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UNION BANKSHARES INC
Form 10-Q
November 14, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

OR

() TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended: September 30, 2006

Commission file number: 001-15985

UNION BANKSHARES, INC.

VERMONT 03-0283552

P.O. BOX 667
MAIN STREET
MORRISVILLE, VT 05661

Registrant's telephone number: 802-888-6600

Former name, former address and former fiscal year, if changed since last report: Not applicable

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No

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

(Check One):

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of November 3, 2006:

Common Stock, \$2 par value 4,538,240 shares

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PART I FINANCIAL INFORMATION

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and Subsidiary

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Part 1 Financial Information

Item 1. Financial Statements

UNION BANKSHARES, INC. AND SUBSIDIARY CONSOLIDATED BALANCE SHEETS

	(Unaudited) September 30, 2006	December 31 2005
	-----	-----
Assets	(Dollars in thousands)	
Cash and due from banks	\$ 10,345	\$ 14,019
Federal funds sold and overnight deposits	5,304	189
	-----	-----
Cash and cash equivalents	15,649	14,208
Interest bearing deposits in banks	6,107	8,598
Investment securities available-for-sale	22,323	32,408
Loans held for sale	2,423	6,546
Loans	315,592	300,677
Allowance for loan losses	(3,324)	(3,071)
Unearned net loan fees	(127)	(152)
	-----	-----
Net loans	312,141	297,454
Accrued interest receivable	1,871	1,972
Premises and equipment, net	5,994	5,898
Other assets	8,531	7,662
	-----	-----

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Total assets	\$375,039	\$374,746
	=====	=====
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Non-interest bearing	\$ 50,492	\$ 52,617
Interest bearing	258,440	260,682
	-----	-----
Total deposits	308,932	313,299
Borrowed funds	19,075	16,256
Accrued interest and other liabilities	4,397	3,588
	-----	-----
Total liabilities	332,404	333,143
	-----	-----
Commitments and Contingencies		
Stockholders' Equity		
Common stock, \$2.00 par value; 5,000,000 shares authorized; 4,918,611 shares issued at 9/30/06 and 12/31/05	9,837	9,837
Paid-in capital	147	140
Retained earnings	34,888	33,761
Treasury stock at cost; 377,871 shares at 9/30/06 and 375,948 at 12/31/05	(2,079)	(2,037)
Accumulated other comprehensive loss	(158)	(98)
	-----	-----
Total stockholders' equity	42,635	41,603
	-----	-----
Total liabilities and stockholders' equity	\$375,039	\$374,746
	=====	=====

See accompanying notes to the unaudited consolidated financial statements.

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UNION BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENT OF INCOME
(Unaudited)

	Three Months Ended		Nine
	September 30,		Sep
	2006	2005	2006
	----	----	----
	(Dollars in thousands except Per		
Interest income			
Interest and fees on loans	\$ 6,122	\$ 5,241	\$ 17,4
Interest on debt securities			
Taxable	188	303	7
Tax exempt	47	45	1
Dividends	49	24	
Interest on federal funds sold and overnight deposits	67	98	1
Interest on interest bearing deposits in banks	61	71	2
	-----	-----	-----

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Total interest income	6,534	5,782	18,7
	-----	-----	-----
Interest expense			
Interest on deposits	1,532	1,108	4,1
Interest on borrowed funds	287	160	7
	-----	-----	-----
Total interest expense	1,819	1,268	4,8
	-----	-----	-----
Net interest income	4,715	4,514	13,8
	-----	-----	-----
Provision for loan losses	-	-	1
	-----	-----	-----
Net interest income after provision for loan losses	4,715	4,514	13,6
	-----	-----	-----
Noninterest income			
Trust income	74	67	2
Service fees	787	756	2,2
Net gains on sales of investment securities	5	-	2
Net gains on sales of loans held for sale	108	48	2
Other income	19	29	1
	-----	-----	-----
Total noninterest income	993	900	2,9
	-----	-----	-----
Noninterest expenses			
Salaries and wages	1,536	1,444	4,5
Pension and employee benefits	541	497	1,6
Occupancy expense, net	184	190	5
Equipment expense	269	277	7
Other expenses	893	944	2,6
	-----	-----	-----
Total noninterest expense	3,423	3,352	10,2
	-----	-----	-----
Income before provision for income taxes	2,285	2,062	6,3
	-----	-----	-----
Provision for income taxes	623	568	1,6
	-----	-----	-----
Net income	\$ 1,662	\$ 1,494	\$ 4,6
	=====	=====	=====
Earnings per common share	\$ 0.37	\$ 0.33	\$ 1.
	=====	=====	=====
Weighted average number of common shares outstanding	4,540,740	4,554,663	4,541,0
	=====	=====	=====
Dividends per common share	\$ 0.26	\$ 0.24	\$ 0.
	=====	=====	=====

See accompanying notes to the unaudited consolidated financial statements.

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(Unaudited)

	Common Stock				
	Shares, net of Treasury	Amount	Paid-in capital	Retained earnings	Treasury stock
	-----	-----	-----	-----	-----
	(Dollars in thousands)				
Balances, December 31, 2005	4,542,663	\$9,837	\$140	\$33,761	\$(2,037)
Comprehensive income:					
Net income	-	-	-	4,669	-
Change in net unrealized loss on investment securities available-for-sale, net of reclassification adjustment and tax effects	-	-	-	-	-
Total comprehensive income	-	-	-	-	-
Cash dividends declared (\$0.78 per share)	-	-	-	(3,542)	-
Issuance of stock options	-	-	7	-	-
Purchase of treasury stock	(1,923)	-	-	-	(42)
	-----	-----	-----	-----	-----
Balances, September 30, 2006	4,540,740	\$9,837	\$147	\$34,888	\$(2,079)
	=====	=====	=====	=====	=====

See accompanying notes to the unaudited consolidated financial statements.

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UNION BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended	
	September 30, 2006	September 30, 2005
	----	----
	(Dollars in thousands)	
Cash Flows From Operating Activities		
Net Income	\$ 4,669	\$ 4,322
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation	585	588
Provision for loan losses	150	-

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Credit for deferred income taxes	(109)	(212)
Net amortization on investment securities	55	112
Equity in losses of limited partnerships	231	156
Issuance of stock options	7	-
Decrease in unamortized loan fees	(26)	(11)
Proceeds from sales of loans held for sale	15,476	13,810
Origination of loans held for sale	(11,127)	(12,116)
Net gain on sales of investment securities	(22)	(1)
Net gain on sales of loans held for sale	(227)	(167)
Net gain on disposals of premises and equipment	(6)	(2)
Decrease (increase) in accrued interest receivable	101	(205)
Increase in other assets	(341)	(115)
Increase (decrease) in income taxes	153	(105)
Decrease in accrued interest payable	289	89
Increase in other liabilities	369	749
	-----	-----
Net cash provided by operating activities	10,227	6,892
	-----	-----
Cash Flows From Investing Activities		
Interest bearing deposits in banks		
Maturities and redemptions	2,788	1,581
Purchases	(297)	(6,151)
Investment securities available-for-sale		
Sales	7,594	1,994
Maturities, calls and paydowns	3,321	11,297
Purchases	(954)	(7,611)
Net purchase of Federal Home Loan Bank stock	(443)	-
Increase in loans, net	(15,156)	(18,807)
Recoveries of loans charged off	152	43
Purchases of premises and equipment	(683)	(875)
Investments in limited partnerships	-	(142)

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	Nine Months Ended	
	September 30,	September 30,
	2006	2005
	----	----
	(Dollars in thousands)	
Proceeds from sales of premises and equipment	9	2
Proceeds from sales of repossessed property	15	11
	-----	-----
Net cash used in investing activities	(3,654)	(18,658)
	-----	-----
Cash Flows From Financing Activities		
Increase in borrowings outstanding, net	2,819	5,605
Net decrease in non-interest bearing deposits	(2,125)	(6,031)
Net (decrease) increase in interest bearing deposits	(2,242)	17,339
Purchase of treasury stock	(42)	-
		-
Dividends paid	(3,542)	(5,102)
	-----	-----

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Net cash (used in) provided by in financing activities	(5,132)	11,811
	-----	-----
Increase in cash and cash equivalents	1,441	45
Cash and cash equivalents		
Beginning	14,208	21,117
	-----	-----
Ending	\$ 15,649	\$ 21,162
	=====	=====
Supplemental Disclosures of Cash Flow Information		
Interest paid	\$ 4,588	\$ 3,061
	=====	=====
Income taxes paid	\$ 1,685	\$ 1,001
	=====	=====
Supplemental Schedule of Noncash Investing and Financing Activities		
Investment in limited partnerships acquired by capital contributions payable	-	\$ (748)
	=====	=====
Change in unrealized losses on investment securities available-for-sale	\$ (90)	\$ (230)
	=====	=====
Other real estate acquired in settlement of loans	\$ 177	\$ 244
	=====	=====
Repossessed property acquired in settlement of loans	\$ 15	\$ 12
	=====	=====

See accompanying notes to the unaudited consolidated financial statements.

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UNION BANKSHARES, INC. AND SUBSIDIARY

Note 1. Basis of Presentation

The accompanying interim unaudited consolidated financial statements of Union Bankshares, Inc. (the Company) for the interim periods ended September 30, 2006 and 2005, and for the quarters then ended have been prepared in conformity with U.S. generally accepted accounting principles (GAAP), general practices within the banking industry, and the accounting policies described in the Company's Annual Report to Shareholders and Annual Report on Form 10-K for the year ended December 31, 2005. In the opinion of the Company's management, all adjustments, consisting only of normal recurring adjustments and disclosures necessary for a fair presentation of the information contained herein have been made. This information should be read in conjunction with the Company's 2005 Annual Report to Shareholders, 2005 Annual Report on Form 10-K, and current reports on Form 8-K. The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2006, or any other interim period.

Certain amounts in the 2005 consolidated financial statements have been reclassified to conform to the 2006 presentation.

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Note 2. Commitments and Contingencies

In the normal course of business, the Company is involved in various legal proceedings. In the opinion of management, any liability resulting from such proceedings would not have a material adverse effect on the Company's financial condition or results of operations.

Note 3. Per Share Information

Earnings per common share amounts are computed based on the weighted average number of shares of common stock outstanding during the period and reduced for shares held in treasury. The assumed conversion of available stock options does not result in material dilution.

Note 4. New Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (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). The Statement requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. This Statement also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions.

This Statement will require the Company to recognize the funded status of a benefit plan--measured as the difference between plan assets at fair value (with limited exceptions) and the benefit obligation--in its statement of financial position. For a pension plan, the benefit obligation is the projected benefit obligation. Recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to FASB Statement No. 87, Employers' Accounting for Pensions. Amounts recognized in accumulated other comprehensive income, including the gains or losses and prior service costs or credits, are adjusted as they are subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization provisions of those Statements. Measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end statement of financial position (with limited exceptions). Disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses and prior service costs or credits.

The Company is required to initially recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of 2006. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end is effective beginning in the Company's 2008 fiscal year. The Company is currently evaluating the impact of this new standard to determine its effects on the Company's consolidated financial statements.

In September 2006, the FASB issued SFAS No. 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. Accordingly, this Statement does not require any new fair value measurements. However, for some entities, the application of this Statement will change current practice.

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This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the impact of this new standard to determine its effects, if any, on the Company's consolidated financial statements.

In September 2006, the Securities and Exchange Commission (SEC) issued SEC Staff Accounting Bulletin (SAB) No. 108 - Financial Statements - Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements. SAB 108 addresses the diversity in practice of evaluating and quantifying financial statement misstatements and the related accumulation of such misstatements. SAB No.108 states that both a balance sheet and an income statement approach should be used when quantifying and evaluating the materiality of a potential misstatement and contains guidance for correcting errors under this dual approach. SAB No. 108 is effective for the Company's financial statements for the fiscal year beginning January 1, 2007. Management does not expect the adoption of SAB No. 108 to have a significant impact on the consolidated financial statements.

In June 2006, the FASB issued Interpretation No. 48 ("FIN 48") "Accounting for Uncertainty in Income Taxes," which clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. FIN 48 provides guidance on the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of this new standard to determine its effects, if any, on the Company's consolidated financial statements.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets, an amendment of SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, with respect to the accounting for separately recognized servicing assets and servicing liabilities. The Statement 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. It requires all separately recognized servicing assets and liabilities to be initially measured at fair value, if practicable. It permits an entity to choose either the amortization method or the fair value measurement method for each class of separately recognized servicing assets and liabilities and requires additional disclosures in the financial statements under the fair value measurement method. SFAS No. 156 is effective for fiscal years beginning after September 15, 2006, with early adoption permitted. The Company does not believe the adoption of SFAS No. 156 will have a material impact on the Company's financial position or results of operations but is still in the process of analyzing that impact.

Note 5. Stock Option Plan

In December 2005 the Company adopted SFAS No. 123R Share Based Payment using the modified prospective application. Under SFAS 123R, the Company must recognize as compensation expense the grant date fair value of stock-based awards over the vesting period of the awards. Prior to the adoption of SFAS No. 123R the Company accounted for its stock option plan in accordance with the provisions of APB Opinion No. 25, Accounting for Stock Issued to Employees as allowed under SFAS No. 123 Accounting for Stock-Based Compensation. Under APB Opinion No. 25, the Company provided pro forma net income disclosures for employee stock-based awards granted on or after January 1, 1995 as if the fair value based method defined in SFAS No. 123 had been applied.

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Had compensation cost been determined on the basis of fair value pursuant to SFAS No.123R, the effects on net income and earnings per common share for the three and nine months ended September 30, 2005 would have been:

	Three Months Ended 2005	Nine Months Ended 2005
	----- (Dollars in thousands)	
Net income as reported	\$1,494	\$4,322
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects	-	-
	-----	-----
Pro forma net income	\$1,494 =====	\$4,322 =====
Earnings per common share		
As reported	\$ 0.33	\$ 0.95
Pro forma	\$ 0.33	\$ 0.95

Note 6. Defined Benefit Pension Plan

Union Bank (Union), the Company's bank subsidiary, sponsors a non-contributory defined benefit pension plan covering all eligible employees. The plan provides defined benefits based on years of service and final average salary.

Net periodic pension benefit cost for the three and nine months ended September 30, 2006 and 2005 consisted of the following components:

	Three Months Ended		Nine Months Ended	
	2006	2005	2006	2005
	----- (Dollars in thousands)			
Service cost	\$ 129	\$ 116	\$ 371	\$ 348
Interest cost on projected benefit obligation	131	120	406	362
Expected return on plan assets	(122)	(107)	(364)	(321)
Amortization of prior service cost	1	1	4	5
Amortization of net loss	21	15	63	45
	-----	-----	-----	-----
Net periodic benefit cost	\$ 160 =====	\$ 145 =====	\$ 480 =====	\$ 439 =====

Note 7. Other Comprehensive Loss

The components of other comprehensive loss and related tax effects for the three and nine months periods ended September 30, 2006 and 2005 are as follows:

	Three Months Ended	Nine Months Ended

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	2006	2005	2006	2005
	----	----	----	----
	(Dollars in thousands)			
Unrealized holding gains (losses) on investment securities available-for-sale	\$ 327	\$ 26	\$ (69)	\$ (228)
Reclassification adjustment for gains realized in income	(5)	-	(22)	(1)
	-----	-----	-----	-----
Net unrealized gains (losses)	322	26	(91)	(229)
Tax effect	(109)	(9)	31	78
	-----	-----	-----	-----
Net of tax amount	\$ 213	\$ 17	\$ (60)	\$ (151)
	=====	=====	=====	=====

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

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

GENERAL

The following discussion and analysis by management focuses on those factors that had a material effect on Union Bankshares, Inc.'s (the Company's) financial position as of September 30, 2006, and as of December 31, 2005, and its results of operations for the three and nine months ended September 30, 2006 and 2005. This discussion is being presented to provide a narrative explanation of the financial statements and should be read in conjunction with the financial statements and related notes and with other financial data appearing elsewhere in this filing and with the Company's Annual Report on Form 10-K for the year ended December 31, 2005. In the opinion of Company's management, the interim unaudited data reflects all adjustments, consisting only of normal recurring adjustments, and disclosures necessary to fairly present the Company's consolidated financial position and results of operations for the interim period. Management is not aware of the occurrence of any events after September 30, 2006, which would materially affect the information presented.

CAUTIONARY ADVICE ABOUT FORWARD LOOKING STATEMENTS

The Company may from time to time make written or oral statements that are considered "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements may include financial projections, statements of plans and objectives for future operations, estimates of future economic performance and assumptions relating thereto. The Company may include forward-looking statements in its filings with the Securities and Exchange Commission (SEC), in its reports to stockholders, including this Quarterly Report, in other written materials, and in statements made by senior management to analysts, rating agencies, institutional investors, representatives of the media and others.

Forward-looking statements reflect management's current expectations and are subject to uncertainties, both general and specific, and risk exists that those predictions, forecasts, projections and other estimates contained in forward-looking statements will not be achieved. When management uses any of the words "believes," "expects," "anticipates," "intends," "plans," "seeks,"

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"estimates", or similar expressions, they are making forward-looking statements. Many possible events or factors, including those beyond the control of management, could affect the future financial results and performance of the Company. This could cause results or performance to differ materially from those expressed in forward-looking statements. The possible events or factors that might affect forward-looking statements include, but are not limited to, the following:

- o uses of monetary, fiscal, and tax policy by various governments;
- o political, legislative, or regulatory developments in Vermont, New Hampshire, or the United States including changes in laws concerning accounting, taxes, banking, and other aspects of the financial services industry;
- o developments in general economic or business conditions nationally, in Vermont, or in northern New Hampshire, including interest rate fluctuations, market fluctuations and perceptions, job creation and unemployment rates, ability to attract new business, and inflation and their effects on the Company or its customers;
- o changes in the competitive environment for financial services organizations, including increased competition from tax-advantaged credit unions;
- o the Company's ability to attract and retain key personnel;
- o changes in technology, including demands for greater automation which could present operational issues or significant capital outlays;
- o acts or threats of terrorism or war, and actions taken by the United States or other governments that might adversely affect business or economic conditions for the Company or its customers;
- o adverse changes in the securities market which could adversely affect the value of the Company's stock;

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- o changes in accounting rules and standards and regulatory requirements for financial reporting;
- o increased competition within the Company's market area to provide financial services;
- o the ability to retain and attract deposits;
- o illegal acts of theft or fraud perpetrated against the bank or its customers;
- o unanticipated lower revenues or increased cost of funds, loss of customers or business, or higher operating expenses;
- o the failure of assumptions underlying the establishment of the allowance for loan losses and estimations of values of collateral and various financial assets and liabilities;
- o the amount invested in new business opportunities and the timing of these investments;
- o the failure of actuarial, investment, work force, salary, and other assumptions underlying the establishment of reserves for future pension costs or changes in legislative or regulatory requirements;
- o future cash requirements might be higher than anticipated due to loan commitments or unused lines of credit being drawn upon or depositors withdrawing their funds;
- o assumptions made regarding interest rate movement and sensitivity could vary substantially if actual experience differs from historical experience which could adversely affect the Company's results of operations; and
- o the creditworthiness of current loan customers is different from management's understanding or changes dramatically and therefore the allowance for loan losses becomes inadequate.

When evaluating forward-looking statements to make decisions with respect to

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the Company, investors and others are cautioned to consider these and other risks and uncertainties and are reminded not to place undue reliance on such statements. Forward-looking statements speak only as of the date they are made and the Company undertakes no obligation to update them to reflect new or changed information or events, except as may be required by federal securities laws.

CRITICAL ACCOUNTING POLICIES

The Company has established various accounting policies which govern the application of accounting principles generally accepted in the United States of America in the preparation of the Company's financial statements. Certain accounting policies involve significant judgments and assumptions by management which have a material impact on the reported amount of assets, liabilities, revenues and expenses and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying related notes. The SEC has defined a company's critical accounting policies as the ones that are most important to the portrayal of the company's financial condition and results of operations, and which require the company to make its most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Based on this definition, the Company has identified the accounting policies and judgments most critical to the Company. The judgments and assumptions used by management are based on historical experience and other factors, which are believed to be reasonable under the circumstances. Because of the nature of the judgments and assumptions made by management, actual results could differ from estimates and have a material impact on the carrying value of assets, liabilities, or the results of operations of the Company.

The Company believes the allowance for loan losses is a critical accounting policy that requires the most significant judgments and estimates used in the preparation of its consolidated financial statements. In estimating the allowance for loan losses, management utilizes historical experience as well as other factors including the effect of changes in the local real estate market on collateral values, the effect on the loan portfolio of current economic indicators and their probable impact on borrowers and changes in delinquent, nonperforming or impaired loans. Changes in these factors may cause management's estimate of the allowance for loan losses to increase or decrease and result in adjustments to the Company's provision for loan losses in future periods. For additional information see, FINANCIAL CONDITION - Allowance for Loan Losses below. The Company also has other key accounting policies, which involve the use of estimates, judgments and assumptions that are significant to understanding the Company's results of operation and financial condition, including the liability for the defined benefit pension plan, valuation of deferred tax assets and analysis of potential impairment of investment securities. Although management believes that its estimates, assumptions and judgments are

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reasonable, they are based upon information presently available. Actual results may differ significantly from these estimates under different assumptions, judgments or conditions.

OVERVIEW

The Company's net income was \$1.66 million for the quarter ended September 30, 2006, compared with net income of \$1.49 million for the same period of 2005, or an 11.2% increase between years. The Company's net income for the nine months ended September 30, 2006 was \$4.67 million, compared with net income of \$4.32 million for the same period of 2005, or an 8.0% increase between years. Despite

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a challenging interest rate environment, the year to date increase in net interest income of \$708 thousand was achieved by an increase in total interest income of \$2.4 million, or 15.0% in 2006 versus 2005, while interest expense increased \$1.7 million or 54.8%. Interest rates have continued to rise throughout 2006 with four twenty-five basis point increases in the prime rate during the first half of the year and has remained flat at 8.25% since June 29, 2006. The Company had an increase in its net interest margin from 5.26% for the third quarter of 2005 to 5.45% for the third quarter of 2006. The net interest margin on a year to date basis grew from 5.30% for 2005 to 5.40% for 2006. Although the year-to-date net interest spread was down 5 basis points to 4.93% compared to the September 30, 2005 level of 4.98%, it was slightly higher for the third quarter of 2006, at 4.92%, up by 1 basis point compared to the third quarter of 2005. A reduction in interest rates in the short term would not necessarily be in the Company's best interest. Managing the interest margin in the current rate environment will be a challenge.

The 2006 year-to-date results also reflect the \$150 thousand provision for loan losses (none in the third quarter of 2006) compared to none in 2005. The increase in the provision for loan losses was mainly necessitated by the growth in construction and residential real estate loans between years, a change in the composition of the loans within the portfolio and an increase of \$1.4 million in classified and problem loans.

Also contributing to the increase in net income for the quarter was an increase in non-interest income of \$93 thousand compared to the third quarter of 2005. Non-interest income earned for the quarter was partially offset by the increase of \$71 thousand in non-interest expenses. For additional information see quarterly results analysis beginning on page 13. Regular quarterly cash dividends of \$0.26 per share were declared and paid in January, April, and July 2006. The dividend was increased to \$0.28 per share for the quarterly dividend declared and paid in October 2006.

The Company's total assets increased from \$374.7 million at December 31, 2005, to \$375.0 million at September 30, 2006. Deposits decreased from \$313.3 million at December 31, 2005 to \$308.9 million at September 30, 2006, or a decrease of 1.4%. While the customer relationships we have with the State of Vermont and the local municipalities and school districts are fairly stable, the dollar level of deposits tends to vary widely based on their cash flow needs. Municipal deposits were \$32.0 million at December 31, 2005 and \$26.8 million at September 30, 2006.

With the Company's loan-to-deposit ratio over 100% at September 30, 2006, deposit generation to fund loan demand has become an area of focus as deposits, which provide a lower cost funding source than borrowings or other purchased funds, have declined during the first nine months of 2006. Rates paid to attract deposits have risen rapidly over the last nine months. As generational wealth transfers to younger individuals who tend to be more widely diversified in their investment portfolio, retaining and attracting deposits may become more difficult. During the third quarter of 2006, the Company introduced two new certificate of deposit products that offer a variable rate of interest. Initial customer reaction to these products has been positive. Loans and loans held for sale increased \$10.8 million year to date, net of the sale of \$15.2 million in commercial and residential real estate loans during the first nine months of 2006. Gross average loans for the first nine months of 2006 were \$315.6 million compared to the 2005 average of \$285.0 million reflecting the continuing high demand for loans despite rising interest rates. Investment securities available-for-sale decreased \$10.1 million, as maturities and sales in the investment portfolio were utilized to fund loan demand. The increase in loans was also funded by a decrease in interest bearing deposits in banks of \$2.5 million, and an increase in Borrowed Funds of \$2.8 million.

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The following unaudited per share information and key ratios depict several measurements of performance or financial condition for or at the quarters and nine months ended September 30, 2006 and 2005, respectively:

	Quarter Ended	
	September 30,	
	2006	2005
	-----	-----
Return on average assets (ROA) (1)	1.77%	1.60%
Return on average equity (ROE) (1)	15.83%	14.57%
Net interest margin (1) (2)	5.45%	5.26%
Efficiency ratio (3)	58.91%	61.91%
Net interest spread (4)	4.92%	4.91%
Loan to deposit ratio	102.94%	93.48%
Net loan charge-offs (recoveries) to average loans not held for sale	(0.11%)	0.00%
Allowance for loan losses to loans not held for sale	1.05%	1.04%
Non-performing assets to total assets	1.22%	1.00%
Equity to assets	11.37%	11.00%
Total capital to risk weighted assets	17.54%	17.32%
Book value per share	\$9.39	\$9.11
Earnings per share	\$0.37	\$0.33
Dividends paid per share (5)	\$0.26	\$0.24
Dividend payout ratio (6)	70.27%	72.73%