

LAKELAND FINANCIAL CORP
Form 10-Q
November 08, 2006

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

FORM 10-Q

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

For the quarterly period ended September 30, 2006

OR

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

For the transition period from _____ to _____

LAKELAND FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Indiana
(State or other jurisdiction
Of incorporation)

0-11487
(Commission File Number)

35-1559596
(IRS Employer
Identification No.)

202 East Center Street, P.O. Box 1387, Warsaw, Indiana 46581-1387

(Address of principal executive offices)(Zip Code)

(574) 267-6144

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 []

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

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

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

Number of shares of common stock outstanding at October 31, 2006: 12,115,658

LAKELAND FINANCIAL CORPORATION

Form 10-Q Quarterly Report

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PART 1**LAKELAND FINANCIAL CORPORATION****ITEM 1 FINANCIAL STATEMENTS****LAKELAND FINANCIAL CORPORATION****CONSOLIDATED BALANCE SHEETS**

As of September 30, 2006 and December 31, 2005

(in thousands except for share data)

(Page 1 of 2)

| | September 30, 2006 (Unaudited) | December 31, 2005 |
|--|---|------------------------------|
| ASSETS | | |
| Cash and due from banks | \$ 73,774 | \$ 77,387 |
| Short-term investments | 30,390 | 5,292 |
| Total cash and cash equivalents | 104,164 | 82,679 |
| Securities available for sale (carried at fair value) | 299,520 | 290,935 |
| Real estate mortgages held for sale | 1,422 | 960 |
| Loans, net of allowance for loan losses of \$14,288 and \$12,774 | 1,316,897 | 1,185,956 |
| Land, premises and equipment, net | 25,136 | 24,563 |
| Bank owned life insurance | 20,337 | 19,654 |
| Accrued income receivable | 8,245 | 7,416 |
| Goodwill | 4,970 | 4,970 |
| Other intangible assets | 877 | 1,034 |
| Other assets | 18,098 | 16,446 |
| Total assets | \$ 1,799,666 | \$ 1,634,613 |

(continued)

LAKELAND FINANCIAL CORPORATION

CONSOLIDATED BALANCE SHEETS

As of September 30, 2006 and December 31, 2005

(in thousands except for share data)

(Page 2 of 2)

| | September 30, 2006 (Unaudited) | December 31, 2005 |
|--|--------------------------------------|----------------------|
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Noninterest bearing deposits | \$ 245,420 | \$ 247,605 |
| Interest bearing deposits | 1,288,457 | 1,018,640 |
| Total deposits | 1,533,877 | 1,266,245 |
| Short-term borrowings | | |
| Federal funds purchased | 0 | 43,000 |
| Securities sold under agreements to repurchase | 93,992 | 91,071 |
| U.S. Treasury demand notes | 1,820 | 2,471 |
| Other short-term borrowings | 0 | 75,000 |
| Total short-term borrowings | 95,812 | 211,542 |
| Accrued expenses payable | 11,522 | 10,423 |
| Other liabilities | 495 | 2,095 |
| Long-term borrowings | 45 | 46 |
| Subordinated debentures | 30,928 | 30,928 |
| Total liabilities | 1,672,679 | 1,521,279 |
| STOCKHOLDERS' EQUITY | | |
| Common stock: 180,000,000 shares authorized ,no par value 12,097,378 shares issued and 12,011,019 outstanding as of September 30, 2006 11,972,108 shares issued and 11,894,684 outstanding as of December 31, 2005 | 1,453 | 1,453 |
| Additional paid-in capital | 16,169 | 14,287 |
| Retained earnings | 113,471 | 102,327 |
| Accumulated other comprehensive loss | (2,988) | (3,814) |
| Treasury stock, at cost (2006-86,359 shares, 2005-77,424 shares) | (1,118) | (919) |
| Total stockholders' equity | 126,987 | 113,334 |
| Total liabilities and stockholders' equity | \$ 1,799,666 | \$ 1,634,613 |

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

LAKELAND FINANCIAL CORPORATION

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

For the Three Months and Nine Months Ended September 30, 2006 and 2005

(in thousands except for share and per share data)

(Unaudited)

(Page 1 of 2)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|----------|------------------------------------|----------|
| | 2006 | 2005 | 2006 | 2005 |
| NET INTEREST INCOME | | | | |
| Interest and fees on loans | | | | |
| Taxable | \$23,936 | \$17,894 | \$66,968 | \$48,561 |
| Tax exempt | 74 | 47 | 206 | 132 |
| Interest and dividends on securities | | | | |
| Taxable | 2,463 | 2,313 | 7,461 | 6,949 |
| Tax exempt | 591 | 585 | 1,793 | 1,759 |
| Interest on short-term investments | 157 | 83 | 504 | 184 |
| Total interest income | 27,221 | 20,922 | 76,932 | 57,585 |
| Interest on deposits | 12,398 | 6,609 | 31,875 | 16,139 |
| Interest on borrowings | | | | |
| Short-term | 1,167 | 1,207 | 4,363 | 2,950 |
| Long-term | 661 | 572 | 1,877 | 1,607 |
| Total interest expense | 14,226 | 8,388 | 38,115 | 20,696 |
| NET INTEREST INCOME | 12,995 | 12,534 | 38,817 | 36,889 |
| Provision for loan losses | 510 | 659 | 1,602 | 1,779 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 12,485 | 11,875 | 37,215 | 35,110 |
| NONINTEREST INCOME | | | | |
| Wealth advisory and investment brokerage fees | 952 | 742 | 2,864 | 2,261 |
| Service charges on deposit accounts | 1,983 | 1,860 | 5,668 | 5,112 |
| Loan, insurance and service fees | 548 | 480 | 1,746 | 1,442 |
| Merchant card fee income | 661 | 692 | 1,809 | 1,857 |
| Other income | 476 | 331 | 1,496 | 1,319 |
| Net gains on sales of real estate mortgages held for sale | 137 | 275 | 467 | 726 |
| Net securities gains (losses) | (14) | 0 | (68) | 0 |
| Total noninterest income | 4,743 | 4,380 | 13,982 | 12,717 |

(continued)

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LAKELAND FINANCIAL CORPORATION

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

For the Three Months and Nine Months Ended September 30, 2006 and 2005

(in thousands except for share and per share data)

(Unaudited)

(Page 2 of 2)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|------------|------------------------------------|------------|
| | 2006 | 2005 | 2006 | 2005 |
| NONINTEREST EXPENSE | | | | |
| Salaries and employee benefits | 5,595 | 5,051 | 16,609 | 15,224 |
| Net occupancy expense | 680 | 728 | 1,901 | 2,059 |
| Equipment costs | 430 | 468 | 1,345 | 1,476 |
| Data processing fees and supplies | 611 | 586 | 1,754 | 1,715 |
| Credit card interchange | 465 | 442 | 1,211 | 1,158 |
| Other expense | 2,156 | 2,080 | 6,721 | 6,384 |
| Total noninterest expense | 9,937 | 9,355 | 29,541 | 28,016 |
| INCOME BEFORE INCOME TAX EXPENSE | 7,291 | 6,900 | 21,656 | 19,811 |
| Income tax expense | 2,561 | 2,378 | 7,494 | 6,830 |
| NET INCOME | \$4,730 | \$4,522 | \$14,162 | \$12,981 |
| Other comprehensive income/loss, net of tax: | | | | |
| Unrealized gain/(loss) on available for sale securities | 3,106 | (1,552) | 826 | (1,793) |
| TOTAL COMPREHENSIVE INCOME | \$7,836 | \$2,970 | \$14,988 | \$11,188 |
| BASIC WEIGHTED AVERAGE COMMON SHARES | 12,084,244 | 11,957,730 | 12,054,663 | 11,913,014 |
| BASIC EARNINGS PER COMMON SHARE | \$0.39 | \$0.38 | \$1.17 | \$1.09 |
| DILUTED WEIGHTED AVERAGE COMMON SHARES | 12,388,372 | 12,309,552 | 12,366,453 | 12,279,174 |
| DILUTED EARNINGS PER COMMON SHARE | \$0.38 | \$0.37 | \$1.15 | \$1.06 |

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

LAKELAND FINANCIAL CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Nine Months Ended September 30, 2006 and 2005

(in thousands)

(Unaudited)

(Page 1 of 2)

| | 2006 | 2005 |
|---|-----------|-----------|
| Cash flows from operating activities: | | |
| Net income | \$ 14,162 | \$ 12,981 |
| Adjustments to reconcile net income to net cash from operating activities: | | |
| Depreciation | 1,241 | 1,214 |
| Provision for loan losses | 1,602 | 1,779 |
| Amortization of intangible assets | 157 | 158 |
| Amortization of loan servicing rights | 467 | 449 |
| Net change in loan servicing rights valuation allowance | (64) | (109) |
| Loans originated for sale | (26,715) | (34,192) |
| Net gain on sales of loans | (466) | (725) |
| Proceeds from sale of loans | 26,467 | 34,114 |
| Net (gain) loss on sale of premises and equipment | (19) | (74) |
| Net loss on sales of securities available for sale | 68 | 0 |
| Net securities amortization | 1,078 | 2,003 |
| Stock compensation expense | 141 | 0 |
| Earnings on life insurance | (538) | (494) |
| Net change: | | |
| Accrued income receivable | (829) | (738) |
| Accrued expenses payable | 2,196 | 2,417 |
| Other assets | (1,732) | (815) |
| Other liabilities | (1,600) | (42) |
| Total adjustments | 1,454 | 4,945 |
| Net cash from operating activities | 15,616 | 17,926 |
| Cash flows from investing activities: | | |
| Proceeds from sale of securities available for sale | \$ 21,616 | \$ 0 |
| Proceeds from maturities, calls and principal paydowns of securities available for sale | 38,681 | 37,206 |
| Purchases of securities available for sale | (68,724) | (44,653) |
| Purchase of life insurance | (145) | (131) |
| Net increase in total loans | (132,614) | (142,447) |
| Proceeds from sales of land, premises and equipment | 194 | 591 |
| Purchases of land, premises and equipment | (1,989) | (1,494) |
| Net cash from investing activities | (142,981) | (150,928) |

(Continued)

LAKELAND FINANCIAL CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Nine Months Ended September 30, 2006 and 2005

(in thousands)

(Unaudited)

(Page 2 of 2)

| | 2006 | 2005 |
|--|------------|-----------|
| Cash flows from financing activities: | | |
| Net increase in total deposits | 267,632 | 135,571 |
| Net increase (decrease) in short-term borrowings | (115,730) | (40,996) |
| Payments on long-term borrowings | (1) | 0 |
| Dividends paid | (4,394) | (3,984) |
| Proceeds from stock option exercise | 1,542 | 1,158 |
| Purchase of treasury stock | (199) | (162) |
| Net cash from financing activities | 148,850 | 91,587 |
| Net change in cash and cash equivalents | 21,485 | (41,415) |
| Cash and cash equivalents at beginning of the period | 82,679 | 103,858 |
| Cash and cash equivalents at end of the period | \$ 104,164 | \$ 62,443 |
| Cash paid during the period for: | | |
| Interest | \$ 36,276 | \$ 18,971 |
| Income taxes | 8,395 | 6,620 |
| Supplemental non-cash disclosures: | | |
| Loans transferred to other real estate | 71 | 0 |

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

LAKELAND FINANCIAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006

(In thousands)

(Unaudited)

NOTE 1. BASIS OF PRESENTATION

This report is filed for Lakeland Financial Corporation (the Company) and its wholly-owned subsidiary, Lake City Bank (the Bank). All significant inter-company balances and transactions have been eliminated in consolidation. Also included is the Bank's wholly-owned subsidiary, LCB Investments Limited (LCB Investments).

The unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with instructions for Form 10-Q. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (all of which are normal and recurring in nature) considered necessary for a fair presentation have been included. Operating results for the three-month and nine-month periods ending September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. The 2005 Lakeland Financial Corporation Annual Report on Form 10-K should be read in conjunction with these statements.

NOTE 2. STOCK COMPENSATION

Effective January 1, 2006, employee compensation expense under stock options is reported using Statement 123 (revised 2004), *Share-Based Payment*. Previously all awards were recorded under the intrinsic value method of APB Opinion No. 25 *Accounting for Stock Issued to Employees*. Statement 123(R) was adopted using the modified prospective method and no restatements were made to prior periods. The following tables provide comparative information on the effects of stock-based compensation expense on net income and earnings per share, as if Statement 123 had been applied for all periods.

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| | Nine Months Ended | |
|--|-----------------------|-----------|
| | September 30, 2006 | 2005 |
| Net income (in thousands) as reported | \$ 14,162 | \$ 12,981 |
| Deduct: stock based compensation expense determined under fair value based method | n/a | 246 |
| Pro forma net income | \$ 14,162 | \$ 12,735 |
| | | |
| Basic earnings per common share as reported | \$ 1.17 | \$ 1.09 |
| Pro forma basic earnings per share | n/a | \$ 1.07 |
| Diluted earnings per share as reported | \$ 1.15 | \$ 1.06 |
| Pro forma diluted earnings per share | n/a | \$ 1.04 |
| | | |
| | Three Months Ended | |
| | September 30, 2006 | 2005 |
| Net income (in thousands) as reported | \$ 4,730 | \$ 4,522 |
| Deduct: stock based compensation expense determined under fair value based method | n/a | 66 |
| Pro forma net income | \$ 4,730 | \$ 4,456 |
| | | |
| Basic earnings per common share as reported | \$ 0.39 | \$ 0.38 |
| Pro forma basic earnings per share | n/a | \$ 0.38 |
| Diluted earnings per share as reported | \$ 0.38 | \$ 0.37 |
| Pro forma diluted earnings per share | n/a | \$ 0.36 |

There is no pro forma effect for the nine months and three months ended September 30, 2006 since stock based compensation was recorded under Statement 123(R) in 2006. Included in net income for the nine months ended September 30, 2006 was employee compensation expense of \$141,000, net of tax of \$57,000. Included in net income for the three months ended September 30, 2006 was employee compensation expense of \$47,000, net of tax of \$19,000.

Basic earnings per common share is based upon weighted-average common shares outstanding. Diluted earnings per share show the dilutive effect of additional common shares issueable.

The common shares outstanding for the stockholders' equity section of the consolidated balance sheet at September 30, 2006 reflects the acquisition of 86,359 shares of Company common stock to offset a liability for a directors' deferred compensation plan. These fully vested shares are treated as outstanding when computing the weighted-average common shares outstanding for the calculation of both basic and diluted earnings per share.

NOTE 3. LOANS

| | September 30, 2006 | December 31, 2005 |
|--|-----------------------|----------------------|
| Commercial and industrial loans | \$ 944,616 | \$ 850,984 |
| Agri-business and agricultural loans | 125,146 | 113,574 |
| Real estate mortgage loans | 96,467 | 66,833 |
| Real estate construction loans | 5,954 | 7,987 |
| Installment loans and credit cards | 159,024 | 159,390 |
| Subtotal | 1,331,207 | 1,198,768 |
| Less: Allowance for loan losses | (14,288) | (12,774) |
| Net deferred loan fees | (22) | (38) |
| Loans, net | \$1,316,897 | \$1,185,956 |
| | | |
| Impaired loans | \$ 14,898 | \$ 6,948 |
| Non-performing loans | \$ 15,413 | \$ 7,495 |
| | | |
| Allowance for loan losses to total loans | 1.07% | 1.07% |

Changes in the allowance for loan losses are summarized as follows:

| | Nine months ended September 30, | |
|--------------------------------|------------------------------------|-----------|
| | 2006 | 2005 |
| Balance at beginning of period | \$ 12,774 | \$ 10,754 |
| Provision for loan losses | 1,602 | 1,779 |
| Charge-offs | (176) | (410) |
| Recoveries | 88 | 110 |
| Net loans charged-off | (88) | (300) |
| Balance at end of period | \$ 14,288 | \$ 12,233 |

NOTE 4. SECURITIES

The fair values of securities available for sale were as follows:

| | September 30, 2006 | December 31, 2005 |
|--------------------------------|-----------------------|----------------------|
| U.S. Treasury securities | \$ 965 | \$ 966 |
| U.S. Government agencies | 30,486 | 30,484 |
| Mortgage-backed securities | 212,999 | 206,596 |
| State and municipal securities | 55,070 | 52,889 |
| Total | \$ 299,520 | \$ 290,935 |

As of September 30, 2006, net unrealized losses on the total securities available for sale portfolio totaled \$2.9 million. As of December 31, 2005, net unrealized losses on the total securities available for sale portfolio totaled \$4.2 million. Management considers the unrealized losses to be market driven and no loss is expected to be realized unless the securities are sold. All of the securities are backed by the U.S. Government, government agencies, government sponsored agencies or are A rated or better, in the case of non-local municipal securities. None of the securities have call provisions (with the exception of the municipal securities) and payments as originally agreed are being received. There are no concerns of credit losses and there is nothing to indicate that full principal will not be received. The Company does not have a history of actively trading securities, but keeps the securities available for sale should liquidity or other needs develop that would warrant the sale of securities. While these securities are held in the available for sale portfolio, the current intent and ability is to hold them until a recovery in fair value or maturity.

NOTE 5. EMPLOYEE BENEFIT PLANS

Components of Net Periodic Benefit Cost

| | Nine Months Ended September 30, | | SERP Benefits | |
|--------------------------------|---------------------------------|-------|---------------|-------|
| | Pension Benefits 2006 | 2005 | 2006 | 2005 |
| Service cost | \$ 0 | \$ 0 | \$ 0 | \$ 0 |
| Interest cost | 108 | 112 | 57 | 60 |
| Expected return on plan assets | (126) | (109) | (69) | (77) |
| Recognized net actuarial loss | 33 | 28 | 39 | 33 |
| Net pension expense | \$ 15 | \$ 31 | \$ 27 | \$ 16 |

| | Three Months Ended September 30, | | SERP Benefits | |
|--------------------------------|----------------------------------|-------|---------------|------|
| | Pension Benefits 2006 | 2005 | 2006 | 2005 |
| Service cost | \$ 0 | \$ 0 | \$ 0 | \$ 0 |
| Interest cost | 36 | 37 | 19 | 20 |
| Expected return on plan assets | (42) | (36) | (23) | (26) |
| Recognized net actuarial loss | 11 | 9 | 13 | 12 |
| Net pension expense | \$ 5 | \$ 10 | \$ 9 | \$ 6 |

The Company previously disclosed in its financial statements for the year ended December 31, 2005, that it expected to contribute \$229,000 to its pension plan and \$68,000 to its SERP plan in 2006. As of September 30, 2006, \$173,000 had been contributed to the pension plan and \$68,000 to the SERP plan. The Company does not anticipate making any additional contributions to its pension plan or SERP plan during the remainder of 2006.

NOTE 6. NEW ACCOUNTING PRONOUNCEMENTS

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 158 (SFAS No. 158), *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* an amendment of FASB Statements No. 87, 88, 106, and 132(R). SFAS No. 158 requires the recognition of the funded status of a benefit plan in the statement of financial position. The Statement also requires recognition in other comprehensive income of certain gains and losses that arise during the period but are deferred under current pension accounting rules, as well as modifies the timing of reporting. SFAS No. 158 provides recognition and disclosure elements to be effective as of the end of the fiscal year after December 15, 2006 and measurement elements to be effective for fiscal years ending after December 15, 2008. The Company is currently assessing the potential impact that the adoption of SFAS No. 158 will have on its financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108 (SAB No. 108), *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. This SAB addresses how the effects of prior-year uncorrected misstatements should be considered when quantifying misstatements in current-year financial statements. SAB No. 108 requires registrants to quantify errors using both the balance sheet and income statement approaches and to evaluate whether either approach results in quantifying a misstatement as material in light of relevant quantitative and qualitative factors. When the effect of initial adoption is determined to be material, the SAB allows registrants to record that effect as a cumulative effect adjustment of beginning-of-year retained earnings. SAB No. 108 is effective for annual financial statements covering the first fiscal year ending after November 15, 2006. The Company is currently assessing the potential impact that the adoption of SAB No. 108 will have on its financial statements; the impact is not expected to be material.

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In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. FIN 48 requires that realization of an uncertain income tax position be more likely than not before it can be recognized in the financial statements. Further, FIN 48 prescribes the benefit to be recorded in the financial statements as the amount most likely to be realized assuming a review by tax authorities having all relevant information and applying current conventions. FIN 48 also clarifies the financial statement classification of tax-related penalties and interest and sets forth new disclosures regarding unrecognized tax benefits. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the requirements of FIN 48 and the impact this interpretation may have on its financial statements.

NOTE 7. RECLASSIFICATIONS

Certain amounts appearing in the financial statements and notes thereto for prior periods have been reclassified to conform with the current presentation. The reclassification had no effect on net income or stockholders' equity as previously reported.

Part 1

LAKELAND FINANCIAL CORPORATION

ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION

and

RESULTS OF OPERATIONS

September 30, 2006

OVERVIEW

Lakeland Financial Corporation is the holding company for Lake City Bank. The Company is headquartered in Warsaw, Indiana and operates 43 offices in 12 counties in northern Indiana. The Company earned \$14.2 million for the first nine months of 2006, versus \$13.0 million in the same period of 2005, an increase of 9.1%. The increase was driven by a \$1.9 million increase in net interest income as well as an increase of \$1.3 million in noninterest income. Offsetting these positive impacts was an increase of \$1.5 million in noninterest expense. Basic earnings per share for the first nine months of 2006 were \$1.17 per share versus \$1.09 per share for the first nine months of 2005. Diluted earnings per share reflect the potential dilutive impact of stock options granted under the stock option plan. Diluted earnings per share for the first nine months of 2006 were \$1.15 per share, versus \$1.06 per share for the first nine months of 2005.

Net income for the third quarter of 2006 was \$4.7 million, an increase of 4.6% versus \$4.5 million for the comparable period of 2005. The increase was driven by a \$461,000 increase in net interest income as well as a \$363,000 increase in noninterest income. Offsetting these positive impacts was an increase of \$582,000 in noninterest expense. Basic earnings per share for the third quarter of 2006 were \$0.39 per share, versus \$0.38 per share for the third quarter of 2005. Diluted earnings per share for the third quarter of 2006 were \$0.38 per share, versus \$0.37 per share for the third quarter of 2005.

RESULTS OF OPERATIONS

Net Interest Income

For the nine-month period ended September 30, 2006, net interest income totaled \$38.8 million, an increase of 5.2%, or \$1.9 million, versus the first nine months of 2005. Net interest income increased in the nine-month period of 2006 versus the comparable period of 2005, primarily due to a \$197.8 million, or 14.5%, increase in average earning assets to \$1.556 billion. For the three-month period ended September 30, 2006, net interest income totaled \$13.0 million, an increase of 3.7%, or \$461,000. This increase was driven by a \$180.7 million, or 12.8%, increase in average earning assets.

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Given the Company's mix of interest earning assets and interest bearing liabilities at September 30, 2006, the Company would generally be considered to have an asset sensitive balance sheet, although the current interest rate environment has countered the asset-sensitive nature of the balance sheet. This balance sheet structure would normally be expected to produce a stable or improving net interest margin in a rising rate

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environment. Despite this balance sheet structure and a rising rate environment during 2006 and 2005, the Company experienced net interest margin compression in the first nine months of 2006 versus the first nine months of 2005. Management attributes this compression primarily to a highly competitive deposit pricing environment that is having a negative impact on the net interest margin. In addition, the Company's mix of deposits has shifted to more reliance on certificates of deposits, which generally carry a higher interest rate cost than other types of interest bearing deposits. Also contributing to the erosion in net interest margin was the yield performance of the Company's investment portfolio, which is primarily composed of collateralized mortgage obligations and municipal securities. As a result of the flat yield curve, reinvestment rates have typically been substantially lower than those of the maturing security.

During the first nine months of 2006, total interest and dividend income increased by \$19.3 million, or 33.6%, to \$76.9 million, versus \$57.6 million during the first nine months of 2005. During the third quarter of 2006, interest and dividend income increased by \$6.3 million, or 30.1%, to \$27.2 million, versus \$20.9 million during the same quarter of 2005. These increases were primarily the result of general increases in interest rates, as well as an increase in average earning assets. The tax equivalent yield on average earning assets increased by 92 basis points to 6.7% for the nine-month period ended September 30, 2006 versus the same period of 2005. For the third quarter of 2006, the yield increased 89 basis points to 6.8%, versus 6.0% for the third quarter of 2005.

During the first nine months of 2006, loan interest income increased by \$18.5 million, or 38.0%, to \$67.2 million, versus \$48.7 million during the first nine months of 2005. The increase was driven by a \$187.1 million, or 17.6%, increase in average daily loan balances, as well as a 106 basis point increase in the tax equivalent yield on loans to 7.2%, versus 6.1% in the first nine months of 2005. During the third quarter of 2006, loan interest income increased \$6.1 million, or 33.8% to \$24.0 million versus \$17.9 million during the third quarter of 2005. The increase was driven by a \$173.5 million, or 15.6%, increase in average daily loan balances as well as a 101 basis point increase in the tax equivalent yield on loans, to 7.4%, versus 6.4% in the third quarter of 2005.

The average daily securities balances for the first nine months of 2006 increased \$5.4 million, or 1.9%, to \$292.3 million, versus \$286.9 million for the same period of 2005. During the same periods, income from securities increased by \$546,000, or 6.3%, to \$9.3 million versus \$8.7 million during the first nine months of 2005. The increase was primarily the result of a 14 basis point increase in the tax equivalent yield on securities, to 4.6% versus 4.5% in the first nine months of 2005. The average daily securities balances for the third quarter of 2006 increased \$5.0 million, or 1.7%, to \$292.9 million, versus \$288.0 million, for the same period of 2005. During the third quarter of 2006, income from securities was \$3.1 million, an increase of \$156,000, or 5.4%, versus the third quarter of 2005. The increase was driven by the increase in average daily securities balances. The tax equivalent yield for the third quarter of 2006 was 4.5% compared to 4.4% for the third quarter of 2005.

Total interest expense increased \$17.4 million, or 84.2%, to \$38.1 million for the nine-month period ended September 30, 2006, from \$20.7 million for the comparable period in 2005. The increase was primarily the result of a 126 basis point increase in the Company's daily cost of funds to 3.3%, versus 2.0% for the same period of 2005. Total interest expense increased \$5.8 million, or 69.6%, to \$14.2 million for the third quarter of 2006, versus \$8.4 million for the third quarter of 2005. The increase was primarily the result of a 120 basis point increase in the Company's daily cost of funds to 3.6%, from 2.4% for the same period of 2005. Increases in total deposits also contributed to increases in total interest expense over the nine-month and three-month periods.

On an average daily basis, total deposits (including demand deposits) increased \$217.6 million, or 19.0%, to \$1.362 billion for the nine-month period ended September 30, 2006, versus \$1.144 billion during the same period in 2005. The average daily balances for the third quarter of 2006 increased \$233.7 million, or 19.6%, to \$1.426 billion from \$1.193 billion during the third quarter of 2005. On an average daily basis, non-interest bearing demand deposits increased to \$219.9 million for the nine-month period ended September 30, 2006, versus \$218.9 million for the same period in 2005. The average daily noninterest bearing demand deposit balances for the third quarter of 2006 were \$219.8 million, versus \$217.0 million for the third quarter of 2005. On an average daily basis, interest bearing transaction accounts increased \$53.0 million, or 15.7%, to \$389.7 million for the nine-month period ended September 30, 2006, versus the same period in 2005. Average daily interest bearing transaction accounts increased \$88.3 million, or 27.3%, to \$412.0 million for the third quarter of 2006, versus \$323.7 million for the third quarter of 2005. When comparing the nine months ended September 30, 2006 with the same period of 2005, the average daily balance of time deposits, which pay a higher rate of interest compared to demand deposit and transaction accounts, increased \$166.9 million, primarily as a result of increases in public fund deposits and brokered certificates of deposit. The rate paid on time deposit accounts increased 129 basis points to 4.5% for the nine-month period ended September 30, 2006, versus the same period in 2005. During the third quarter of 2006, the average daily balance of time deposits increased \$146.0 million, and the rate paid increased 127 basis points to 4.8%, versus the third quarter of 2005.

Due to strong loan growth and additional relationship opportunities, the Company also continues to focus on public fund deposits as a core funding strategy. In addition, the Company has introduced brokered certificates of deposit to the funding mix as a result of loan growth. On an average daily basis, total brokered certificates of deposit increased \$37.4 million to \$55.2 million for the nine-month period ended September 30, 2006, versus \$17.9 million for the same period in 2005. During the third quarter of 2006, average daily brokered certificates of deposit were \$44.9 million, versus \$49.1 million during the third quarter of 2005. On an average daily basis, total public fund certificates of deposit increased \$60.5 million to \$267.8 million for the nine-month period ended September 30, 2006, versus \$207.3 million for the same period in 2005. During the third quarter of 2006, average daily public fund certificates of deposit were \$296.9 million, versus \$231.8 million during the third quarter of 2005.

Average daily balances of borrowings were \$181.4 million during the nine months ended September 30, 2006, versus \$209.3 million during the same period of 2005, and the rate paid on borrowings increased 170 basis points to 4.6%. During the third quarter of 2006, the average daily balances of borrowings decreased \$59.1 million to \$154.2 million, versus \$213.3 million for the same period of 2005. The rate on borrowings increased 143 basis points to 4.7% for the third quarter of 2006 versus the third quarter of 2005. On an average daily basis, total deposits (including demand deposits) and purchased funds increased 14.0% and 12.4%, respectively, when comparing the nine-month and three-month periods ended September 30, 2006 versus the same periods in 2005. The following tables set forth consolidated information regarding average balances and rates:

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DISTRIBUTION OF ASSETS, LIABILITIES AND STOCKHOLDERS EQUITY;
INTEREST RATES AND INTEREST DIFFERENTIAL
(in thousands of dollars)

| | Nine Months Ended September 30, 2006 | | | | 2005 | | | |
|-------------------------------------|---|--------------------|-----------|---|--------------------|--------------------|-----------|---|
| | Average Balance | Interest Income | Yield (1) | | Average Balance | Interest Income | Yield (1) | |
| ASSETS | | | | | | | | |
| Earning assets: | | | | | | | | |
| Loans: | | | | | | | | |
| Taxable (2)(3) | \$ 1,243,736 | \$ 66,968 | 7.20 | % | \$ 1,058,227 | \$ 48,561 | 6.14 | % |
| Tax exempt (1) | 5,958 | 245 | 5.50 | | 4,416 | 172 | 5.21 | |
| Investments: (1) | | | | | | | | |
| Available for sale | 292,298 | 10,057 | 4.60 | | 286,866 | 9,569 | 4.46 | |
| Short-term investments | 10,608 | 392 | 4.94 | | 4,761 | 83 | 1.49 | |
| Interest bearing deposits | 3,268 | 112 | 4.58 | | 3,838 | 101 | 3.52 | |
| Total earning assets | 1,555,868 | 77,774 | 6.68 | % | 1,358,108 | 58,486 | 5.76 | % |
| Nonearning assets: | | | | | | | | |
| Cash and due from banks | 58,854 | 0 | | | 54,439 | 0 | | |
| Premises and equipment | 24,597 | 0 | | | 25,068 | 0 | | |
| Other nonearning assets | 50,367 | 0 | | | 43,907 | 0 | | |
| Less allowance for loan loss losses | (13,453) | 0 | | | (11,403) | 0 | | |
| Total assets | \$ 1,676,233 | \$ 77,774 | | | \$ 1,470,119 | \$ 58,486 | | |

- (1) Tax exempt income was converted to a fully taxable equivalent basis at a 35 percent tax rate for 2006 and 2005. The tax equivalent rate for tax exempt loans and tax exempt securities acquired after January 1, 1983 included the TEFRA adjustment applicable to nondeductible interest expenses.
- (2) Loan fees, which are immaterial in relation to total taxable loan interest income for the nine months ended September 30, 2006 and 2005, are included as taxable loan interest income.
- (3) Nonaccrual loans are included in the average balance of taxable loans.

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DISTRIBUTION OF ASSETS, LIABILITIES AND STOCKHOLDERS EQUITY;
INTEREST RATES AND INTEREST DIFFERENTIAL (Cont.)
(in thousands of dollars)

Nine Months Ended September 30,

| | 2006 | Interest | Yield | 2005 | Interest | Yield | |
|---|--------------|-----------|-------|--------------|-----------|-------|---|
| | Average | Expense | | Average | Expense | | |
| | Balance | | | Balance | | | |
| LIABILITIES AND STOCKHOLDERS EQUITY | | | | | | | |
| Interest bearing liabilities: | | | | | | | |
| Savings deposits | \$ 68,426 | \$ 108 | 0.21 | % \$71,668 | \$ 58 | 0.11 | % |
| Interest bearing checking accounts | 389,657 | 8,715 | 2.99 | 336,705 | 3,649 | 1.45 | |
| Time deposits: | | | | | | | |
| In denominations under \$100,000 | 260,771 | 7,697 | 3.95 | 225,411 | 5,179 | 3.07 | |
| In denominations over \$100,000 | 423,089 | 15,355 | 4.85 | 291,589 | 7,253 | 3.33 | |
| Miscellaneous short-term borrowings | 150,434 | 4,363 | 3.88 | 168,365 | 2,950 | 2.34 | |
| Long-term borrowings | 30,973 | 1,877 | 8.10 | 40,974 | 1,607 | 5.24 | |
| Total interest bearing liabilities | 1,323,350 | 38,115 | 3.85 | % 1,134,712 | 20,696 | 2.44 | % |
| Noninterest bearing liabilities and stockholders equity: | | | | | | | |
| Demand deposits | 219,925 | 0 | | 218,925 | 0 | | |
| Other liabilities | 13,340 | 0 | | 9,697 | 0 | | |
| Stockholders equity | 119,618 | 0 | | 106,785 | 0 | | |
| Total liabilities and stockholders equity | \$ 1,676,233 | \$ 38,115 | | \$ 1,470,119 | \$ 20,696 | | |
| Net interest differential yield on average daily earning assets | | \$ 39,659 | 3.40 | % | \$ 37,790 | 3.72 | % |

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DISTRIBUTION OF ASSETS, LIABILITIES AND STOCKHOLDERS EQUITY;
INTEREST RATES AND INTEREST DIFFERENTIAL
(in thousands of dollars)

| | Three Months Ended September 30, 2006 | | | | 2005 | | | |
|-------------------------------------|--|--------------------|-----------|---|--------------------|--------------------|-----------|---|
| | Average Balance | Interest Income | Yield (1) | | Average Balance | Interest Income | Yield (1) | |
| ASSETS | | | | | | | | |
| Earning assets: | | | | | | | | |
| Loans: | | | | | | | | |
| Taxable (2)(3) | \$ 1,283,130 | \$ 23,936 | 7.40 | % | \$ 1,111,440 | \$ 17,894 | 6.39 | % |
| Tax exempt (1) | 6,264 | 88 | 5.57 | | 4,426 | 62 | 5.60 | |
| Investments: (1) | | | | | | | | |
| Available for sale | 292,938 | 3,315 | 4.49 | | 287,968 | 3,180 | 4.38 | |
| Short-term investments | 8,474 | 110 | 5.15 | | 5,412 | 45 | 3.30 | |
| Interest bearing deposits | 3,727 | 47 | 5.00 | | 4,568 | 38 | 3.30 | |
| Total earning assets | 1,594,533 | 27,496 | 6.84 | % | 1,413,814 | 21,219 | 5.95 | % |
| Nonearning assets: | | | | | | | | |
| Cash and due from banks | 61,153 | 0 | | | 54,287 | 0 | | |
| Premises and equipment | 25,005 | 0 | | | 25,124 | 0 | | |
| Other nonearning assets | 51,545 | 0 | | | 44,652 | 0 | | |
| Less allowance for loan loss losses | (13,960) | 0 | | | (11,932) | 0 | | |
| Total assets | \$ 1,718,276 | \$ 27,496 | | | \$ 1,525,945 | \$ 21,219 | | |

- (1) Tax exempt income was converted to a fully taxable equivalent basis at a 35 percent tax rate for 2006 and 2005. The tax equivalent rate for tax exempt loans and tax exempt securities acquired after January 1, 1983 included the TEFRA adjustment applicable to nondeductible interest expenses.
- (2) Loan fees, which are immaterial in relation to total taxable loan interest income for the three months ended September 30, 2006 and 2005, are included as taxable loan interest income.
- (3) Nonaccrual loans are included in the average balance of taxable loans.

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DISTRIBUTION OF ASSETS, LIABILITIES AND STOCKHOLDERS EQUITY;
INTEREST RATES AND INTEREST DIFFERENTIAL (Cont.)
(in thousands of dollars)

Three Months Ended September 30,

| | 2006 | Interest | Yield | 2005 | Interest | Yield | |
|---|--------------|-----------|-------|--------------|-----------|-------|---|
| | Average | Expense | | Average | Expense | | |
| | Balance | | | Balance | | | |
| LIABILITIES AND STOCKHOLDERS EQUITY | | | | | | | |
| Interest bearing liabilities: | | | | | | | |
| Savings deposits | \$ 67,744 | \$ 36 | 0.21 | % \$ 71,158 | \$ 23 | 0.13 | % |
| Interest bearing checking accounts | 411,977 | 3,528 | 3.40 | 323,660 | 1,383 | 1.70 | |
| Time deposits: | | | | | | | |
| In denominations under \$100,000 | 270,490 | 2,839 | 4.16 | 231,511 | 1,891 | 3.24 | |
| In denominations over \$100,000 | 456,355 | 5,995 | 5.21 | 349,332 | 3,312 | 3.76 | |
| Miscellaneous short-term borrowings | 123,253 | 1,167 | 3.76 | 172,329 | 1,207 | 2.78 | |
| Long-term borrowings | 30,973 | 661 | 8.47 | 40,974 | 572 | 5.54 | |
| Total interest bearing liabilities | 1,360,792 | 14,226 | 4.15 | % 1,188,964 | 8,388 | 2.80 | % |
| Noninterest bearing liabilities and stockholders equity: | | | | | | | |
| Demand deposits | 219,789 | 0 | | 216,995 | 0 | | |
| Other liabilities | 14,328 | 0 | | 9,926 | 0 | | |
| Stockholders equity | 123,367 | 0 | | 110,060 | 0 | | |
| Total liabilities and stockholders equity | \$ 1,718,276 | \$ 14,226 | | \$ 1,525,945 | \$ 8,388 | | |
| Net interest differential yield on average daily earning assets | | \$ 13,270 | 3.30 | % | \$ 12,831 | 3.59 | % |

Provision for Loan Losses

Based on management's review of the adequacy of the allowance for loan losses, provisions for losses on loans of \$1.6 million and \$510,000 were recorded during the nine-month and three-month periods ended September 30, 2006, versus provisions of \$1.8 million and \$659,000 recorded during the same periods of 2005. Factors impacting the provision included the amount and status of classified credits, the level of charge-offs, management's overall view on current credit quality, the amount and status of impaired loans and the amount and status of past due accruing loans (90 days or more), as discussed in more detail below in the analysis relating to the Company's financial condition.

Noninterest Income

Noninterest income categories for the nine and three-month periods ended September 30, 2006 and 2005 are shown in the following table:

| | Nine Months Ended September 30, | | Percent Change | |
|---|-------------------------------------|-----------|-------------------|---|
| | 2006 | 2005 | | |
| Wealth advisory and investment brokerage fees | \$ 2,864 | \$ 2,261 | 26.7 | % |
| Service charges on deposit accounts | 5,668 | 5,112 | 10.9 | |
| Loan, insurance and service fees | 1,746 | 1,442 | 21.1 | |
| Merchant card fee income | 1,809 | 1,857 | (2.6) | |
| Other income | 1,496 | 1,319 | 13.4 | |
| Net gains on sales of real estate mortgages held for sale | 467 | 726 | (35.7) | |
| Net securities gains (losses) | (68) | 0 | (100.0) | |
| Total noninterest income | \$ 13,982 | \$ 12,717 | 10.0 | % |
| | | | | |
| | Three Months Ended September 30, | | Percent Change | |
| | 2006 | 2005 | | |
| Wealth advisory and investment brokerage fees | \$ 952 | \$ 742 | 28.3 | % |
| Service charges on deposit accounts | 1,983 | 1,860 | 6.6 | |
| Loan, insurance and service fees | 548 | 480 | 14.2 | |
| Merchant card fee income | 661 | 692 | (4.5) | |
| Other income | 476 | 331 | 43.8 | |
| Net gains on sales of real estate mortgages held for sale | 137 | 275 | (50.2) | |
| Net securities gains (losses) | (14) | 0 | (100.0) | |
| Total noninterest income | \$ 4,743 | \$ 4,380 | 8.3 | % |

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Noninterest income increased \$1.3 million and \$363,000, respectively, in the nine-month and three-month periods ended September 30, 2006, versus the same periods in 2005. Wealth advisory and brokerage income increased by \$603,000 and \$210,000, respectively, in the nine and three-month periods ended September 30, 2006, primarily due to a \$463,000 year-to-date increase in brokerage fees, driven by higher trading volume. Service charges on deposit accounts increased \$556,000 and \$123,000, respectively, in the nine and three-month periods ended September 30, 2006, due largely to increased overdraft activity resulting in more overdraft charges and an increase in the per item fee implemented in 2006. Loan, insurance and service fees increased due largely to higher fee income on Visa check cards. Partially offsetting these increases were decreases in profits from the sale of mortgages primarily due to lower mortgage loan volumes, which is expected in a rising interest rate environment.

Noninterest Expense

Noninterest expense categories for the nine-month and three-month periods ended September 30, 2006 and 2005 are shown in the following table:

| | Nine Months Ended September 30, | | Percent Change | |
|-----------------------------------|------------------------------------|-----------|-------------------|---|
| | 2006 | 2005 | | |
| Salaries and employee benefits | \$ 16,609 | \$ 15,224 | 9.1 | % |
| Net occupancy expense | 1,901 | 2,059 | (7.7) | |
| Equipment costs | 1,345 | 1,476 | (8.9) | |
| Data processing fees and supplies | 1,754 | 1,715 | 2.3 | |
| Credit card interchange | 1,211 | 1,158 | 4.6 | |
| Other expense | 6,721 | 6,384 | 5.3 | |
| Total noninterest expense | \$ 29,541 | \$ 28,016 | 5.4 | % |

| | Three Months Ended September 30, | | Percent Change | |
|-----------------------------------|-------------------------------------|----------|-------------------|---|
| | 2006 | 2005 | | |
| Salaries and employee benefits | \$ 5,595 | \$ 5,051 | 10.8 | % |
| Net occupancy expense | 680 | 728 | (6.6) | |
| Equipment costs | 430 | 468 | (8.1) | |
| Data processing fees and supplies | 611 | 586 | 4.3 | |
| Credit card interchange | 465 | 442 | 5.2 | |
| Other expense | 2,156 | 2,080 | 3.7 | |
| Total noninterest expense | \$ 9,937 | \$ 9,355 | 6.2 | % |

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Noninterest expense increased \$1.5 million and \$582,000, respectively, in the nine-month and three-month periods ended September 30, 2006 versus the same periods of 2005. Driving this increase were salaries and employee benefits, which increased \$1.4 million and \$544,000, respectively, in the nine and three-month periods ended September 30, 2006. The increases were due largely to staff additions, normal salary increases and increased incentive based compensation. In addition, other expense increased due primarily to increased advertising and business development costs. Offsetting these increases were decreases in net occupancy expense due to reduced maintenance and repair expense, and decreased equipment cost due to lower depreciation expense.

Income Tax Expense

Income tax expense increased \$664,000, or 9.7%, for the first nine months of 2006, compared to the same period in 2005. Income tax expense for the third quarter of 2006 increased \$183,000, or 7.7%, compared to the same period of 2005. The combined state franchise tax expense and the federal income tax expense, as a percentage of income before income tax expense, increased to 34.6% during the first nine months of 2006 compared to 34.5% during the same period of 2005. It increased to 35.1% for the third quarter of 2006, versus 34.5% for the third quarter of 2005. The increase was driven by an increase in the proportion of income derived from taxable sources in the third quarter of 2006 versus the same period of 2005.

CRITICAL ACCOUNTING POLICIES

Certain of the Company's accounting policies are important to the portrayal of the Company's financial condition, since they require management to make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Some of the facts and circumstances which could affect these judgments include changes in interest rates, in the performance of the economy or in the financial condition of borrowers. Management believes that its critical accounting policies include determining the allowance for loan losses and the valuation of mortgage servicing rights. The Company's critical accounting policies are discussed in detail in the Annual Report for the year ended December 31, 2005 (incorporated by reference as part of the Company's 10-K filing).

FINANCIAL CONDITION

Total assets of the Company were \$1.800 billion as of September 30, 2006, an increase of \$165.1 million, or 10.1%, when compared to \$1.635 billion as of December 31, 2005.

Total cash and cash equivalents increased by \$21.5 million, or 26.0%, to \$104.2 million at September 30, 2006 from \$82.7 million at December 31, 2005.

Total securities available-for-sale increased by \$8.6 million, or 3.0%, to \$299.5 million at September 30, 2006 from \$290.9 million at December 31, 2005. The increase was a result of a number of transactions in the securities portfolio. Securities purchases totaled \$68.7 million and the fair market value of the securities portfolio increased by \$1.3 million. A falling interest rate environment during the third quarter of 2006 drove the market value increase. Offsetting these increases were securities paydowns totaling \$36.1 million, maturities, sales and calls of securities totaling \$24.2 million and the amortization of premiums, net of the

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accretion of discounts totaling \$1.1 million. The investment portfolio is managed to limit the Company's exposure to risk by containing mostly collateralized mortgage obligations and other securities which are either directly or indirectly backed by the federal government or a local municipal government.

Real estate mortgages held-for-sale increased by \$462,000, or 48.1%, to \$1.4 million at September 30, 2006 from \$960,000 at December 31, 2005. The balance of this asset category is subject to a high degree of variability depending on, among other things, recent mortgage loan rates and the timing of loan sales into the secondary market. During the nine months ended September 30, 2006, \$26.7 million in real estate mortgages were originated for sale and \$26.5 million in mortgages were sold.

Total loans, excluding real estate mortgages held-for-sale, increased by \$132.5 million, or 11.0%, to \$1.331 billion at September 30, 2006 from \$1.199 billion at December 31, 2005. The mix of loan types within the Company's portfolio consisted of 80% commercial and industrial and agri-business, 8% real estate and 12% consumer loans at September 30, 2006 compared to 81% commercial and industrial and agri-business, 6% real estate and 13% consumer at December 31, 2005.

The Company has a relatively high percentage of commercial and commercial real estate loans, most of which are extended to small or medium-sized businesses. Commercial loans represent higher dollar loans to fewer customers and therefore higher credit risk. Pricing is adjusted to manage the higher credit risk associated with these types of loans. The majority of fixed rate residential mortgage loans, which represent increased interest rate risk, are sold in the secondary market, as well as some variable rate residential mortgage loans. The remainder of the variable rate residential mortgage loans and a small number of fixed rate residential mortgage loans are retained. Management believes the allowance for loan losses is at a level commensurate with the overall risk exposure of the loan portfolio. However, as a result of the uncertain economic recovery, certain borrowers may experience difficulty and the level of non-performing loans, charge-offs, and delinquencies could rise and require further increases in the provision for loan losses.

Loans are charged against the allowance for loan losses when management believes that the uncollectibility of the principal is confirmed. Subsequent recoveries, if any, are credited to the allowance. The allowance is an amount that management believes will be adequate to absorb probable incurred credit losses relating to specifically identified loans based on an evaluation as well as other probable incurred losses inherent in the loan portfolio. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, and current economic conditions that may affect the borrower's ability to repay. Management also considers trends in adversely classified loans based upon a monthly review of those credits. An appropriate level of general allowance is determined based on the application of loss allocations to graded loans. Federal regulations require insured institutions to classify their own assets on a regular basis. The regulations provide for three categories of classified loans—substandard, doubtful and loss. The regulations also contain a special mention category. Special mention is defined as loans that do not currently expose an insured institution to a sufficient degree of risk to warrant classification but do possess credit deficiencies or potential weaknesses deserving management's close attention. Assets classified as substandard or doubtful require the institution to establish general allowances for loan losses. If an asset or portion thereof is classified as loss, the insured institution must either establish specified allowances for loan losses in the amount of 100% of the portion of the asset classified loss, or charge off such amount. At September 30, 2006, on the basis of management's review of the loan portfolio, the Company had \$38.9 million of assets classified as special mention, \$32.1 million classified as substandard,

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\$63,000 classified as doubtful and \$0 classified as loss as compared to \$24.6 million, \$24.7 million, \$333,000 and \$0 at December 31, 2005.

Allowance estimates are developed by management taking into account actual loss experience, adjusted for current economic conditions. The Company discusses this methodology with regulatory authorities to ensure compliance. Allowance estimates are considered a prudent measurement of the risk in the Company's loan portfolio and are applied to individual loans based on loan type. In accordance with FASB Statements 5 and 114, the allowance is provided for losses that have been incurred as of the balance sheet date and is based on past events and current economic conditions, and does not include the effects of expected losses on specific loans or groups of loans that are related to future events or expected changes in economic conditions.

Total impaired loans increased by \$8.0 million to \$14.9 million at September 30, 2006 from \$6.9 million at December 31, 2005. The increase in the impaired loans category resulted from the addition of a single borrowing relationship with aggregate loans totaling \$9.0 million. The borrower is engaged in commercial and residential real estate development in Northern Indiana. Borrower collateral, including real estate, and personal guarantees of its principals support this credit, although there can be no assurances that full repayment of the loans will result. All impaired loans were considered nonaccrual at September 30, 2006. A loan is impaired when full payment under the original loan terms is not expected. Impairment is evaluated in total for smaller-balance loans of similar nature such as residential mortgage, and consumer loans, and on an individual loan basis for other loans. If a loan is impaired, a portion of the allowance may be allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. The following table summarizes nonperforming assets at September 30, 2006 and December 31, 2005.

| | September 30, 2006 (in thousands) | December 31, 2005 |
|--|---|----------------------|
| NONPERFORMING ASSETS: | | |
| Nonaccrual loans | \$ 15,308 | \$ 7,321 |
| Loans past due over 90 days and accruing | 105 | 174 |
| Total nonperforming loans | 15,413 | 7,495 |
| Other real estate | 71 | 0 |
| Repossessions | 43 | 25 |
| Total nonperforming assets | \$ 15,527 | \$ 7,520 |
| Total impaired loans | \$ 14,898 | \$ 6,948 |
| Nonperforming loans to total loans | 1.16% | 0.63% |
| Nonperforming assets to total assets | 0.86% | 0.46% |

Total deposits increased by \$267.6 million, or 21.1% to \$1.534 billion at September 30, 2006 from \$1.266 billion at December 31, 2005. The increase resulted from increases of \$230.2 million in certificates of deposit, \$22.6 million in money market transaction accounts, \$16.1 million in Investors' Money Market

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accounts and \$937,000 in savings accounts. Offsetting these increases were declines of \$2.2 million in demand deposit accounts and \$47,000 in money market accounts. Total short-term borrowings decreased by \$115.7 million, or 54.7%, to \$95.8 million at September 30, 2006 from \$211.5 million at December 31, 2005. The decrease resulted primarily from decreases of \$75.0 million in other borrowings, primarily short-term advances from the Federal Home Loan Bank of Indianapolis and \$43.0 million in federal funds purchased.

Total stockholders' equity increased by \$13.7 million, or 12.1%, to \$127.0 million at September 30, 2006 from \$113.3 million at December 31, 2005. Net income of \$14.2 million, plus the increase in the accumulated other comprehensive income of \$826,000, minus dividends of \$3.0 million, plus \$1.6 million for stock issued through options exercised, minus \$199,000 for the cost of treasury stock purchased plus \$141,000 in stock option expense (including tax benefit), comprised most of this increase.

The Federal Deposit Insurance Corporation's risk based capital regulations require that all banking organizations maintain an 8.0% total risk based capital ratio. The FDIC has also established definitions of "well capitalized" as a 5.0% Tier I leverage capital ratio, a 6.0% Tier I risk based capital ratio and a 10.0% total risk based capital ratio. All of the Company's ratios continue to be above "well capitalized" levels. As of September 30, 2006, the Company's Tier 1 leverage capital ratio, Tier 1 risk based capital ratio and total risk based capital ratio were 8.9%, 10.7% and 11.7%, respectively.

FORWARD-LOOKING STATEMENTS

This document (including information incorporated by reference) contains, and future oral and written statements of the Company and its management may contain, forward-looking statements, within the meaning of such term in the Private Securities Litigation Reform Act of 1995, with respect to the financial condition, results of operations, plans, objectives, future performance and business of the Company. Forward-looking statements, which may be based upon beliefs, expectations and assumptions of the Company's management and on information currently available to management, are generally identifiable by the use of words such as "believe," "expect," "anticipate," "plan," "intend," "estimate," "will," "would," "could," "should" or other similar expressions. Additionally, all statements in this document, including forward-looking statements, speak only as of the date they are made, and the Company undertakes no obligation to update any statement in light of new information or future events.

The Company's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. The factors, which could have a material adverse effect on the operations and future prospects of the Company and its subsidiaries are detailed in the "Risk Factors" section included under Item 1a. of Part I of our Form 10-K. In addition to the risk factors described in that section, there are other factors that may impact any public company, including ours, which could have a material adverse effect on the operations and future prospects of the Company and its subsidiaries. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements.

ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest rate risk represents the Company's primary market risk exposure. The Company does not have a material exposure to foreign currency exchange risk, does not have any material amount of derivative financial instruments and does not maintain a trading portfolio. The board of directors annually reviews and approves the policy used to manage interest rate risk. The policy was last reviewed and approved in May 2006. The policy

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sets guidelines for balance sheet structure, which are designed to protect the Company from the impact that interest rate changes could have on net income, but does not necessarily indicate the effect on future net interest income. The Company, through its Asset/Liability Committee, manages interest rate risk by monitoring the computer simulated earnings impact of various rate scenarios and general market conditions. The Company then modifies its long-term risk parameters by attempting to generate the type of loans, investments, and deposits that currently fit the Company's needs, as determined by the Asset/Liability Committee. This computer simulation analysis measures the net interest income impact of various interest rate scenario changes during the next 12 months. If the change in net interest income is less than 3% of primary capital, the balance sheet structure is considered to be within acceptable risk levels. At September 30, 2006, the Company's potential pretax exposure was within the Company's policy limit, and not significantly different from December 31, 2005.

ITEM 4 CONTROLS AND PROCEDURES

As required by Rules 13a-15(b) and 15d-15(b) under the Securities Exchange Act of 1934, management has evaluated, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based on this evaluation, management concluded the Company's disclosure controls and procedures (as defined in Securities Exchange Act Rules 13a-15(e) and 15d-15(e)) were effective as of September 30, 2006 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms and were effective as of September 30, 2006. These disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. During the quarter ended September 30, 2006, the Company has not made a change to its disclosure controls and procedures or its internal controls over financial reporting that has materially affected or is reasonably likely to materially affect its disclosure controls or its controls over financial reporting.

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Part II - Other Information

Item 1. Legal proceedings

There are no material pending legal proceedings to which the Company or its subsidiaries is a party other than ordinary routine litigation incidental to their respective businesses.

Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in Item 1A. to Part I of the Company's 2005 Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table provides information as of September 30, 2006 with respect to shares of common stock repurchased by the Company during the quarter then ended:

Issuer Purchases of Equity Securities(a)

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Appropriate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs |
|-----------|----------------------------------|------------------------------|--|--|
| July 1-31 | 3,792 | \$ 23.76 | 0 | \$ 0 |

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| | | | | |
|----------------|-------|----------|---|------|
| August 1-31 | 433 | 24.48 | 0 | 0 |
| September 1-30 | 0 | 0 | 0 | 0 |
| Total | 4,225 | \$ 23.83 | 0 | \$ 0 |

- (a) The shares purchased during the periods were credited to the deferred share accounts of seven non-employee directors under the Company's director's deferred compensation plan.

Item 3. Defaults Upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 5. Other Information

None

Item 6. Exhibits

31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a)

31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a)

32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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Part II - Other Information

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

LAKELAND FINANCIAL CORPORATION

(Registrant)

Date: November 6, 2006

/s/ Michael L. Kubacki
Michael L. Kubacki President and Chief
Executive Officer

Date: November 6, 2006

/s/ David M. Findlay
David M. Findlay Executive Vice President
and Chief Financial Officer

Date: November 6, 2006

/s/ Teresa A. Bartman
Teresa A. Bartman Vice President
and Controller

