferred tax assets, net	2,108	2,0
Other assets	2,048	1,9
	$584,744	$585,9

Liabilities and Stockholders'' Equity

Deposits:		
Noninterest-bearing	$ 75,754	$ 80,7
Interest-bearing	332,035	335,1
Total deposits	407,789	415,8
Short-term borrowings	20,500	7,0
Long-term borrowings	93,752	100,8
Subordinated debentures	10,310	10,3
Accrued expenses and other liabilities	2,654	3,0
Total liabilities	535,005	537,0
Stockholders' equity:		
Common stock, par value $0.01 per share; authorized 10,000,000 shares; issued and outstanding 4,155,712 shares at March 31, 2006 and 4,132,200 shares at December 31, 2005	41	
Additional paid-in capital	31,405	31,0
Retained earnings	19,530	18,9
Accumulated other comprehensive loss	(1,237)	(1,1
Total stockholders' equity	49,739	48,8
	$584,744	$585,9

The accompanying notes are an integral part of these consolidated financial statements.

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SLADE'S FERRY BANCORP. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended March 31 2006	2005
	(In thousands, except share da	
Interest and dividend income:		
Interest and fees on loans	$ 6,435	$ 5,266
Interest and dividends on securities:		
Taxable	1,333	1,231
Tax-exempt	69	91
Interest on federal funds sold	11	65
Other interest	8	4
Total interest and dividend income	7,856	6,657
Interest expense:		
Interest on deposits	1,911	1,159
Interest on Federal Home Loan Bank advances	1,156	911
Interest on subordinated debentures	224	136
Total interest expense	3,291	2,206
Net interest and dividend income	4,565	4,451
Provision for loan losses	39	50
Net interest income, after provision for loan losses	4,526	4,401
Noninterest income:		
Service charges on deposit accounts	307	208
Gain on sales and calls of available-for-sale securities, net	3	2
Increase in cash surrender value of life insurance policies	107	147
Other income	286	212
Total noninterest income	703	569
Noninterest expense:		
Salaries and employee benefits	2,111	1,975
Occupancy and equipment expense	493	409
Professional fees	412	307
Marketing expense	78	99
Other expense	656	525
Total noninterest expense	3,750	3,315
Income before income taxes	1,479	1,655
Provision for income taxes	572	555
Net income	$ 907	$ 1,100
Earnings per share:		
Basic	$ 0.22	$ 0.27
Diluted	$ 0.22	$ 0.27

Average common shares outstanding:		
Basic	4,149,686	4,076,707
Diluted	4,160,028	4,113,256

The accompanying notes are an integral part of these consolidated financial statements.

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SLADE'S FERRY BANCORP. AND SUBSIDIARY
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
(Unaudited)

	Shares of Common Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accum Ot Compre L
	(In thousands, except share data)				
Balance at December 31, 2005	4,132,200	$41	$31,014	$18,998	$(1
Comprehensive income:					
Net income		-	-	907	
Other comprehensive income (loss)		-	-	-	
Comprehensive income					
Issuance of common stock	8,512	-	155	-	
Stock options exercised	22,000	-	228	-	
Tax benefit of stock options exercised		-	69	-	
Stock-based compensation		-	65	-	
Purchase of treasury stock	(7,000)	-	(126)	-	
Dividends declared ($.09 per share)		-	-	(375)	
Balance at March 31, 2006	4,155,712	$41	$31,405	$19,530	$(1

The accompanying notes are an integral part of these consolidated financial statements.

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SLADE''S FERRY BANCORP. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
	(In thousands)	
Cash flows from operating activities:		
Net income	$ 907	$ 1,100
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization, net of accretion of securities	32	59
Gain on sales and calls of available-for-sale securities, net	(3)	(2)
Change in net deferred loan fees	(15)	37
Provision for loan losses	39	50
Deferred tax provision (benefit)	80	(418)
Depreciation and amortization	221	184
Gain on sale of loans, net	-	(40)
Increase in cash surrender value of life insurance	(107)	(147)
Net change in:		
Other assets	(131)	1,070
Accrued interest receivable	(56)	(86)
Other liabilities	(384)	(85)
Net cash provided by operating activities	583	1,722
Cash flows from investing activities:		
Activity in available-for-sale securities:		
Purchases	(489)	(767)
Sales	665	892
Maturities	1,602	1,670
Activity in held-to-maturity securities:		
Maturities	1,092	1,772
Purchases of Federal Home Loan Bank stock	-	(1,255)
Loan principal originations, net	(4,810)	(17,299)
Recoveries of loans previously charged off	-	25
Capital expenditures	(161)	(696)
Proceeds from sale of investment real estate	-	652
Redemption of life insurance policy	-	132
Net cash used in investing activities	(2,101)	(14,874)

The accompanying notes are an integral part of these consolidated financial statements.

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SLADE'S FERRY BANCORP. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(Unaudited)

	Three Months Ended March 31,	
	2006	2005
	(In thousands)	
Cash flows from financing activities:		
Net decrease in noninterest-bearing deposits	$ (4,951)	$ (3,630)
Net decrease in interest-bearing deposits	(3,106)	(10,737)
Short-term advances from Federal Home Loan Bank	17,000	-
Long-term advances from Federal Home Loan Bank	10,000	20,000
Payments on Federal Home Loan Bank short-term advances	(13,500)	-
Payments on Federal Home Loan Bank long-term advances	(7,113)	(106)
Proceeds from issuance of common stock	155	154
Stock-based compensation	65	-
Stock options exercised	228	196
Purchase of treasury stock	(126)	-
Dividends paid	(375)	(368)
Net cash provided (used) by financing activities	(1,723)	5,509
Net decrease in cash and cash equivalents	(3,241)	(7,643)
Cash and cash equivalents at beginning of period	20,018	35,194
Cash and cash equivalents at end of period	$ 16,777	$ 27,551
Supplemental disclosures:		
Interest paid	$ 3,291	$ 2,132
Income taxes paid	$ 475	$ 555

The accompanying notes are an integral part of these consolidated financial statements.

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SLADE'S FERRY BANCORP. AND SUBSIDIARY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
March 31, 2006

Note A - Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and the instructions to Form 10-Q and, accordingly, do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of the management of Slade's Ferry Bancorp. (the "Company"), all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

The year-end consolidated financial data was derived from audited financial statements, but does not include all disclosures required by GAAP. This Form 10-Q should be read in conjunction with the Company's Annual Report filed on Form 10-K for the year ended December 31, 2005.

Note B - Accounting Policies

The accounting principles followed by Slade's Ferry Bancorp. and subsidiary and the methods of applying these principles which materially affect the determination of financial position, results of operations, or changes in financial position are consistent with those used for the year ended December 31, 2005, except for the adoption of Statement of Financial Accounting Standards No. 123(R), Share-Based Payment, ("SFAS 123(R)" or the "Statement") effective January 1, 2006 applicable to the Company's stock-based employee compensation plans. See Note C

The consolidated financial statements include the accounts of Slade's Ferry Bancorp. (the "Company"), its wholly-owned subsidiary, Slade's Ferry Trust Company (the "Bank") and the Bank's wholly-owned subsidiaries. All significant inter-company balances and transactions have been eliminated in consolidation. The Company accounts for its wholly-owned subsidiary, Slade's Ferry Statutory Trust I, are using the equity method.

Slade's Ferry Statutory Trust I, a subsidiary of the Company, was formed on March 17, 2004 to sell capital securities to the public through a third party trust pool. In accordance with Financial Accounting Standards Board ("FASB") Interpretation No. 46R, "Consolidation of Variable Interest Entities" ("FIN 46R"), the subsidiary has not been included in the consolidated financial statements.

Slade's Ferry Loan Company was dissolved in early 2005.

Note C - Stock Based Compensation

The Company adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment, ("SFAS 123 (R)" or the "Statement") effective January 1, 2006 applicable to the Company's stock-based employee compensation plans. The Company's stock-based compensation plans are described in Note 15 to the Company's consolidated financial statements included in its Form 10-K for the year ended December 31, 2005. No changes have been made to the plans during the three months ended March 31, 2006 and no awards were granted under the plans during this period. In accordance with SFAS No. 123(R), for the three months ended March 31, 2006, the Company has recognized compensation costs related to the non-vested portion of awards outstanding as of January 31, 2006 based on the grant-date fair value of those awards as calculated

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under the original provisions of Statement No. 123. Fair value has been determined using Black-Scholes option-pricing model. Compensation costs are now being recognized over the period the employee is required to provide services for the award. The impact of adopting SFAS No. 123(R) was a reduction of income before income taxes of $65,000 and a reduction of net income by $47,000 for the three months ended March 31, 2006. Basic and diluted earnings per share were reduced by $0.01 per share. At March 31, 2006, non-vested stock options pertaining to 36,166 shares of common stock were outstanding with a weighted average fair value ranging from $5.07 to $7.20 and will vest within the next 14 months.

The intrinsic value of options exercised during the three months ended March 31, 2006 amounted to $229,000. At March 31, 2006 the intrinsic value of options outstanding and options exercisable amounted to $4,185,000 and $3,495,000, respectively.

Prior to the adoption of SFAS No. 123(R), the Company accounted for the plans under the recognition and measurement principles of Accounting Principle Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations. Accordingly, no stock-based employee compensation cost was reflected in net income, as all options granted under the plans had an exercise price equal to the market value of the underlying common stock on the date of grant.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of Statement of Financial Accounting Standards ("SFAS") Statement No. 123(R), "Accounting for Stock-Based Compensation," to stock-based employee compensation for the three months ended March 31, 2005.

		2005 (In thousands)
Net income, as reported		$1,100
Deduct: stock-based employee compensation expense determined under fair value method, net of related tax effects		38
Net income, pro forma		$1,062
Earnings per share - basic	As reported	$ 0.27
	Pro forma	$ 0.26
Earnings per share - assuming dilution	As reported	$ 0.27
	Pro forma	$ 0.26

Note D - Pension Plan

The components of net periodic pension income are as follows:

	Three Months Ended March 31, 2006	2005
	(In thousands)	
Interest cost	$ 17	$ 21
Expected return on plan assets	(29)	(37)
Recognized net actuarial loss	7	9
	$ (5)	$ (7)

The Company previously disclosed in its consolidated financial statements for the year ended December 31, 2005 that it expects to make no contributions to the plan in 2006.

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ITEM 2

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Slade's Ferry Bancorp., a Massachusetts corporation, is a bank holding company headquartered in Somerset, Massachusetts with consolidated assets of $584.7 million, consolidated net loans and leases of $414.4 million, consolidated deposits of $407.8 million and consolidated shareholders' equity of $49.7 million as of March 31, 2006. We conduct our business principally through our wholly-owned subsidiary, Slade's Ferry Trust Company (referred to herein as the "Bank"), a Massachusetts-chartered trust company. Our common stock is quoted on the Nasdaq Capital Market under the symbol "SFBC."

Forward-looking Statements

This Form 10-Q contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including statements regarding the strength of the company's capital and asset quality. Such statements may be identified by words such as "believes," "will," "expects," "project," "may," "could," "developments," "strategic," "launching," "opportunities," "anticipates," "estimates," "intends," "plans," "targets" and similar expressions. These statements are based upon the current beliefs and expectations of Slade's Ferry Bancorp.'s management and are subject to significant risks and uncertainties. Actual results may differ materially from those set forth in the forward-looking statements as a result of numerous factors.

The following factors, among others, could cause actual results to differ materially from the anticipated results or other expectations expressed in our forward-looking statements:

(1) enactment of adverse government regulation;

(2) competitive pressures among depository and other financial institutions may increase significantly and have an effect on pricing, spending, third-party relationships and revenues;

(3) the strength of the United States economy in general and specifically the strength of the New England economies may be different than expected, resulting in, among other things, a deterioration in overall credit quality and borrowers' ability to service and repay loans, or a reduced demand for credit, including the resultant effect on the our loan portfolio, levels of charge-offs and non-performing loans and allowance for loan losses;

(4) changes in the interest rate environment may reduce interest margins and adversely impact net interest income; and

(5) changes in assumptions used in making such forward-looking statements.

Should one or more of these risks materialize or should underlying beliefs or assumptions prove incorrect, Slade's Ferry Bancorp.'s actual results could differ materially from those discussed.

All subsequent written and oral forward-looking statements attributable to Slade's Ferry Bancorp. or any person acting on its behalf are expressly qualified in their entirety by the cautionary statements set forth above. Slade's Ferry Bancorp. does not intend or undertake any obligation to update any forward-looking statement to reflect circumstances or events that occur after the date the forward-looking statements are made.

As used throughout this report, the terms "we," "our," "us," or the "Company" refer to Slade's Ferry Bancorp. and its consolidated subsidiary, unless context otherwise requires.

Critical Accounting Policies

Our significant accounting policies are incorporated by reference to Note 1 to our Consolidated Financial Statements filed within Form 10-K for the year ended December 31, 2005. In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and other-than-temporary impairment losses.

Allowance for loan losses. The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

Other than temporary impairment. In estimating other-than-temporary-impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

Comparison of Financial Condition at March 31, 2006 and December 31, 2005

General

Total assets decreased by $1.2 million, or 0.2%, from $585.9 million at December 31, 2005 to $584.7 million at March 31, 2006. The decrease was the result of a decline in the investment portfolio, totaling $3.0 million, along with a decline in cash and cash equivalents totaling $3.2 million. The decrease in the investment portfolio and cash and cash equivalents were partially offset by an increase in the loan portfolio. Total net loans increased by $4.8 million, or 1.2%, from $409.6 million to $414.4 million. During the first quarter of 2006, deposits decreased by $8.1 million, or 1.9%, from $415.8 million to $407.8 million. The decrease in deposits was offset by an increase in Federal Home Loan Bank advances totaling $6.4 million.

Cash and Cash Equivalents

Cash and cash equivalents decreased by $3.2 million, from $20.0 million at December 31, 2005 to $16.8 million at March 31, 2006. The decrease funded a portion of the growth in the loan portfolio.

Investment Portfolio

The main objectives of our investment portfolio are to achieve a competitive rate of return over a reasonable time period and to provide liquidity.

Our total investment portfolio decreased from $129.9 million at December 31, 2005 to $126.9 million at March 31, 2006, a decrease of 2.3%. The decrease is the result of the maturity, calls and paydowns of certain state

and municipal obligations and mortgage-backed securities. Those funds were used to provide liquidity for current loan growth.

The current investment strategy is to reduce the investment portfolio through normal paydowns and maturities and reinvest these funds into higher yielding loans. At March 31, 2006, the portfolio duration was 3.4 years within the investment policy limit of 5 years. We do not purchase investments with imbedded derivative characteristics, or free-standing derivative instruments such as swaps, options, or futures.

Securities Held to Maturity

The held-to-maturity portfolio consists of mortgage-backed securities and securities issued by states and municipalities. Held-to-maturity securities decreased from $29.3 million at December 31, 2005 to $28.2 million at March 31, 2006. Management has designated these mortgage-backed securities to secure advances from the FHLB. We have the positive intent and ability to hold these securities to maturity.

The following table shows the amortized cost basis, gross unrealized gains and losses, and fair value of securities held to maturity at March 31, 2006 and December 31, 2005.

	March 31, 2006		December 31, 2005	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)			
State and municipal obligations	$ 6,099	$ 6,194	$ 6,766	$ 6,892
Mortgage-backed securities	22,102	21,540	22,540	21,966
Total securities held to maturity	$28,201	$27,734	$29,306	$28,858

Securities Available for Sale

Securities not designated as held-to-maturity are designated as available for sale. Although we do not anticipate the sale of these securities, the designation as available for sale allows us the flexibility to alter our investment strategies and sell these securities when conditions warrant. Additionally, marketable equity securities that have no maturity date must be designated as available-for-sale. These securities are carried at fair value. The available-for-sale securities portfolio includes obligations and mortgage-backed securities of government-sponsored enterprises, corporate debt and equity securities.

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The following table shows the amortized cost basis, gross unrealized gains and losses, and fair value of securities available for sale at March 31, 2006 and December 31, 2005.

	March 31, 2006		December 31, 2005	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)			
Debt Securities:				
Government-sponsored enterprises	$50,452	$49,524	$50,443	$49,581
Corporate	9,540	9,070	9,564	9,014

Mortgage-backed	29,958	29,501	31,574	31,232
Total debt securities	89,950	88,095	91,581	89,827
Marketable equity securities	3,253	3,159	3,426	3,271
Mutual funds	1,215	1,181	1,205	1,200
Total securities available for sale	$94,418	$92,435	$96,212	$94,298

Loans

The loan portfolio consists primarily of residential and commercial real estate loans, construction and land development loans, commercial loans, home equity lines of credit and consumer loans originated primarily in our market area. There are no foreign loans outstanding. Interest rates charged on loans are affected principally by the demand for such loans, the supply of money available for lending purposes and the rates offered by the Bank's competitors. Total net loans were 70.9% of total assets at March 31, 2006, as compared to 69.9% of total assets at December 31, 2005.

Multi-Family and Commercial Real Estate Lending

We originate multi-family and commercial real estate loans that are generally secured by five or more unit apartment buildings and properties used for business purposes such as small office buildings, restaurants or retail facilities primarily located in our primary market area. Loans secured by multi-family and commercial real estate properties generally involve larger principal amounts and a greater degree of risk than one-to-four family residential mortgage loans. Because payments on loans secured by multi-family and commercial real estate properties are often dependent on successful operation or management of the properties, repayment of such loans may be subject to adverse conditions in the real estate market or the economy. We seek to minimize these risks through our underwriting standards.

Multi-family and commercial real estate loans totaled $213.7 million and comprised 51% of the total gross loan portfolio at March 31, 2006. At December 31, 2005, the multi-family and commercial real estate loan portfolio totaled $213.8 million, or 51.6% of total gross loans.

Residential Lending

We currently offer fixed-rate, one-to-four family mortgage loans with terms from 10 to 30 years and a number of adjustable-rate mortgage ("ARM") loans with terms of up to 30 years and interest rates which adjust every one or three years from the outset of the loan.

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We generally underwrite our residential real estate loans to comply with secondary market standards established by the Federal National Mortgage Association. Although loans are underwritten to standards that make them readily salable, we have not chosen to sell these loans, rather to maintain them in portfolio, consistent with our income and interest rate risk management targets.

Residential real estate loans totaled $123.7 million and comprised 29.5% of the total gross loan portfolio at March 31, 2006. At December 31, 2005, the residential real estate loan portfolio totaled $120.3 million, or 29.1% of total gross loans. Due to competitive pricing our residential loan portfolio continues to increase.

Commercial Loans

The commercial business loan portfolio consists of loans and lines predominantly collateralized by inventory, furniture and fixtures, and accounts receivable. In assessing the collateral for this type of loan, we apply a 50% liquidation value to inventories; 25% to furniture, fixtures and equipment; and 70% to accounts receivable less than 90 days of invoice date.

Commercial loans totaled $41.8 million and comprised 10% of the total gross loan portfolio at March 31, 2006. At December 31, 2005, the commercial loan portfolio totaled $38.1 million, or 9.2% of total gross loans. With the implementation of our loan portfolio management team our commercial loan officers are able to concentrate their efforts on business development.

Construction Lending

Fixed-rate construction loans are originated for the development of one-to-four family residential properties. Although we do not generally make loans secured by raw land, our policies permit the origination of such loans. Construction loan proceeds are disbursed periodically in increments as construction progresses and as inspections by an independent construction specialist warrant.

Construction and land development loans totaled $20.5 million and comprised 4.9% of total gross loan portfolio at March 31, 2006. At December 31, 2005, construction and land development loan portfolio totaled $21.5 million or 5.2% of total gross loans. With the implementation of our loan portfolio management team our commercial loan officers are able to concentrate their efforts on business development.

Home Equity Lines of Credit

Home equity lines of credit are secured by second mortgages on owner-occupied, one-to-four family residences located in our primary market area. Our home equity lines of credit generally have interest rates, indexed to the Wall Street Journal Prime Rate, that adjust on a monthly basis.

Home equity lines of credit totaled $16.8 million and comprised 4% of the total gross loan portfolio at March 31, 2006. At December 31, 2005, the home equity line of credit portfolio totaled $17.9 million, or 4.3% of total gross loans.

Consumer Lending

Consumer loans secured by rapidly depreciable assets such as recreational vehicles and automobiles entail greater risks than one-to-four family, residential mortgage loans. Consumer loans are typically made based on the borrower's ability to repay the loan through continued financial stability. We endeavor to minimize risk by reviewing the borrower's repayment history on past debts, and assessing the borrower's ability to meet existing obligations on the proposed loan. Consumer loans are both secured and unsecured borrowings.

Consumer loans totaled $2.6 million and comprised 0.6% of the total gross loan portfolio at March 31, 2006 and March 31, 2005.

The following table summarizes our loan portfolio by category at March 31, 2006 and December 31, 2005.

	March 31, 2006	December 31, 2005	Perce Increase (
	(In thousands)		
Real estate mortgage loans:			
Commercial	$213,733	$213,815	(0.0
Residential	123,716	120,345	2.8
Construction and land development	20,499	21,490	(4.6
Home equity lines of credit	16,758	17,915	(6.4
Commercial, financial and agricultural loans	41,781	38,111	9.6
Consumer loans	2,622	2,623	(0.0
Total loans	419,109	414,299	1.1
Less: Allowance for loan losses	(4,372)	(4,333)	0.9
Net deferred loan fees	(341)	(356)	(4.2
Loans, net	$414,396	$409,610	1.1

The increases in the loan portfolio are the result of the continued demand by small businesses for commercial and industrial loans and the normal origination process for residential loans. These increases were partially offset by the overall general market environment relating to construction loans and home equity lines of credit.

The following table presents information with respect to non-performing loans as of the dates indicated.

	At March 31, 2006	At December 31, 2005
	(Dollars in thousands)	
Non-accrual loans	$ 446	$ 906
Loans 90 days or more past due and still accruing	100	-
Total non-performing loans	$ 546	$ 906
Percentage of non-accrual loans to total loans	0.11%	0.22%
Percentage of allowance for loan losses to non-accrual loans	980.27%	478.30%

The $446,000 in non-accrual loans as of March 31, 2006 consists mainly of $405,000 of commercial real estate loans, $38,000 of residential real estate loans and $3,000 of consumer loans. There were no restructured loans included in non-accrual loans for the first three months of 2006.

It is our policy to manage our loan portfolio in order to recognize problem loans at an early stage and thereby minimize loan losses. Loans are considered delinquent when any payment of principal or interest is one month or more past due. We generally commence collection procedures when accounts are 15 days past due. Generally, when a loan becomes past due 90 days or more, management discontinues the accrual of interest and reverses previously accrued interest, unless the credit is well-secured and in process of collection. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current

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and future payments are reasonably assured. When a loan is determined to be uncollectible, it is charged off to the Allowance for Loan Losses or, if applicable, any real estate that is securing the loan is acquired through foreclosure, and recorded as Other Real Estate Owned. At March 31, 2006, the Bank had a time note fully collateralized by real estate which is in the process of being renewed that was not placed on non-accrual status.

Management defines non-performing loans to include non-accrual loans, loans past due 90 days or more and still accruing, and restructured loans not performing in accordance with amended terms.

Statement of Financial Accounting Standards No. 114 "Accounting by Creditors for Impairment of a Loan" ("SFAS No. 114") applies to all loans except large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment, loans measured at fair value or at the lower of cost or fair value. SFAS No. 114 requires that impaired loans be valued at the present value of expected future cash flows discounted at the loan's effective interest rate or as a practical expedient, at the market value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify consumer loans for impairment disclosures. A loan is considered impaired when, based on current information and events, it is probable that we will be unable to collect the scheduled payments of principle or interest when due according to the contractual terms of the loan agreement.

At March 31, 2006 there were $546,000 of loans which we have determined to be impaired, with a related allowance for credit losses of $63,000.

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Analysis of Allowance for Loan Losses

The table below illustrates the changes in the Allowance for Loan Losses for the periods indicated.

Three Months Ended March 31

	2006	2005
	(Dollars in thousands)	
Balance at beginning of period	$4,333	$4,101
Charge-offs:		
Real estate mortgage loans:		
Commercial	-	-
Residential	-	-
Home equity lines of credit	-	-
Commercial, financial and agricultural loans	-	-
Consumer	-	-
	-	-
Recoveries:		
Real estate mortgage loans:		
Commercial	-	-
Residential	-	16
Home equity lines of credit	-	-
Commercial, financial and agricultural loans	-	8
Consumer	-	1
	-	25
Net loan recoveries (charge-offs)	-	25
Provision for loan losses	39	50
Balance at end of period	$4,372	$4,176
Allowance for loan losses as a percent of loans at end of period	1.04%	1.05%
Ratio of net recoveries (charge-offs) to average loans outstanding	0.00%	0.01%

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as either doubtful, substandard or special mention. For such loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

As the composition of the loan portfolio gradually changes and diversifies from higher credit risk weighted loans, such as commercial real estate and commercial, to residential and home equity loans, a lower overall

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reserve allowance rate will be required. After thorough review and analysis of the adequacy of the loan loss allowance, management determined a provision for losses of $39,000 was required for the three months ended March 31, 2006 as compared to a provision of $50,000 for the three months ended March 31, 2005. The allowance for loan losses as a percentage of total loans outstanding declined from 1.05% at December 31, 2005 to 1.04% at March 31, 2006. The decline in the provision for loan losses in 2006 was attributable to the decrease in commercial loan activity during the first quarter of 2006, as compared to the first quarter of 2005.

This table below shows an allocation of the allowance for loan losses at the dates indicated.

	March 31, 2006		December 31, 2005	
	Amount	Percent of Loans in Each Category to Total Loans	Amount	Percent of Loans in Each Category to Total Loans
	(Dollars in thousands)			
Commercial	$ 715	10.0%	$ 905	9.2%
Real estate construction	101	4.9%	248	5.2%
Real estate mortgage	3,500	84.5%	3,056	85.0%
Consumer	56	0.6%	124	0.6%
	$4,372	100.0%	$4,333	100.0%

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Deposits

We continue our efforts to competitively price products and develop and maintain relationship banking with our customers. The flow of deposits is influenced significantly by general economic conditions, changes in money market rates, prevailing interest rates and the aggressive competition from local branches of nationwide and regional as well as local banks and credit unions. Our total deposits decreased from $415.8 million at December 31, 2005 to $407.8 million at March 31, 2006, a decrease of $8.1 million or 1.9%. We believe this decrease is attributable to the level of competition in our market area.

The following table presents deposits by category at March 31, 2006 and

December 31, 2005.

	March 31, 2006	December 31, 2005	Percentage Increase/(Decreas
	(Dollars in thousands)		
Demand deposits	$ 75,754	$ 80,705	(6.13%)
NOW	55,132	55,493	(0.65%)
Regular and other savings	85,769	87,146	(1.58%)
Money market deposits	26,679	29,835	(10.58%)
Total non-certificate accounts	243,334	253,179	(3.89%)
Term certificates less than $100,000	114,968	116,861	(1.62%)
Term certificates of $100,000 or more	49,487	45,806	8.04%
Total certificate accounts	164,455	162,667	1.10%
Total deposits	$407,789	$415,846	(1.94%)

Federal Home Loan Bank Advances

Advances from the Federal Home Loan Bank totaled $114.3 million at March 31, 2006, as compared to $107.9 million at December 31, 2005, an increase of $6.4 million or 5.9%. Management's strategy is to utilize advances from the Federal Home Loan Bank in conjunction with the investment portfolio to fund loans and deposit runoff. There was no change in the balance of our subordinated debentures or underlying trust preferred securities.

Comparison of Results of Operations for the Three Months Ended March 31, 2006 and 2005

General

Net income decreased from $1.1 million or $0.27 per share on a diluted basis, for the three months ended March 31, 2005 to $907,000 or $0.22 per share on a diluted basis, for the three months ended March 31, 2006, a decrease of 17.5%. Net interest and dividend income increased by $114,000 or 2.6%, from $4.5 million to $4.6 million when comparing the three months ended March 31, 2005 and 2006. Over the same period, the provision for loan losses decreased from $50,000 to $39,000. Non-interest income increased by $134,000 or 23.6% from $569,000 to $703,000 for the quarters ended March 31, 2005 and 2006. Non-interest expenses increased by $435,000 or 13.1%, from $3.3 million for the three months ended March 31, 2005 to $3.8 million for the three months ended March 31, 2006.

Interest Income

Our operating performance is dependent on net interest and dividend income, the difference between interest and dividend income earned on loans and investments and interest expense paid on deposits and borrowed funds. The level of net interest income and dividend income is significantly impacted by factors such as economic conditions, interest rates, asset/liability management, and strategic planning.

Interest and dividend income increased by $1.2 million or 18.0%, from $6.7 million for the three months ended March 31, 2005 to $7.9 million for the three months ended March 31, 2006. This increase can be attributed to the growth in the loan portfolio, as the average balance of loans increased by $43.0 million or 11.56%. The yield on the loan portfolio increased from 5.71% for the three months ended March 31, 2005 to 6.26% for the three months ended March 31, 2006. The increase was the result of a greater volume and higher rates earned on commercial and real estate loans reflecting current market conditions. Interest and dividends on investments increased by $18,000, on a fully taxable equivalent basis, for the three months ended March 31, 2006 compared to the three months ended March 31, 2005, respectively. The increase in interest and dividends on investments reflected a higher yield on investments, partially offset by a decrease in the average balance of the investment portfolio, which decreased from an average balance of $138.0 million for the 2005 period to $129.7 million for the 2006 period.

Interest Expense

Total interest expense increased by $1.1 million or 49.2%, from $2.2 million for the three months ended March 31, 2005 to $3.3 million for the three months ended March 31, 2006. The increase was based on management's strategy to utilize FHLB advances to supplement deposit runoff. Market interest rates and our own deposit rates have also increased. Interest on deposits increased by $752,000 or 64.9% when comparing the three months ended March 31, 2006 and 2005. The increase is attributed primarily to increases in the interest rates offered on deposit products. In response to competitive pressures and the rising rate environment, we raised all rates on our deposit products with the most significant increases in certificate of deposit and certain money-market based products. As a result of the rate increases, the weighted average cost of deposits increased from 1.49% for the three months ended March 31, 2005 to 2.33% for the three months ended March 31, 2006. Interest expense associated with subordinated debentures increased by $88,000, the result of increased market interest rates. The debentures carry an adjustable rate of interest tied to the three-month LIBOR rate.

Net Interest Margin

As a result of the current interest rate environment and our rate increases on deposit accounts, the net interest margin has compressed 14 basis points from 3.56% for the three months ended March 31, 2005 to 3.41% at March 31, 2006. The compression in net interest margin was mostly due to the rise in short term rates and the prolonged flatness of the yield curve, which has reduced the gap between short and intermediate-term interest rates and the spread between what banks earn on loans and securities and pay on deposits and borrowings.

The following table sets forth our average assets, liabilities, and stockholders' equity, interest income earned and interest paid, average rates earned and paid, net interest spread and the net interest margin for the three months ended March 31, 2006, and 2005. Average balances reported are daily averages.

	Three Months Ended March 31,			
	2006			
	Average Balance	Interest Income/Expense	Average Rate	Average Balance
	(Dollars in thousands)			
Assets:				
Interest earning assets (2)				
Loans:				
Commercial	$ 42,701	$ 773	7.34%	$ 28,506
Commercial real estate	228,934	3,609	6.39%	214,475
Residential real estate	142,962	2,015	5.72%	128,848
Consumer	2,550	38	6.04%	2,353
Total loans	417,147	6,435	6.26%	374,182
Federal funds sold	1,072	11	4.16%	12,157
Taxable debt securities	110,937	1,211	4.43%	106,755
Tax-exempt debt securities (1)	6,422	106	6.69%	8,472
Marketable equity securities	4,332	40	3.74%	4,946
FHLB stock	6,304	82	5.28%	5,060
Other investments	650	8	4.99%	650
Total interest earning assets	546,864	7,893	5.85%	512,222
Allowance for loan losses	(4,342)	------		(4,120)
Deferred loan fees	(349)			(460)
Cash and due from banks	13,295			16,538
Other assets	26,721			27,442
	$582,189			$551,622
Liabilities and Stockholders' Equity:				
Interest bearing liabilities				
Savings accounts	$ 85,090	$ 257	1.22%	$ 89,855
NOW accounts	55,772	173	1.26%	46,326
Money market accounts	28,100	109	1.57%	41,187
Time deposits	163,980	1,372	3.39%	138,106
FHLB advances	111,197	1,156	4.22%	98,738
Subordinated debt	10,310	224	8.81%	10,310
Total interest-bearing liabilities	454,449	3,291	2.94%	424,522
Demand deposits	76,137	------		77,287
Other liabilities	2,350			2,366

Total liabilities	532,936			504,175
Total stockholders' equity	49,253			47,447
	$582,189			$551,622
Net interest income		$4,602		
Net interest spread			2.91%	
Net interest margin			3.41%	