TREATY OAK BANCORP INC
Form 10QSB
May 15, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-QSB

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2007

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

Commission File Number: 333-112325

Treaty Oak Bancorp, Inc.

(Exact name of registrant as specified in its charter)

Texas
(State or other jurisdiction of
corporation or organization)

20-0413144
(I.R.S. Employer Identification Number)

101 Westlake Drive, Austin, Texas
(Address of Principal Executive Offices)

78746
(Zip Code)

(512) 617-3600
(Registrant s telephone number, including area code)

Indicate by check mark whether the issuer (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 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**

Indicate the number of shares outstanding of each of the issuer s classes of common stock as of the close of business on May 10, 2007.

$0.01 Par Value Common Stock	2,748,414 shares

Transitional Small Business Disclosure Format (Check one): **Yes o No x**

QUARTERLY REPORT ON FORM 10-QSB
FOR THE PERIOD ENDED MARCH 31, 2007

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This Form 10-QSB contains forward-looking statements consisting of estimates with respect to the financial condition, results of operations, and other business of Treaty Oak Bancorp, Inc., that are subject to various factors which could cause actual results to differ materially from those estimates. Factors that could influence the estimates include changes in the national, regional, and local market conditions, legislative and regulatory conditions, and an adverse interest rate environment.

Treaty Oak Bancorp, Inc.
Consolidated Balance Sheets (unaudited)
March 31, 2007 and September 30, 2006
(Dollars In Thousands, Except Par Value and Share Amounts)

	March 31, 2007	September 30, 2006(1)
ASSETS		
Cash and cash items	$ 278	$ 267
Due from banks	2,563	2,312
Federal funds sold	8,827	23,775
Total cash and cash equivalents	11,668	26,354
Securities available for sale	13	16
Securities held to maturity, fair value of $1,447 and $2,001, respectively	1,448	2,006
Investment in Federal Home Loan Bank stock, at cost	224	224
Investment in Independent Banker s Financial Corporation stock, at cost	102	102
Loans, net	73,152	59,620
Premises and equipment, net	5,543	5,593
Note receivable from affiliate		2,821
Accrued interest receivable	645	484
Due from affiliates		192
Goodwill and other intangibles, net	1,200	1,205
Other assets	767	474
Total assets	$ 94,762	$ 99,091
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits:		
Noninterest-bearing demand	$ 21,526	$ 28,091
NOW, money market and savings	24,199	32,401
Time deposits	27,483	20,526
Total deposits	73,208	81,018
Accounts payable and accrued expenses	323	352
Accrued interest payable	238	160
Federal funds purchased	5,000	
Property mortgage	2,636	2,667
Notes payable		2,483
Minority interest - PGI Equity Partners, LP		1,106
Other liabilities	31	33
Total liabilities	81,436	87,819
Shareholders equity:		
Preferred stock, $0.01 par value; 1,000,000 shares authorized; none issued		
Common stock, $0.01 par value; 20,000,000 shares authorized; 2,740,131 and 2,640,226, respectively, issued	27	26
Paid-in capital	16,878	14,989
Accumulated deficit	(3,529)	(3,693)
Less shares held in treasury, at cost (6,003 shares)	(50)	(50)
Total shareholders equity	13,326	11,272
Total liabilities and shareholders equity	$ 94,762	$ 99,091

(1) Derived from Audited Consolidated Financial Statements

See Notes to Consolidated Financial Statements (unaudited)

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Treaty Oak Bancorp, Inc.
Consolidated Statements of Operations (unaudited)
Three Months and Six Months Ended March 31, 2007 and 2006
(Dollars In Thousands, Except Share and Per Share Amounts)

	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006	Six Months Ended March 31, 2007	Six Months Ended March 31, 2006
Interest income:				
Loans, including fees	$ 1,599	$ 950	$ 3,144	$ 1,772
Taxable securities	17	25	31	57
Interest on deposits with other banks		20		56
Federal funds sold	82	71	308	107
Total interest income	1,698	1,066	3,483	1,992
Interest expense:				
Deposits	544	207	1,109	381
Other borrowings	40	41	107	83
Total interest expense	584	248	1,216	464
Net interest income	1,114	818	2,267	1,528
Provision for loan losses	70	45	145	90
Net interest income after provision for loan losses	1,044	773	2,122	1,438
Noninterest income:				
Service charges on deposit accounts	39	19	72	39
Other noninterest income	61	102	133	197
Total noninterest income	100	121	205	236
Noninterest expense:				
Salaries and employee benefits	615	442	1,141	833
Occupancy and equipment expenses	101	114	213	175
Accounting and other professional fees	47	52	102	176
Other noninterest expense	353	262	707	540
Total noninterest expense	1,116	870	2,163	1,724
Net income (loss)	$ 28	$ 24	$ 164	$ (50)
Earnings (loss) per common share - basic	$ 0.01	$ 0.01	$ 0.06	$ (0.02)
Earnings (loss) per common share - diluted	$ 0.01	$ 0.01	$ 0.06	$ (0.02)
Weighted average shares outstanding - basic	2,733,222	2,635,887	2,707,665	2,635,816
Weighted average shares outstanding - diluted	2,963,399	2,637,882	2,869,690	2,660,599

See Notes to Consolidated Financial Statements (unaudited)

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Treaty Oak Bancorp, Inc.
Consolidated Statement of Shareholders Equity (unaudited)
Six Months Ended March 31, 2007
(Dollars In Thousands, Except Share Amounts)

	Common Stock Shares	Amount	Additional Paid-In Capital	Accumulated Deficit	Treasury Stock	Total
Balances at October 1, 2006	2,640,226	$ 26	$ 14,989	$ (3,693)	$ (50)	$ 11,272
Shares issued from Treaty Oak Holdings merger	1,094,163	11	9,082			9,093
Shares retired from Treaty Oak Holdings merger	(1,000,000)	(10)	(8,300)			(8,310)
Warrants and options from Treaty Oak Holdings merger			932			932
Shares issued through the exercise of common stock warrants	3,341		33			33
Non-cash stock based compensation			133			133
Shares issued for services provided	2,401		9			9
Net income				164		164
Balances at March 31, 2007	2,740,131	$ 27	$ 16,878	$ (3,529)	$ (50)	$ 13,326

See Notes to Consolidated Financial Statements (unaudited)

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Treaty Oak Bancorp, Inc.
Consolidated Statements of Cash Flows (unaudited)
Six Months Ended March 31, 2007 and 2006
(Dollars In Thousands)

	Six Months Ended March 31, 2007	Six Months Ended March 31, 2006
Cash flows from operating activities:		
Net income (loss)	$ 164	$ (50)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for loan losses	145	90
Non-cash stock based compensation	142	
Depreciation and amortization	183	176
Other	(7)	9
Changes in other operating assets and liabilities:		
Accrued interest receivable	(118)	(3)
Other assets	(229)	(80)
Accrued interest payable	77	(5)
Other liabilities	(111)	96
Net cash provided by operating activities	246	233
Cash flows from investing activities:		
Proceeds from maturities and principal repayments on securities - available for sale	3	10
Proceeds from maturities and principal repayments on securities - held to maturity	2,001	997
Purchases of securities - held to maturity	(1,443)	
Acquistion of interest in PGI Equity Partners, LP		(80)
Purchases of correspondent bank stock		(7)
Net increase in loans	(13,610)	(12,940)
Cash received from the acquistion of Treaty Oak Holdings, Inc.	515	
(Advances to) repayments from affiliates	194	(411)
Collection of notes receivable from affiliates	2,821	
Purchases of premises and equipment	(122)	(34)
Net cash used in investing activities	(9,641)	(12,465)
Cash flows from financing activities:		
Net increase (decrease) in deposits	(7,810)	10,768
Increase in federal funds purchased	5,000	
Payments of principal on mortgage	(31)	
Payments of principal on notes payable	(2,483)	(39)
Proceeds from exercise of warrants	33	2
Net cash provided by (used in) in financing activities	(5,291)	10,731
Net decrease in cash and cash equivalents	(14,686)	(1,501)
Cash and cash equivalents at beginning of period	26,354	13,107
Cash and cash equivalents at end of period	$ 11,668	$ 11,606

Treaty Oak Bancorp, Inc.
Consolidated Statements of Cash Flows (unaudited)
Six Months Ended March 31, 2007 and 2006
(Dollars In Thousands)

	Six Months Ended March 31, 2007	Six Months Ended March 31, 2006
Supplemental disclosures of cash flow information:		
Non-cash investing and financing information:		
Cash interest received	$ 3,322	$ 1,525
Cash interest paid	$ 1,138	$ 469
Acquisition of Treaty Oak Holdings, Inc.		
Assets acquired, excluding cash acquired	$ 1,280	
Liabilities assumed	(80)	
Issuance of common stock	(9,093)	
Retirement of comon stock	8,310	
Issuance of warrants and assumption of options	(932)	
Net cash acquired	$ (515)	

See Notes to Consolidated Financial Statements (unaudited)

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Treaty Oak Bancorp, Inc.
Notes to Consolidated Financial Statements (unaudited)

Note 1. Basis of Presentation

Treaty Oak Bancorp, Inc. (the Company) is a bank holding company incorporated on November 18, 2003, and organized December 8, 2003 for the purpose of holding the common stock of Treaty Oak Bank (formerly Texline State Bank, the Bank). The Company, through Treaty Oak Bank, provides a full range of commercial and consumer banking services to individuals and businesses in the commercial sector in Austin, Texas, and in the agriculture, cattle and commercial sectors in the community of Texline, Texas.

On November 15, 2006, the Company completed its acquisition of Treaty Oak Holdings, Inc. (TOHI) pursuant to the Agreement and Plan of Merger, dated October 3, 2006 (the Merger Agreement). The merger was approved by the Company s Board of Directors and also by the Company s shareholders at a Special Meeting of Shareholders held on October 24, 2006. Prior to the merger, TOHI operated as a bank holding company and significant shareholder of the Company, but otherwise had no active operations. As a result of the merger, the Company now owns TOHI s subsidiary companies, Treaty Oak Financial Holdings, Inc. (TOFHI) and PGI Capital, Inc. These entities have been consolidated in the Company s financial statements since the merger on November 15, 2006. TOFHI is an inactive corporate entity with assets of cash and a note receivable. PGI Capital, Inc. is the general partner of PGI Equity Partners, LP, the entity which owns the Company s corporate headquarters.

The Company acquired a 47.5% interest in PGI Equity Partners, LP (the Partnership) on December 31, 2004. The Partnership owns and operates the building in which the Company offices. On February 23, 2006, the Company acquired additional 2.5% Class A and 1.25% Class B interests in the Partnership from the sole remaining minority shareholder, bringing the Company s total ownership interest in the Partnership to 51.25% at September 30, 2006. TOHI owned 43.25% of the limited partnership interests, while PGI Capital, Inc. owned the remaining 0.5% limited partnership interest. Thus, following the Company s merger with TOHI on November 15, 2006, the Company now owns 100.0% of the limited partnership interests in the Partnership as well as the 5.0% general partnership interest held by PGI Capital, Inc., the Partnership s general partner. The Partnership has been consolidated in the Company s financial statements since December 31, 2004. TOHI and PGI Capital, Inc. s interests have been accounted for as minority interests until the merger on November 15, 2006.

The consolidated financial statements include the accounts of Treaty Oak Bancorp, Inc., its wholly owned subsidiary Treaty Oak Bank, and PGI Equity Partners, LP. The consolidated financial statements also include the accounts of PGI Capital, Inc. and TOFHI subsequent to the merger on November 15, 2006.

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions to Form 10-QSB and, therefore, do not include all of the disclosures and notes required by accounting principles generally accepted in the United States of America. In the opinion of management, all material adjustments (which are of a normal recurring nature) considered necessary for a fair presentation have been made. The results for the interim period are not necessarily indicative of the results to be expected for the entire year or any other interim period.

New Accounting Pronouncements

The Company adopted Financial Accounting Standards Board Statement No. 123R, Share-Based Payment , (Statement 123R) on October 1, 2006. Under Statement 123R, the cost of employee services received in exchange for an award of equity instruments is based on the grant-date fair value of the award (with limited exceptions). That cost is recognized over the period during which an employee is required to provide service in exchange for the award the requisite service period (usually the vesting period).

Prior to October 1, 2006, the Company accounted for stock-based compensation to employees using the intrinsic value method. Accordingly, compensation costs for employee stock options were measured as the excess, if any, of the fair value of the Company s common stock at date of grant over the exercise price.

The Company accounts for stock-based compensation to non-employees at fair value.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). Fin 48 clarifies the accounting and reporting for income taxes recognized in accordance with SFAS No. 109, Accounting for Income Taxes. This Interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. The Company is currently evaluating the impact of FIN 48. The Company will adopt this Interpretation in the first quarter of fiscal 2008.

In September 2006, the SEC issued Staff Accounting Bulletin (SAB) No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB 108 addresses the views of the SEC staff regarding the process of quantifying financial statement misstatements. SEC registrants are expected to reflect the effects of initially applying the guidance in SAB 108 in their annual financial statements covering the first fiscal year ending after November 15, 2006. The cumulative effect of the initial application should be reported in the carrying amounts of assets and liabilities as of the beginning of that fiscal year and the offsetting adjustment should be made to the opening balance of retained earnings for that year. The Company adopted SAB 108 on October 1, 2006. The adoption did not have any impact on the 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 and expands disclosures about fair value measurements. It clarifies that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. This Statement does not require any new fair value measurements, but rather, it provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. This Statement is effective for fiscal years beginning after November 15, 2007, with earlier adoption permitted. The Company will adopt this standard in the first quarter of fiscal 2008. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operation and cash flows.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities . This Statement permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company will adopt this standard in the first quarter of fiscal 2008. The Company is currently evaluating the impact of SFAS No. 159 on its consolidated financial position, results of operations and cash flows.

Note 2. Merger with Organizing Shareholder

On November 15, 2006, the Company completed the acquisition of TOHI pursuant to the Agreement and Plan of Merger, dated October 3, 2006. TOHI was one of the five organizing shareholders of the Company and operated as a bank holding company and significant shareholder of the Company, but otherwise had no active operations. The primary purpose of the merger was to achieve certain operational efficiencies for the Company and its affiliates. The merger was approved by the Company s Board of Directors and also by the Company s shareholders at a Special Meeting of Shareholders held on October 24, 2006. Prior to the consummation of the merger, TOHI held approximately 38% of the issued and outstanding shares of the Company s common stock. Pursuant to the Merger Agreement, (1) each issued and outstanding share of TOHI s common stock, par value $0.01 per share was converted into the right to receive 0.8121 shares of the Company s common stock, par value $0.01 per share, and (2) each issued and outstanding share of TOHI s preferred stock, par value $10.00 per share, was converted into the right to receive 1.2034 shares of the Company s common stock.

TOHI had issued options to acquire shares of common stock to various individuals, 40,000 of which were outstanding as of the date of the merger. These options were assumed by the Company and, pursuant to the conversion ratio, now represent options to acquire 32,484 shares of the Company s common stock. The options were fully vested at the merger date. Also, at the closing of the merger, certain TOHI warrantholders were issued new warrants to acquire, in the aggregate, 450,000 shares of the Company s common stock. The warrants were fully vested when issued. The Company granted the TOHI shareholders certain limited registration rights pursuant to a Registration Rights Agreement executed at the closing of the merger. Pursuant to the Registration Rights Agreement these former TOHI shareholders can request that the Company register their shares of the Company s common stock on a Registration Statement on Form S-3 if such form is available for use by the Company, but only once during any 12-month period. The former TOHI warrantholders were also granted similar S-3 registration rights.

The TOHI shareholders contributed certain assets and liabilities to the Company in connection with the merger. As of November 15, 2006, the assets and liabilities contributed by TOHI were as follows (in thousands):

	As of November 15, 2006
Cash	$ 441
Subscriptions receivable	72
Notes receivable	100
Accrued interest receivable	5
Investment in PGI Equity Partnership, LP	875
Investment in PGI Capital, Inc. (1)	54
Investment in Treaty Oak Financial Holdings, Inc. (2)	248
	1,795
Accrued expenses	(80)
Net assets contributed by TOHI	$ 1,715

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(1) PGI Capital, Inc. s assets were comprised of $31,000 in cash and $224,000 of general and limited partnership interests in PGI Equity Partners LP. PGI Capital, Inc. liabilities included a note payable to the Bank of $200,000 plus accrued interest of $1,000.

(2) Treaty Oak Financial Holdings assets were comprised of $43,000 in cash, a $166,500 note receivable and related accrued interest of $38,000.

The Company and TOHI were deemed to be under common control. A majority of the directors of the Company also served on TOHI s board of directors and were shareholders of both entities. TOHI also owned 1,000,000 shares of the Company s common stock, representing approximately 38% of the Company shares then outstanding. Because the Company and TOHI were deemed to be under common control, purchase accounting was not applied to the merger. Instead the net assets contributed by TOHI were recorded at their predecessor basis. The 1,000,000 shares of Company common stock owned by TOHI were cancelled by the Company and recorded as a reduction of its common stock accounts (par value and paid in capital) at their fair market value, as determined by an independent appraisal, of $8.31 per share, or $8,310,000 in the aggregate. The 1,094,163 new shares of Company stock issued to the TOHI shareholders were also recorded at the fair market value price of $8.31 per share, or $9,093,000 in the aggregate. The warrants issued by the Company in exchange for the TOHI warrants and the TOHI options assumed by the Company were valued and recorded at their fair value using a Black-Scholes pricing model. The net effect of the contribution of assets and the capital stock transactions was a $1,715,000 increase to the Company s equity and a 94,163 net increase in the number of Company shares issued. Although the net assets contributed by TOHI to the Company were not adjusted to their fair value, the assets were evaluated for collectibility and/or impairment according to generally accepted accounting principles prior to the merger and adjusted accordingly by TOHI prior to the merger.

Note 3. Earnings (Loss) Per Share

Basic earnings (loss) per share is computed by dividing net earnings (loss) by the weighted-average number of common shares outstanding for the period. Diluted earnings per share is computed using the weighted-average number of common shares outstanding plus the number of additional common shares that would have been outstanding if dilutive common shares had been issued. For the three months and six months ended March 31, 2007, potentially dilutive securities totaled 1,206,432. The dilutive securities include 308,603 warrants to purchase common stock at $10.00 per share which were issued in connection with the Company s initial public offering, 414,700 options to purchase common stock issued under the Company s Stock Incentive Plan, 645 options to purchase stock issued outside of the Plan, stock options to purchase 32,484 shares of the Company s common stock

at an exercise price of $6.16 that were assumed in conjunction with the merger with TOHI and warrants to purchase 450,000 of the Company s common stock at an exercise price of the greater of $6.67 per share or the book value of the Company as defined by the warrant agreements.

For the three months ended March 31, 2006, all potentially dilutive securities were anti-dilutive except for stock options to purchase 140,500 shares of the Company s common stock at an exercise price of $8.33. For the six months ended March 31, 2006, all potentially dilutive securities outstanding were anti-dilutive.

Note 4. Securities

Securities consisted of the following (in thousands):

	As of March 31, 2007		As of September 30, 2006	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities Available for Sale:				
U.S. Government Agencies	$ 11	$ 11	$ 14	$ 14
Other mortgage backed securities	2	2	2	2
Total Securities Available for Sale	$ 13	$ 13	$ 16	$ 16
Securities Held to Maturity:				
U.S. Government Agencies	$ 1,448	$ 1,447	$ 2,000	$ 1,996
Other mortgage backed securities	0	0	6	5
Total Securities Held to Maturity	$ 1,448	$ 1,447	$ 2,006	$ 2,001

At March 31, 2007, $612,000 of the Company s securities were pledged to Texline Independent School District, $600,000 to the City of Texline and $249,000 to the State of Texas.

Note 5. Loans and Allowance for Loan Losses

The Company grants real estate, commercial and agribusiness loans to customers primarily in the Austin and Northwest Texas markets. Loans at March 31, 2007, and September 30, 2006 were as follows (in thousands):

	As of March 31, 2007	As of September 30, 2006
Agriculture	$ 3,729	$ 2,989
Commercial	24,514	19,068
Commercial real estate	20,232	18,582
Residential real estate	8,484	8,221
Construction real estate	9,556	4,329
Consumer and other	7,283	6,981
Gross Loans	73,798	60,170
Less: allowance for loan losses	(646)	(550)
Net Loans	$ 73,152	$ 59,620

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Activity in the allowance for loan losses for the three months and six months ended March 31, 2007, was as follows (in thousands):

	Three Months Ended March 31,		Six Months Ended March 31,	
	2007	**2006**	**2007**	**2006**
Balance at beginning of period	$ 575	$ 317	$ 550	$ 277
Provision for loan losses	70	45	145	90
Loans charged off		(4)	(51)	(10)
Recoveries on loans previously charged off	1		2	1
Balance at end of period	$ 646	$ 358	$ 646	$ 358

At March 31, 2007 and September 30, 2006, the Bank had approximately $109,000 and $123,000, respectively, in nonperforming loans and non accrual loans. At March 31, 2007 and September 30, 2006 the Bank had $5,000 in repossessed assets, and $76,000 and $41,000, respectively, in other real estate owned.

Note 6. Premises and Equipment

Premises and equipment at March 31, 2007, and September 30, 2006, were as follows (in thousands):

	As of March 31, 2007	**As of September 30, 2006**
Land	$ 959	$ 959
Building and leasehold improvements	4,614	4,568
Furniture, fixtures and equipment	854	778
	6,427	6,305
Less accumulated depreciation and amortization	(884)	(712)
Total	$ 5,543	$ 5,593

Depreciation and amortization expense for the six months ending March 31, 2007 and 2006 was $172,000 and $171,000, respectively.

Note 7. Deposits

Time deposits of $100,000 or more totaled $11,518,000 and $8,989,000 at March 31, 2007 and September 30, 2006, respectively. At March 31, 2007 and September 30, 2006, the scheduled maturities of time deposits were as follows (in thousands):

Years Ending September 30,	As of March 31, 2007		As of September 30, 2006	
2007	$	16,646	$	20,197
2008	10,761		329	
2009	76			
	$	27,483	$	20,526

Note 8. Goodwill and Other Intangibles

In conjunction with the acquisition of Texline State Bank, the Company recorded goodwill of $1,161,000 and core deposit intangibles of $70,000. Goodwill is periodically, but at least annually, reviewed to determine whether a decline in value exists which requires a charge to earnings and a reduction to the goodwill reflected on the statement of financial condition of the Company.

Core deposit intangibles are amortized on a straight-line basis over seven years. The following table reflects the net carrying amount of core deposit intangibles at March 31, 2007 and September 30, 2006 (in thousands):

	As of March 31, 2007		As of September 30, 2006	
Gross core deposit intangibles	$	70	$	70
Less: accumulated amortization	(31	)	(26	)
Net core deposit intangibles	$	39	$	44

Note 9. Stock Based Compensation and 2004 Stock Incentive Plan

The Company adopted Financial Accounting Standards Board Statement No. 123R, Share-Based Payment , (Statement 123R) on October 1, 2006. Under Statement 123R, the cost of employee services received in exchange for an award of equity instruments is based on the grant-date fair value of the award (with limited exceptions). That cost is recognized over the period during which an employee is required to provide service in exchange for the award the requisite service period (usually the vesting period). The Company adopted Statement 123R using the modified prospective application, which was required for public companies. Under the modified prospective application, Statement 123R applies to new awards and to awards modified, repurchased, or cancelled after October 1, 2006. Additionally, compensation cost for the portion of awards for which the requisite service had not been rendered that are outstanding as of October 1, 2006 will be recognized as the requisite service is rendered subsequent to October 1, 2006.

Prior to October 1, 2006, the Company accounted for stock-based compensation to employees using the intrinsic value method. Accordingly, compensation costs for employee stock options was measured as the excess, if any, of the fair value of the Company s common stock at date of grant over the exercise price.

The Company accounts for stock-based compensation to non-employees at fair value.

On January 19, 2004, the Company and its shareholders approved the Company s 2004 Stock Incentive Plan (the Plan). The Plan authorizes incentive stock option grants, non-statutory stock option grants, direct stock issuances,

stock appreciation rights, salary investment option grants, and director fee option grants. Eligible participants are employees, non-employee board members, and independent consultants or advisors. The Company has reserved 500,000 shares of common stock under the Plan, and the share reserve increases on the 1st business day in January each year (beginning in 2005) by an amount equal to 2% of the number of outstanding shares of the Company on the last business day in December of the preceding year, subject to a maximum annual increase of 100,000 shares. No person may receive stock option grants, stock issuances, or stock appreciation rights for more than 100,000 shares in the aggregate in any calendar year under the Plan. Option awards are generally granted with an exercise price equal to the market price of the Company s stock at the date of the grant; have 10-year contractual terms and vest based on three years of continuous service. Share awards generally vest over four years.

For the three months and six months ended March 31, 2007, the expense related to the stock options and restricted stock grant compensation totaled $50,000 and $142,000, respectively, which was comprised of $44,000 and $107,000 for stock options granted to employees and directors and $6,000 and $35,000 for restricted stock granted to employees and advisory board members. The remaining expense for the three months ended March 31, 2007 was related to stock grants outside of the Plan.

For the three months and six months ended March 31, 2006, the expense related to stock option compensation included in the determination of net income was less than that which would have been recognized if the fair value method had been applied. The Company s net income and earnings per share would have been adjusted to the proforma amounts indicated below for the three months and six months ended March 31, 2006, assuming the Company had expensed the fair value of the options (in thousands, except per share amounts):

	Three Months Ended March 31, 2006	Six Months Ended March 31, 2006
Net income (loss) as reported	$ 24	$ (50)
Net loss pro forma	$ (15)	$ (123)
Income (loss) per share as reported		
Basic	$ 0.01	$ (0.02)
Diluted	$ 0.01	$ (0.02)
Loss per share pro forma		
Basic	$ (0.01)	$ (0.05)
Diluted	$ (0.01)	$ (0.05)

The fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model. The Black-Scholes option pricing model requires the input of highly subjective assumptions. The Company continues to assess the assumptions and methodologies used to calculate the estimated fair value of the stock-based compensation. Circumstances may change and additional data may become available over time, which could result in changes to these assumptions and methodologies. The risk-free rate for periods within the expected life of the options is based on the U.S. Treasury yield in effect at the time of the grant. The expected life of the options is estimated based on the vesting life and contractual life of the options. Volatility in the Black-Scholes model is based on historical volatility for comparable publicly-traded banks and the Company s historical stock prices since inception.

The fair value of restricted common stock granted under the Plan is estimated using the most recently traded market price of the Company s common stock at the time of the grant.

The weighted average fair value of the options granted during the three months ended March 31, 2007 and 2006, has been estimated using the Black-Scholes option pricing model with the following assumptions:

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	Three Months Ended March 31, 2007	**Three Months Ended March 31, 2006**
Dividend yield	0%	0%
Risk-free interest rate	5.08 - 5.12%	4.75%
Expected volatility	3.35% - 5.12%	22%
Expected life in years	6.85 Years	6.85 Years

As of March 31, 2007, there were outstanding options under the Company s Stock Incentive Plan to purchase an aggregate of 415,200 shares of the Company s common stock. Each option has an exercise price of between $8.00 and $10.26 per share and may be exercised in three equal annual installments for each year of service measured from the grant date. During the three months ended March 31, 2007, the Company granted stock options to purchase an aggregate of 42,000 shares of its common stock with an exercise price of $9.00 per share to eleven (11) officers and directors and 500 shares with an exercise price of $10.26 per share to an employee. In connection with the execution of his employment agreement with the Company, Jeffrey L. Nash was awarded 15,000 options to purchase shares of stock at an exercise price of $8.00 per share. On December 31, 2006, the Company granted 56,750 options to purchase shares of stock at an exercise price of $9.00 per share to thirteen (13) officers and directors.

During the three months ended December 31, 2005, the Company granted stock options to purchase 82,750 shares of its common stock with an exercise price of $8.50 per share to fifteen (15) officers and directors. The options become exercisable for the option shares in three equal annual installments upon completion of each year of service over the three-year period of service measured from the date of the grant.

On November 20, 2006, the Company awarded 38,006 shares of common stock to six (6) officers. The stock vests in four equal installments upon completion of each year of service over the four-year period of service measured from the date of the award. On January 1, 2007, 2,401 shares of common stock were issued to the Bank s advisory board members. On February 13, 2007, the Company awarded 12,000 shares of common stock to the Company s Chief Financial Officer. The stock vests in four equal installments upon completion of each year of service over the four-year period of service measured from the date of the award.

The table below presents the summary of stock option and restricted stock activity for the Plan during the six months ended March 31, 2007.

	Six Months Ended March 31, 2007					
	Restricted Stock		**Options**			
	Shares	**Weighted Average Remaining Contractual Term in Years**	**Shares**	**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Term in Years**	**Aggregate Intrinsic Value**
Outstanding, beginning of the period			301,350	$ 8.38		
Granted	54,207		114,250	8.91		
Forfeited/expired			(400)	8.50		
Outstanding, end of the period	52,407	3.5	415,200	$ 8.58	8.4	$ 697,850
Exercisable at the end of the period	2,401		154,983	$ 8.43	7.5	$ 284,127

A summary of shares of our common stock subject to our nonvested shares and options as of March 31, 2007 and changes during the six months ended March 31, 2007 is presented below:

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	Six Months Ended March 31, 2007			
	Restricted Stock		Options	
	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value
Nonvested, beginning of the period		$	180,400	$ 1.84
Granted	52,407	8.26	114,250	2.46
Vested	(2,401)	(8.73)	(34,033)	1.81
Forfeited/expired			(400)	1.82
Nonvested, end of the period	50,006	$ 8.24	260,217	$ 2.11

As of March 31, 2007, there was $671,509 of total unrecognized compensation costs related to nonvested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized over a weighted-average period of 2.84 years. No options were exercised during the three months and six months ended March 31, 2007.

Note 10. Other Related Party Transactions

Transactions with Former Organizing Shareholder

On August 30, 2006, TOHI, the Company s largest shareholder at that time, repurchased shares of its stock owned by certain principals of our formerly affiliated services firms, including the Company s former CEO Terry W. Hamann. Concurrent with this stock redemption, those formerly affiliated firms relocated from the headquarters building. At that time, Mr. Hamann resigned his remaining positions with the Company including all committee assignments and his seat on the board of directors. Mr. Hamann had previously resigned his role as Chairman, CEO and President of the Company in February 2006.

Other Transactions

The Company had no amounts due from affiliates at March 31, 2007. The Company had a $192,000 due from affiliate balance as of September 30, 2006 which represented amounts due from TOHI to PGI Equity Partners, LP for occupancy costs.

On October 11, 2005, the Company made a $355,000 loan to TOHI with monthly interest payments due on the first of each month beginning November 1, 2005. The purpose of the loan was to enable TOHI to pay off certain obligations, and to provide sufficient liquidity to TOHI until the proposed merger with the Company was completed. On April 26, 2006, the obligation was renewed and increased to $373,000 at the then current prime rate. The loan was renewed and increased to $400,000 on September 1, 2006. The principal balance ($396,000 as of September 30, 2006), along with any accrued interest, was due and payable in full on November 1, 2006. On November 15, 2006, in connection with the merger of TOHI and the Company, the loan was paid in full.

On August 24, 2006, the Company made a $2,425,000 loan to TOHI with monthly interest payments at the current prime rate (8.25% at September 30, 2006) due on the 24th day of each month. The purpose of the loan was to enable TOHI to redeem shares of common and preferred stock from certain of its shareholders. The loan was due and payable

on February 24, 2007 but was paid-off in full on November 15, 2006 in connection with the Company s acquisition of TOHI.

Note 11. Financial Instruments with Off-Balance Sheet Risk

In the normal course of business, the Company is a party to financial instruments with off-balance sheet risk to meet the financing needs of its customers, through the use of commitments to extend credit. Those instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amount recognized in the consolidated balance sheet. The contract or notional amounts of those instruments reflect the extent of the Company s involvement in particular classes of financial instruments.

The Company s exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as they do for on-balance sheet instruments.

The following table summarizes the Company s off-balance sheet financial instruments as of March 31, 2007 and September 30, 2006 (in thousands):

	As of March 31, 2007		As of September 30, 2006	
Commitments to extend credit	$	27,218	$	21,277
Standby letters of credit	800		1,935	

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer s creditworthiness on a case-by-case basis. The amount of collateral obtained if deemed necessary by the Company upon extension of credit is based on management s credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment and income-producing commercial properties.

Standby letters of credit are written conditional commitments used by the Company to guarantee the performance of a customer to a third party. The Company s policies generally require that letter of credit arrangements contain security and debt covenants similar to those contained in loan arrangements. In the event the customer does not perform in accordance with the terms of the agreement with the third party, the Company would be required to fund the commitment. The maximum potential amount of future payments the Company could be required to make is represented by the contractual amount shown in the table above. If the commitment is funded, the Company would be entitled to seek recovery from the customer. As of March 31, 2007, no amounts have been recorded as liabilities for the Company s potential obligations under these guarantees.

Note 12. Dividend Restrictions and Regulatory Matters

Banks and bank holding companies are subject to regulatory capital requirements administered by state and federal banking regulatory agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action

regulations involve quantitative measures of assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings and other factors. Failure to meet capital requirements can initiate regulatory action. As of March 31, 2007, management believes the Bank is in compliance with all regulatory capital requirements to which it is subject.

The following table sets forth the bank only actual capital levels in addition to the requirements under prompt corrective action regulations (in thousands):

	Actual			For Capital Adequacy Purposes			To Be Well Capitalized Under Prompt Corrective Action Provisions		
	Amount	Ratio		Amount	Ratio		Amount	Ratio	
As of March 31, 2007									
Tier 1 capital (to average assets)	$ 8,669	10.29	%	$ 3,370	4	%	$ 4,213	5	%
Tier 1 capital (to risk-weighted assets)	8,669	11.05	%	3,139	4	%	4,708	6	%
Total Capital (to risk-weighted assets)	9,315	11.87	%	6,278	8	%	7,847	10	%

	Actual			For Capital Adequacy Purposes			To Be Well Capitalized Under Prompt Corrective Action Provisions		
As of September 30, 2006									
Tier 1 capital (to average assets)	$ 8,213	11.07	%	$ 2,967	4	%	$ 3,709	5	%
Tier 1 capital (to risk-weighted assets)	8,213	11.39	%	2,885	4	%	4,328	6	%
Total Capital (to risk-weighted assets)	8,763	12.15	%	5,771	8	%	7,213	10	%

As of March 31, 2007 and September 30, 2006, the Bank met the level of capital required to be categorized as well capitalized under prompt corrective action regulations. Management is not aware of any conditions subsequent to March 31, 2007 that would change the Bank s capital category.

The Bank is a state chartered banking association and is subject to regulation, supervision and examination by the Texas Department of Banking and the Federal Deposit Insurance Corporation (FDIC). In addition, upon making certain determinations with respect to the condition of any insured bank, the FDIC may begin proceedings to terminate a bank s federal deposit insurance.

Certain restrictions exist regarding the ability of the Bank to pay cash dividends. Regulatory approval is required in order to pay dividends until such time as the accumulated deficit is eliminated and certain other conditions are met. Further, the Company has been notified by its banking regulators that no approval will be received in the first three years of operations.

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

Introduction

We are a bank holding company headquartered in Austin, Texas. We operate a state chartered bank, Treaty Oak Bank (the Bank) in Austin, Texas with a branch in Texline, Texas. We began operations in Austin, Texas on September 10, 2004. Given its greater growth potential, we are focusing the majority of our efforts on growing a community-oriented bank out of our headquarters in Austin, Texas. In the course of preparing our consolidated financial statements, we use certain estimates with respect to loans, intangibles, the allowance for loan losses and other estimates necessary for financial reporting. We have made no significant changes to the types of estimates and the manner in which they are determined since the filing of our annual report on Form 10-KSB, except as otherwise noted within this discussion and analysis.

Recent Developments

On November 15, 2006, the Company completed the acquisition of Treaty Oak Holdings, Inc. (TOHI) pursuant to the Agreement and Plan of Merger, dated October 3, 2006. TOHI was one of the five organizing shareholders of the Company and operated as a bank holding company and significant shareholder, but otherwise had no active operations. The merger was approved by the Company s Board of Directors and also by the Company s shareholders at a Special Meeting of Shareholders held on October 24, 2006. Prior to the consummation of the merger, TOHI held approximately 38% of the issued and outstanding shares of our common stock.

The primary purpose of this merger was to achieve certain operational efficiencies for the Company and its affiliates. The following factors were important to both the Company and TOHI Board s decisions to approve the merger and recommend approval to their respective shareholders:

(i) The merger would simplify the bookkeeping, financial reporting, and corporate record keeping for the Treaty Oak affiliated entities;

(ii) The merger would reduce the accounting and other costs for the various Treaty Oak entities, including the costs associated with the filing of multiple tax returns and regulatory reports;

(iii) The merger would eliminate the need to treat TOHI as a separate bank holding company and make the various banking regulatory filings;

(iv) The Company and TOHI Boards of Directors believed that it was beneficial for the Company and TOHI shareholders to have all of the shareholders associated with the Treaty Oak affiliated entities invested in one organization (*i.e*., the Company) rather than multiple organizations;

(v) As part of the exchange, the Company would receive net assets from TOHI, including cash and limited partnership interests in PGI Equity Partners, LP, the entity that owns Treaty Oak Bank s headquarters at 101 Westlake Drive, Austin, Texas, which would increase the liquidity and financial strength of the Company;

(vi) The merger was anticipated to be accretive to the Company s tangible book value per share outstanding;

(vii) Net operating losses incurred by TOHI may be available to offset future earnings of the Company; and

(viii) The TOHI Board believed that the exchange of the TOHI shares for the Company shares in connection with the merger would improve the liquidity of such shares since the Company is a public reporting company.

The Company and TOHI were deemed to be under common control. A majority of the directors of the Company also served on TOHI s board of directors and were shareholders of both entities. TOHI also owned 1,000,000 shares of the Company s common stock, representing approximately 38% of the Company shares then outstanding. Because the Company and TOHI were deemed to be under common control, purchase accounting was not applied to the merger. Instead the net assets contributed by TOHI were recorded at their predecessor cost. The 1,000,000 shares of Company common stock owned by TOHI were cancelled by the Company and recorded as a reduction of its common stock accounts (par value and paid in capital) at their fair market value, as determined by an independent appraisal, of $8.31 per share, or $8,310,000 in the aggregate. The 1,094,163 new shares of Company stock issued to the TOHI shareholders were also recorded at the fair market value price of $8.31 per share, or $9,093,000 in the aggregate. The warrants issued by the Company in exchange for the TOHI warrants and the TOHI options assumed by the Company were valued and recorded at their fair value using a Black-Scholes pricing model. The net effect of the contribution of assets and the capital stock transactions was a $1,715,000 increase to the Company s equity and a 94,163 net increase in the number of Company shares issued. Although the net assets contributed by TOHI to the Company were not adjusted to their fair value, the assets were evaluated for collectibility and/or impairment according to generally accepted accounting principles prior to the merger and adjusted accordingly by TOHI prior to the merger.

Results of Operations

General

The following discussion analyzes the results of the Company for the three months and six months ended March 31, 2007, and March 31, 2006.

Net Income General

The Company s fiscal year ends on September 30. Net income for the three months ended March 31, 2007, was $28,000, compared to net income of $24,000 for the quarter ended March 31, 2006. Net income increased due to earnings generated at the Bank as a result of growth experienced at the Austin branch and the elimination of expenses associated with the start-up of operations in Austin, Texas. The increase was offset, in part, due to an increase in non-cash based stock compensation and an increase in the competition for deposits, which in turn, caused a decrease in the Company s net interest margin. The increase in net income was also offset by an increase in personnel to support the growth of the Company.

For the six months ended March 31, 2007 the Company had net income of $164,000 compared to a net loss of $50,000 for the six months ended March 31, 2006. Again, the improvement in operations is attributable to the increase in net interest income, as the Company grew its earnings assets at a faster pace and at a greater yield than its interest bearing liabilities, and the elimination of expenses associated with the start-up of operations in Austin, Texas.

Our profitability depends primarily on net interest income, which is defined as the difference between total interest earned on interest earning assets (investments and loans) and total interest paid on interest bearing liabilities (deposits, borrowed funds) and non-interest income. The Company s net income is affected by its provision for loan losses, as well as other income and other expenses. The provision for loan losses reflects the amount considered to be adequate to cover probable credit losses in the loan portfolio. Non-interest income or other income consists of service charges on deposits, gain on sale of loans, and other operating income. Other expenses include salaries and employee benefits, occupancy expenses, data processing expenses, marketing, supplies, and other operating expenses.

Net interest income is affected by changes in the volume and mix of interest earning assets, the level of interest rates earned on those assets, the volume and mix of interest bearing liabilities, and the level of interest rates paid on those interest bearing liabilities. The provision for loan losses is dependent upon changes in the loan portfolio and management s assessment of the collectibility of the loan portfolio, as well as economic and market conditions. Other income and other expenses are impacted by growth of operations and growth in the number of accounts through both acquisitions and core banking business growth. Growth in operations affects other expenses as

a result of additional employees, branch facilities, and promotional marketing expense. Growth in the number of accounts affects other income including service fees, as well as other expenses such as computer services, supplies, postage, telecommunications, and other miscellaneous expenses.

Net Interest Income

For the three months ended March 31, 2007, our net interest income was $1,114,000 compared to $818,000 for three months ended March 31, 2006. For the six months ended March 31, 2007, our net interest income was $2,267,000 compared to $1,528,000 for the six months ended March 31, 2006.

For the comparative three month periods of March 31, 2007, and March 31, 2006, the average rate on interest-bearing liabilities increased 143 basis points, from 2.92% to 4.35%, while the average rate on interest bearing assets increased 119 basis points from 7.38% to 8.57% during the same period. For the comparative six month periods of March 31, 2007, and March 31, 2006, the average rate on interest-bearing liabilities increased 149 basis points, from 2.90% to 4.39%, while the average rate on interest bearing assets increased 112 basis points from 7.29% to 8.41% during the same period. The increase in the average rate on interest-bearing assets and liabilities was due to a general increase in interest rates during the period. Interest rates on deposits also increased as a result of increased competition for deposits.

The following tables present, for the periods indicated, the total dollar amount of interest income from average interest earning assets, and the resultant yields, as well as the interest expense on average interest bearing liabilities, and the resultant costs, expressed both in dollars and rates. Yields are reflected on an annualized basis (in thousands except for yields).

	Three Months Ended March 31, 2007			Three Months Ended March 31, 2006		
	Average Balance	Interest (2)	Yield/ Rate	Average Balance	Interest (2)	Yield/ Rate
Interest Earning Assets:						
Loans (1)	$ 71,569	$ 1,599	8.94 %	$ 46,360	$ 950	8.20 %
Taxable investment securities	1,412	17	4.82 %	3,328	25	3.00 %
Federal funds sold	5,971	82	5.49 %	6,422	71	4.42 %
Interest bearing deposits with other Banks			0.00 %	1,333	16	4.80 %
Federal Home Loan Bank Stock	326		0.00 %	321	4	4.98 %
Total interest earning assets	79,278	1,698	8.57 %	57,764	1,066	7.38 %
Non-interest earning assets	10,858			8,895		
Total assets	$ 90,136			$ 66,659		
Interest Bearing Liabilities:						
Deposits:						
NOW and money market deposits	$ 26,844	$ 235	3.50 %	$ 18,161	$ 94	2.07 %
Savings deposits	545	2	1.44 %	491	1	0.81 %
Time deposits	23,497	307	5.22 %	12,499	112	3.58 %
Short-term borrowings	166	1	1.85 %	67		0.00 %
Property mortgage and long term borrowings	2,663	39	5.87 %	2,702	41	6.07 %
Total interest bearing liabilities	53,715	584	4.35 %	33,920	248	2.92 %
Demand deposits non-interest bearing	22,565			21,208		
Other non-interest bearing liabilities	542			314		
Shareholders equity	13,314			11,217		
Total liabilities and shareholders equity	$ 90,136			$ 66,659		
Net interest income		$ 1,114			$ 818	

Interest rate spread (3)						4.22	%					4.46	%
Net interest margin (4)						5.62	%					5.55	%

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	Six Months Ended March 31, 2007			Six Months Ended March 31, 2006		
	Average Balance	**Interest (2)**	**Yield/ Rate**	**Average Balance**	**Interest (2)**	**Yield/ Rate**
Interest Earning Assets:						
Loans (1)	$ 69,208	$ 3,144	9.09 %	$ 43,197	$ 1,772	8.20 %
Taxable investment securities	1,561	31	3.97 %	3,581	54	3.02 %
Federal funds sold	11,776	308	5.23 %	5,105	107	4.19 %
Interest bearing deposits with other Banks			0.00 %	2,476	52	4.20 %
Federal Home Loan Bank Stock	326		0.00 %	319	7	4.39 %
Total interest earning assets	82,871	3,483	8.41 %	54,678	1,992	7.29 %
Non-interest earning assets	10,378			8,916		
Total assets	$ 93,249			$ 63,594		
Interest Bearing Liabilities:						
Deposits:						
NOW and money market deposits	$ 29,863	$ 531	3.56 %	$ 16,031	$ 164	2.05 %
Savings deposits	527	4	1.46 %	482	1	0.41 %
Time deposits	21,691	575	5.30 %	12,705	216	3.40 %
Short-term borrowings	689	27	7.77 %	77	1	2.60 %
Property mortgage and long term borrowings	2,674	79	5.99 %	2,710	82	6.05 %
Total interest bearing liabilities	55,444	1,216	4.39 %	32,005	464	2.90 %
Demand deposits non-interest bearing	24,488			19,917		
Other non-interest bearing liabilities	539			56		
Shareholders equity	12,778			11,616		
Total liabilities and shareholders equity	$ 93,249			$ 63,594		
Net interest income		$ 2,267			$ 1,528	
Interest rate spread (3)			4.02 %			4.39 %
Net interest margin (4)			5.47 %			5.59 %

(1) Non-accrual loans are included in average loans.

(2) Interest income includes loan fees of $56,000 and $105,000, for the three and six months ended March 31, 2007, respectively and $26,000 and $56,000 for the three and six months ended March 31, 2006.

(3) Interest rate spread represents the difference between the average yield on interest earning assets and the average cost of interest bearing liabilities.

(4) Net interest margin represents annualized net interest income as a percentage of average interest earning assets.

Volume, Mix and Rate Analysis of Net Interest Income

The following table presents the extent to which changes in volume, changes in interest rates, and changes in the interest rates times the changes in volume of interest earning assets and interest bearing liabilities affected the Bank s interest income and interest expense during the period

indicated. Information is provided on changes in each category due to (1) changes attributable to changes in volume (change in volume times the prior period interest rate), (2) changes attributable to changes in interest rate (changes in rate times the prior period volume), and (3) changes attributable to changes in rate/volume (changes in interest rate times changes in volume). Changes attributable to the combined impact of volume and rate have been allocated proportionally to the changes due to volume and the changes due to rate (in thousands):

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	Three Months Ended March 31, 2007 Compared to Three Months Ended March 31, 2006		
	Change Due to Volume	**Change Due to Rate**	**Total Change**
Interest Earning Assets:			
Loans	$ 563	$ 86	$ 649
Taxable investment securities	(23)	15	(8)
Federal funds sold	(6)	17	11
Interest bearing deposits with other Banks	(16)		(16)
Increase in interest income	$ 518	$ 118	$ 636
Interest Bearing Liabilities:			
NOW and money market deposit accounts	$ 76	$ 65	$ 141
Savings deposits	1	1	1
Time deposits	144	51	195
Short-term borrowings		1	1
Long term borrowings	(1)	(1)	(2)
Increase (decrease) in interest expense	220	117	336
Increase (decrease) in net interest income	$ 298	$ 1	$ 300

	Six Months Ended March 31, 2007 Compared to Six Months Ended March 31, 2006		
	Change Due to Volume	**Change Due to Rate**	**Total Change**
Interest Earning Assets:			
Loans	$ 1,182	$ 191	$ 1,373
Taxable investment securities	(40)	17	(23)
Federal funds sold	174	27	201
Interest bearing deposits with other Banks	(52)		(52)
Increase in interest income	$ 1,264	$ 235	$ 1,499
Interest Bearing Liabilities:			
NOW and money market deposit accounts	$		