HERITAGE COMMERCE CORP
Form 10-Q/A
February 22, 2008

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

# FORM 10-Q/A

**(Amendment No. 1)**

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

**For the quarterly period ended March 31, 2007**

**OR**

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

**For the transition period from to**

**Commission file number 000-23877**

# Heritage Commerce Corp

(Exact name of Registrant as Specified in its Charter)

| | |
|---|---|
| **California** | **77-0469558** |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification Number) |

**150 Almaden Boulevard**

**San Jose, California 95113**

(Address of Principal Executive Offices including Zip Code)

**(408) 947-6900**

(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 reports), and (2) has been subject to such filing requirements for the past 90 days. YES x NO o

Indicate by check mark whether the Registrant is an 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 o Accelerated filer x Non-accelerated filer o

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

The Registrant had 11,636,828 shares of Common Stock outstanding on April 24, 2007.

**Heritage Commerce Corp and Subsidiaries**

**Quarterly Report on Form 10-Q/A**

**Table of Contents**

**EXPLANATORY NOTE**

Heritage Commerce Corp is filing this Amendment No. 1 to its Quarterly Report on Form 10-Q for the quarter ended March 31, 2007, to reflect the restatement of Heritage Commerce Corp s Consolidated Balance Sheets and Consolidated Statements of Cash Flows, as discussed in Note 9 of the Notes to the Consolidated Financial Statements contained in Part I, Item 1. Except for Part I, Item 1, and related changes to conform Management s Discussion and Analysis of Financial Condition and Results of Operations in Part I, Item 2 to the restated financial statements, no other information in the Form 10-Q for the quarter ended March 31, 2007 is being amended by this Amendment No. 1. This Amendment No. 1 continues to speak as of the date of the original filing of the Form 10-Q and Heritage Commerce Corp has not updated the disclosure in the Amendment to speak as of any later date.

## Part I FINANCIAL INFORMATION

## ITEM 1 CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

### Heritage Commerce Corp

### Consolidated Balance Sheets (Unaudited)

**(Dollars in thousands)**

| | March 31, 2007 (As Restated See Note 9) | December 31, 2006 (As Restated See Note 9) |
|---|---|---|
| **Assets** | | |
| Cash and due from banks | $ 33,718 | $ 34,285 |
| Federal funds sold | 90,400 | 15,100 |
| Total cash and cash equivalents | 124,118 | 49,385 |
| Securities available-for-sale, at fair value | 164,800 | 172,298 |
| Loans held for sale, at lower of cost or market | 25,839 | 33,752 |
| Loans, net of deferred costs | 686,578 | 709,236 |
| Allowance for loan losses | (9,014) | (9,279) |
| Loans, net | 677,564 | 699,957 |
| | | |
| Federal Home Loan Bank and Federal Reserve Bank stock, at cost | 6,185 | 6,113 |
| Company owned life insurance | 36,519 | 36,174 |
| Premises and equipment, net | 2,446 | 2,539 |
| Accrued interest receivable and other assets | 33,593 | 36,920 |
| Total assets | $ 1,071,064 | $ 1,037,138 |
| | | |
| **Liabilities and Shareholders Equity** | | |
| Liabilities: | | |
| Deposits | | |
| Demand, noninterest bearing | $ 221,206 | $ 231,841 |
| Demand, interest bearing | 141,395 | 133,413 |
| Savings and money market | 351,005 | 307,266 |
| Time deposits, under $100 | 30,730 | 31,097 |
| Time deposits, $100 and over | 96,813 | 111,017 |
| Brokered deposits, $100 and over | 42,748 | 31,959 |
| Total deposits | 883,897 | 846,593 |
| Notes payable to subsidiary grantor trusts | 23,702 | 23,702 |
| Securities sold under agreement to repurchase | 15,100 | 21,800 |
| Accrued interest payable and other liabilities | 22,333 | 22,223 |
| Total liabilities | 945,032 | 914,318 |
| | | |
| Shareholders equity: | | |
| Preferred stock, no par value; 10,000,000 shares authorized; none outstanding | | |
| Common Stock, no par value; 30,000,000 shares authorized; | | |
| shares outstanding: 11,636,828 at March 31, 2007 and 11,656,943 at December 31, 2006 | 61,958 | 62,363 |
| Retained earnings | 65,786 | 62,452 |
| Accumulated other comprehensive loss | (1,712) | (1,995) |

| | | | | |
|---|---|---|---|---|
| Total shareholders equity | | 126,032 | | 122,820 |
| Total liabilities and shareholders equity | $ | 1,071,064 | $ | 1,037,138 |

See notes to consolidated financial statements

**Heritage Commerce Corp**

**Consolidated Income Statements (Unaudited)**

| | Three Months Ended March 31, | | | |
|---|---|---|---|---|
| | | 2007 | | 2006 |
| | (Dollars in thousands, except per share data) | | | |
| **Interest income:** | | | | |
| Loans, including fees | $ | 14,670 | $ | 14,721 |
| Securities, taxable | | 1,909 | | 1,746 |
| Securities, non-taxable | | 44 | | 46 |
| Interest bearing deposits in other financial institutions | | 32 | | 18 |
| Federal funds sold | | 579 | | 729 |
| Total interest income | | 17,234 | | 17,260 |
| | | | | |
| Interest expense: | | | | |
| Deposits | | 4,785 | | 4,319 |
| Notes payable to subsidiary grantor trusts | | 581 | | 562 |
| Repurchase agreements and other | | 137 | | 188 |
| Total interest expense | | 5,503 | | 5,069 |
| Net interest income | | 11,731 | | 12,191 |
| Provision for loan losses | | (236) | | (489) |
| Net interest income after provision for loan losses | | 11,967 | | 12,680 |
| | | | | |
| Noninterest income: | | | | |
| Gain on sale of loans | | 1,011 | | 1,497 |
| Servicing income | | 517 | | 468 |
| Increase in cash surrender value of life insurance | | 345 | | 347 |
| Service charges and fees on deposit accounts | | 274 | | 327 |
| Other | | 368 | | 255 |
| Total noninterest income | | 2,515 | | 2,894 |
| | | | | |
| Noninterest expense: | | | | |
| Salaries and employee benefits | | 4,888 | | 5,109 |
| Occupancy | | 765 | | 777 |
| Professional fees | | 337 | | 513 |
| Low income housing investment losses and writedowns | | 237 | | 264 |
| Client services | | 230 | | 300 |
| Advertising and promotion | | 212 | | 210 |
| Data processing | | 203 | | 181 |
| Furniture and equipment | | 110 | | 109 |
| Retirement plan expense | | 61 | | 88 |
| Other | | 1,257 | | 1,210 |
| Total noninterest expense | | 8,300 | | 8,761 |
| Income before income taxes | | 6,182 | | 6,813 |
| Income tax expense | | 2,149 | | 2,437 |
| Net income | $ | 4,033 | $ | 4,376 |
| | | | | |
| Earnings per share: | | | | |
| Basic | $ | 0.35 | $ | 0.37 |
| Diluted | $ | 0.34 | $ | 0.36 |

See notes to consolidated financial statements

**Heritage Commerce Corp**

**Consolidated Statements of Shareholders Equity (Unaudited)**

**Three Months Ended March 31, 2007 and 2006**

| | Common Stock Shares | Common Stock Amount | Retained Earnings | Accumulated Other Comprehensive Loss | Total Shareholders Equity | Comprehensive Income |
|---|---|---|---|---|---|---|
| | | | (Dollars in thousands, except share data) | | | |
| **Balance, January 1, 2006** | 11,807,649 | $ 66,799 | $ 47,539 | $ (2,721) | $ 111,617 | |
| Net Income | | | 4,376 | | 4,376 | $ 4,376 |
| Net change in unrealized gain/loss on securities available-for-sale and Interest-Only strips, net of deferred income taxes | | | | (688) | (688) | (688) |
| Decrease in pension liability, net of deferred income taxes | | | | 162 | 162 | 162 |
| Total comprehensive income | | | | | | $ 3,850 |
| Amortization of restricted stock award | | 38 | | | 38 | |
| Dividend declared on commom stock, $0.05 per share | | | (591) | | (591) | |
| Commom stock repurchased | (32,000) | (739) | | | (739) | |
| Stock options expense | | 175 | | | 175 | |
| Stock options exercised, including related tax benefits | 59,197 | 847 | | | 847 | |
| **Balance, March 31, 2006** | 11,834,846 | $ 67,120 | $ 51,324 | $ (3,247) | $ 115,197 | |
| | | | | | | |
| **Balance, January 1, 2007** | 11,656,943 | $ 62,363 | $ 62,452 | $ (1,995) | $ 122,820 | |
| Net Income | | | 4,033 | | 4,033 | $ 4,033 |
| Net change in unrealized gain/loss on securities available-for-sale and Interest-Only strips, net of deferred income taxes | | | | 268 | 268 | 268 |
| Decrease in pension liability, net of deferred income taxes | | | | 15 | 15 | 15 |
| Total comprehensive income | | | | | | $ 4,316 |
| Amortization of restricted stock award | | 38 | | | 38 | |
| Dividend declared on commom stock, $0.06 per share | | | (699) | | (699) | |
| Commom stock repurchased | (35,000) | (892) | | | (892) | |
| Stock options expense | | 215 | | | 215 | |
| Stock options exercised, including related tax benefits | 14,885 | 234 | | | 234 | |
| **Balance, March 31, 2007** | 11,636,828 | $ 61,958 | $ 65,786 | $ (1,712) | $ 126,032 | |

See notes to consolidated financial statements

**Heritage Commerce Corp**

**Consolidated Statements of Cash Flows (Unaudited)**

| | Three Months Ended March 31, 2007 (As Restated See Note 9) | 2006 (As Restated See Note 9) |
|---|---|---|
| | (Dollars in thousands) | |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | $ 4,033 | $ 4,376 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 150 | 174 |
| Provision for loan losses | (236) | (489) |
| Stock option expense | 215 | 175 |
| Amortization of restricted stock award | 38 | 38 |
| Amortization (accretion) of discounts and premiums on securities | 77 | (303) |
| Gain on sale of Capital Group loan portfolio | | (671) |
| Gain on sale of SBA loans | (1,011) | (826) |
| Proceeds from sales of SBA loans held for sale | 19,849 | 15,040 |
| Change in SBA loans held for sale | (9,953) | (10,547) |
| Increase in cash surrender value of life insurance | (344) | (347) |
| Effect of changes in: | | |
| Accrued interest receivable and other assets | 2,960 | 2,169 |
| Accrued interest payable and other liabilities | 137 | (623) |
| Net cash provided by operating activities | 15,915 | 8,166 |
| | | |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Net change in loans | 21,656 | (3,396) |
| Proceeds from sale of Capital Group loan portfolio | | 30,047 |
| Net decrease in Capital Group loan portfolio prior to sale | | 2,681 |
| Purchases of securities available-for-sale | (2,295) | (17,690) |
| Maturities/paydowns/calls of securities available-for-sale | 10,340 | 29,392 |
| Purchase of premises and equipment | (57) | (22) |
| Purchase of other investments | (73) | (59) |
| Net cash provided by investing activities | 29,571 | 40,953 |
| | | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net change in deposits | 37,304 | (5,026) |
| Payment of other liability | | (1,205) |
| Exercise of stock options | 234 | 847 |
| Common stock repurchased | (892) | (739) |
| Payment of dividends | (699) | (591) |
| Net change in other borrowings | (6,700) | (6,600) |
| Net cash provided by (used in) financing activities | 29,247 | (13,314) |
| Net increase in cash and cash equivalents | 74,733 | 35,805 |
| Cash and cash equivalents, beginning of period | 49,385 | 98,460 |
| Cash and cash equivalents, end of period | $ 124,118 | $ 134,265 |
| | | |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the period for: | | |
| Interest | $ 6,050 | $ 5,539 |
| Income taxes | $ | $ |
| Supplemental schedule of non-cash investing activity: | | |
| Transfer of portfolio loans to loans held for sale | $ 972 | $ |

| | | | | |
|---|---|---|---|---|
| Transfer of loans held for sale to loan portfolio | $ | | $ | 66 |

See notes to consolidated financial statements

**HERITAGE COMMERCE CORP**

**Notes to Consolidated Financial Statements**

**March 31, 2007**

**(Unaudited)**

## 1) Basis of Presentation

The unaudited consolidated financial statements of Heritage Commerce Corp (the Company ) and its wholly owned subsidiary, Heritage Bank of Commerce ( HBC ), have been prepared pursuant to the rules and regulations for reporting on Form 10-Q. Accordingly, certain information and notes required by accounting principles generally accepted in the United States of America ( GAAP ) for annual financial statements are not included herein. The interim statements should be read in conjunction with the consolidated financial statements and notes that were included in the Company s Form 10-K/A (Amendment No. 2) for the year ended December 31, 2006. The Company has also established the following unconsolidated subsidiary grantor trusts: Heritage Capital Trust I; Heritage Statutory Trust I; Heritage Statutory Trust II; and Heritage Commerce Corp Statutory Trust III which are Delaware Statutory business trusts formed for the exclusive purpose of issuing and selling trust preferred securities.

HBC is a commercial bank serving customers located in Santa Clara, Alameda, and Contra Costa counties of California. No customer accounts for more than 10 percent of revenue for HBC or the Company. Management evaluates the Company s performance as a whole and does not allocate resources based on the performance of different lending or transaction activities. Accordingly, the Company and its subsidiary operate as one business segment.

In the Company s opinion, all adjustments necessary for a fair presentation of these consolidated financial statements have been included and are of a normal and recurring nature. All intercompany transactions and balances have been eliminated.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ significantly from these estimates.

Certain amounts reported in previous consolidated financial statements have been reclassified to conform to the 2007 presentation.

The results for the three months ended March 31, 2007 are not necessarily indicative of the results expected for any subsequent period or for the entire year ending December 31, 2007.

***Adoption of New Accounting Standards***

In February, 2006, FASB issued Statement 155, *Accounting for Certain Hybrid Instruments.* This standard amended the guidance in Statement 133, *Accounting for Derivative Instruments and Hedging Activities,* and Statement 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* Statement 155 permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation and clarifies which interest-only and principal-only strips are not subject to the requirements of Statement 133. Statement 155 is effective for all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006. The adoption of this standard did not have a material impact on the Company s financial statements.

In March, 2006, FASB issued Statement 156, *Accounting for Servicing of Financial Assets - An Amendment of FASB Statement No. 140*. This standard amends the guidance in Statement 140, with respect to the accounting for separately recognized servicing assets and servicing liabilities. Among other requirements, Statement 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in certain situations, including a transfer of loans with servicing retained that meets the requirements for sale accounting. Statement 156 is effective as of the beginning of an entity s first fiscal year that begins after September 15, 2006. The adoption of this standard did not have a material impact on the Company s financial statements.

In June 2006, FASB issued FASB Interpretation ( FIN ) 48, *Accounting for Uncertainty in Income Taxes*. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with Statement 109, *Accounting for Income Taxes.* This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. This Interpretation is effective for fiscal years beginning after December 15, 2006.

The Company adopted FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes* ( FIN 48 ), as of January 1, 2007. A tax position is recognized as a benefit only if it is more likely than not that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the more likely than not test, no tax benefit is recorded. The adoption of this standard did not have a material impact on the Company s financial statements.

The Company and its subsidiaries are subject to U.S. federal income tax as well as income tax of the State of California. The Company is no longer subject to examination by taxing authorities for years before 2003. The Company does not expect the total amount of unrecognized tax benefits to significantly increase in the next twelve months.

The Company recognizes interest and/or penalties related to income tax matters in income tax expense. The Company did not have any amounts accrued for interest and penalties at March 31, 2007.

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-5, *Accounting for Purchases of Life Insurance - Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4 (Accounting for Purchases of Life Insurance).* This issue requires that a policyholder consider contractual terms of a life insurance policy in determining the amount that could be realized under the insurance contract. It also requires that if the contract provides for a greater surrender value if all individual policies in a group are surrendered at the same time, that the surrender value be determined based on the assumption that policies will be surrendered on an individual basis. Lastly, the issue discusses whether the cash surrender value should be discounted when the policyholder is contractually limited in its ability to surrender a policy. This issue is effective for fiscal years beginning after December 15, 2006. The adoption of this issue did not have a material impact on the financial statements.

***Newly Issued but not yet Effective Accounting Standards***

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*. This issue requires that a liability be recorded during the service period when a split-dollar life insurance agreement continues after participants employment or retirement. The required accrued liability will be based on either the post-employment benefit cost for the continuing life insurance or based on the future death benefit depending on the contractual terms of the underlying agreement. This issue is effective for fiscal years beginning after December 15, 2007. Adoption of EITF Issue 06-4 is not expected to have a material effect on the Company s financial statements. In 2005, the Company began recognizing the cost of continuing life insurance coverage under split-dollar arrangements. The recorded liability for split-dollar life insurance coverage was

$1,249,000 and $1,082,000 at March 31, 2007 and 2006, respectively.

In September 2006, FASB issued Statement 157, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles ( GAAP ), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements, FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The adoption of this standard is not expected to have a material impact on the Company s financial statements.

In February 2007, FASB issued Statement 159, *The Fair Value Option for Financial Assets and Financial Liabilities.* This statement provides companies with an option to report selected financial assets and liabilities at fair value. The Standard s objective is to reduce both complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. The standard requires companies to provide additional information that will help investors and other users of financial statements to more easily understand the effect of the company s choice to use fair value on its earnings. It also requires entities to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. The new Statement does not eliminate disclosure requirements included in other accounting standards, including requirements for disclosures about fair value measurements included in Statements 157, *Fair Value Measurements,* and 107, *Disclosures about Fair Value of Financial Instruments.* This Statement is effective as of the beginning of an entity s first fiscal year that begins after November 15, 2007. The Company has not completed its evaluation of Statement 159 s potential effects on its financial statements.

## 2) Securities Available-for-Sale

The following table shows the gross unrealized losses and fair value of the Company s securities with unrealized losses aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at March 31, 2007:

| | Less Than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| | **Fair Value** | **Unrealized Losses** | **Fair Value** | **Unrealized Losses** | **Fair Value** | **Unrealized Losses** |
| | | | **(Dollars in thousands)** | | | |
| U.S. Treasuries | $ | $ | $ 6,000 | $ (15) | $ 6,000 | $ (15) |
| U.S. Government Agencies | 13,449 | (13) | 19,507 | (150) | 32,956 | (163) |
| Mortgage-Backed Securities | 6,257 | (27) | 70,486 | (2,604) | 76,743 | (2,631) |
| Municipals - Tax Exempt | | | 7,971 | (127) | 7,971 | (127) |
| Collateralized Mortgage Obligations | | | 3,272 | (134) | 3,272 | (134) |
| Total | $ 19,706 | $ (40) | $ 107,236 | $ (3,030) | $ 126,942 | $ (3,070) |

As of March 31, 2007, the Company held 95 securities, of which 65 had fair values below amortized cost. Fifty-six securities have been carried with an unrealized loss for over 12 months. Unrealized losses were primarily due to higher interest rates. No security sustained a downgrade in credit rating. The issuers are of high credit quality and all principal amounts are expected to be paid when securities mature. The fair value is expected to recover as the securities approach their maturity date and/or market rates decline. Because the Company has the ability and intent to hold these securities until a recovery of fair value, which may be maturity, the Company does not consider these securities to be other-than-temporarily impaired at March 31, 2007.

Securities classified as U.S. Government Agencies as of March 31, 2007 were issued by the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and the Federal Home Loan Bank.

The securities portfolio of the Company is also used as collateral to meet requirements imposed as a condition of deposit by some depositors such as political subdivisions (public funds) bankruptcy trustees and other contractual obligations such as repurchase agreements. Securities with fair value of $50,394,000 and $61,210,000 as of March 31, 2007 and 2006 were pledged to secure public and certain other deposits as required by law or contract and other contractual obligations. A portion of these deposits can only be secured by U.S. Treasury securities. The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or to otherwise mitigate interest rate risk.

### 3) Stock-Based Compensation

The Company has a stock option plan (the Plan ) for directors, officers, and key employees. The Plan provides for the grant of incentive and non-qualified stock options. The Plan provides that the option price for both incentive and non-qualified stock options will be determined by the Board of Directors at no less than the fair value at the date of grant. Options granted vest on a schedule determined by the Board of Directors at the time of grant. Generally, options vest over four years. All options expire no later than ten years from the date of grant. As of March 31, 2007, there are 415,793 shares available for future grants under the Plan. Option activity under the Plan is as follows:

| Total Stock Options | Number of Shares | | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life | | Aggregate Intrinsic Value |
|---|---|---|---|---|---|---|
| Options Outstanding at January 1, 2007 | 752,983 | $ | 16.56 | | | |
| Granted | 7,000 | $ | 27.17 | | | |
| Exercised | (14,885) | $ | 10.47 | | | |
| Forfeited or expired | (3,881) | $ | 22.78 | | | |
| Options Outstanding at March 31, 2007 | 741,217 | $ | 16.75 | 6.9 | $ | 6,478,000 |
| Exercisable at March 31, 2007 | 425,018 | $ | 13.37 | 5.6 | $ | 5,151,000 |

Information related to the stock option plan during the quarter ended March 31, 2007 and 2006 follows:

| | | 2007 | | 2006 |
|---|---|---|---|---|
| Intrinsic value of options exercised | $ | 220,000 | $ | 805,000 |
| Cash received from option exercise | $ | 156,000 | $ | 555,000 |
| Tax benefit realized from option exercises | $ | 78,000 | $ | 292,000 |
| Weighted average fair value of options granted | $ | 7.62 | $ | 8.56 |

As of March 31, 2007, there was $2,214,000 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Company s stock plan. That cost is expected to be recognized over a weighted-average period of approximately 2 years.

The following table presents the assumptions used to estimate the fair value of options granted during the three months periods ending March 31, 2007 and 2006, respectively:

| | 2007 | 2006 |
|---|---|---|
| Expected life in months (1) | 72 | 84 |
| Volatility (1) | 20% | 24% |
| Risk-free interest rate(2) | 4.71% | 4.56% |
| Expected dividends(3) | 0.88% | 0.89% |

---

(1) Estimate based on historical experience. Volatility is based on the historical volatility of the stock over the most recent period that is generally commensurate with the expected life of the option.

(2) Based on the U.S. Treasury constant maturity interest rate with a term consistent with the expected life of the options granted.

(3) The Company began paying cash dividends on common stock in 2006. Each grant s dividend yield is calculated by annualizing the most recent quarterly cash dividend and dividing that amount by the market price of the Company s common stock as of the grant date.

The Company estimates the impact of forfeitures based on the Company s historical experience with previously granted stock options in determining stock option expense. The Company issues new shares of common stock to satisfy stock option exercises.

The Company awarded 51,000 restricted shares of common stock to Walter T. Kaczmarek, President and Chief Executive Officer of the Company, pursuant to the terms of a Restricted Stock Agreement dated March 17, 2005. The grant price was $18.15. Under the terms of the Restricted Stock Agreement, the restricted shares will vest 25% per year at the end of years three, four, five and six, provided Mr. Kaczmarek is still with the Company. Compensation cost associated with the restricted stock issued is measured based on the market price of the stock at the grant date and is expensed on a straight-line basis over the service period. Restricted stock compensation expense for the three months ended March 31, 2007 and 2006 was $38,000.

## 4) Earnings Per Share

Basic earnings per share is computed by dividing net income by the weighted average common shares outstanding. Diluted earnings per share reflects potential dilution from outstanding stock options, using the treasury stock method. There were 220,946 and 132,224 stock options for three months ended March 31, 2007 and 2006, respectively, considered to be antidilutive and excluded from the computation of diluted earnings per share. For each of the periods presented, net income is the same for basic and diluted earnings per share. Reconciliation of weighted average shares used in computing basic and diluted earnings per share is as follows:

| | Three Months Ended March 31, | |
|---|---|---|
| | **2007** | **2006** |
| Weighted average common shares outstanding - used in computing basic earnings per share | 11,602,120 | 11,821,817 |
| Dilutive effect of stock options outstanding, using the treasury stock method | 218,515 | 217,721 |
| Shares used in computing diluted earnings per share | 11,820,635 | 12,039,538 |

## 5) Comprehensive Income

Comprehensive income includes net income and other comprehensive income, which represents the changes in net assets during the period from non-owner sources. The Company s sources of other comprehensive income are unrealized gains and losses on securities available-for-sale and I/O strips, which are treated like available-for-sale securities, and the liability related to the Company s supplemental retirement plan. The items in other comprehensive income are presented net of deferred income tax effects. Reclassification adjustments result from gains or losses on securities that were realized and included in net income of the current period that also had been included in other comprehensive income as unrealized gains and losses. The Company s comprehensive income was as follows:

11

| | Three Months Ended March 31, 2007 | 2006 |
|---|---|---|
| | (Dollars in thousands) | |
| Net Income | $ 4,033 | $ 4,376 |
| Other comprehensive income (loss): | | |
| Unrealized gains (losses) on available-for-sale of securities and I/O strips during the period | 462 | (1,186) |
| Deferred income tax | (194) | 498 |
| Net unrealized gains (losses) on available-for-sale securities and I/O strips, net of deferred income tax | 268 | (688) |
| | | |
| Pension liability adjustment during the period | 26 | 279 |
| Deferred income tax | (11) | (117) |
| Pension liability adjustment, net of deferred income tax | 15 | 162 |
| Other comprehensive income (loss) | 283 | (526) |
| Comprehensive income | $ 4,316 | $ 3,850 |

## 6) Supplemental Retirement Plan

The Company has a supplemental retirement plan covering current and former key executives and directors ( Plan ). The Plan is a nonqualified defined benefit plan. Benefits are unsecured as there are no Plan assets. The following table presents the amount of periodic cost recognized for the three months ended March 31, 2007 and 2006:

| | Three Months Ended March 31, 2007 | 2006 |
|---|---|---|
| | (Dollars in thousands) | |
| Components of net periodic benefits cost | | |
| Service cost | $ 184 | $ 200 |
| Interest cost | 155 | 138 |
| Prior service c | | |