

FIRST INTERSTATE BANCSYSTEM INC

Form 10-Q

August 04, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q**

**Quarterly report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended June 30, 2006**

OR

**Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____**

COMMISSION FILE NUMBER 000-49733

First Interstate BancSystem, Inc.

(Exact name of registrant as specified in its charter)

Montana

81-0331430

(State or other jurisdiction of
incorporation or organization)

(IRS Employer
Identification No.)

401 North 31st Street, Billings, MT

59116-0918

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code: 406/255-5390

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 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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

The Registrant had 8,109,108 shares of common stock outstanding on June 30, 2006.

FIRST INTERSTATE BANCSYSTEM, INC. AND SUBSIDIARIES
Quarterly Report on Form 10-Q

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Table of Contents**FIRST INTERSTATE BANCSYSTEM, INC. AND SUBSIDIARIES****Consolidated Balance Sheets***(Dollars in thousands, except share data)*

(Unaudited)

	June 30, 2006	December 31, 2005
Assets		
Cash and due from banks	\$ 208,351	207,877
Federal funds sold	31,564	27,607
Interest bearing deposits in banks	4,585	5,493
Total cash and cash equivalents	244,500	240,977
Investment securities:		
Available-for-sale	890,966	916,450
Held-to-maturity (estimated fair values of \$109,208 as of June 30, 2006 and \$104,305 as of December 31, 2005)	109,842	103,451
Total investment securities	1,000,808	1,019,901
Loans	3,256,500	3,034,354
Less allowance for loan losses	45,721	42,450
Net loans	3,210,779	2,991,904
Premises and equipment, net	120,278	120,438
Accrued interest receivable	29,809	26,104
Company-owned life insurance	63,579	62,547
Mortgage servicing rights, net of accumulated amortization and impairment reserve	23,453	22,116
Goodwill	37,380	37,390
Core deposit intangibles, net of accumulated amortization	716	1,204
Net deferred tax asset	10,523	3,285
Other assets	38,848	36,447
Total assets	\$ 4,780,673	4,562,313
Liabilities and Stockholders Equity		
Deposits:		
Noninterest bearing	\$ 860,956	864,128
Interest bearing	2,678,625	2,683,462
Total deposits	3,539,581	3,547,590
Federal funds purchased	87,810	1,500

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Securities sold under repurchase agreements	610,220	518,718
Accrued interest payable	13,649	13,185
Accounts payable and accrued expenses	25,586	28,086
Other borrowed funds	43,197	7,495
Long-term debt	53,928	54,654
Subordinated debenture held by subsidiary trust	41,238	41,238
Total liabilities	4,415,209	4,212,466
Stockholders' equity:		
Nonvoting noncumulative preferred stock without par value; authorized 100,000 shares; no shares issued or outstanding as of June 30, 2006 or December 31, 2005		
Common stock without par value; authorized 20,000,000 shares; issued and outstanding 8,109,108 shares as of June 30, 2006 and 8,098,933 shares as of December 31, 2005	42,880	43,569
Retained earnings	338,364	314,843
Unearned compensation - restricted stock		(330)
Accumulated other comprehensive loss, net	(15,780)	(8,235)
Total stockholders' equity	365,464	349,847
Total liabilities and stockholders' equity	\$ 4,780,673	4,562,313

See accompanying notes to unaudited consolidated financial statements.

Table of Contents**FIRST INTERSTATE BANCSYSTEM, INC. AND SUBSIDIARIES****Consolidated Statements of Income***(Dollars in thousands, except per share data)*

(Unaudited)

	For the three months ended June 30,		For the six months ended June 30,	
	2006	2005	2006	2005
Interest income:				
Interest and fees on loans	\$ 59,837	46,627	115,599	90,039
Interest and dividends on investment securities:				
Taxable	10,100	7,095	19,268	13,923
Exempt from Federal taxes	1,132	1,115	2,205	2,188
Interest on deposits in banks	75	139	171	304
Interest on Federal funds sold	414	568	1,284	1,057
Total interest income	71,558	55,544	138,527	107,511
Interest expense:				
Interest on deposits	17,131	10,429	32,115	19,642
Interest on Federal funds purchased	575	22	582	22
Interest on securities sold under repurchase agreements	6,169	2,862	11,169	5,021
Interest on other borrowed funds	337	28	383	46
Interest on long-term debt	525	670	1,040	1,314
Interest on subordinated debenture held by subsidiary trust	857	661	1,659	1,261
Total interest expense	25,594	14,672	46,948	27,306
Net interest income	45,964	40,872	91,579	80,205
Provision for loan losses	2,578	1,365	4,331	2,990
Net interest income after provision for loan losses	43,386	39,507	87,248	77,215
Noninterest income:				
Other service charges, commissions and fees	5,302	4,914	10,535	9,617
Service charges on deposit accounts	4,357	4,339	8,457	8,398
Technology services revenues	3,905	3,288	7,533	6,630
Financial services revenues	2,777	2,149	5,265	4,468
Income from origination and sale of loans	2,255	2,011	4,116	3,790
Investment securities losses, net	(4)	(438)	(4)	(1,130)
Other income	1,467	1,476	3,277	2,812
Total noninterest income	20,059	17,739	39,179	34,585
Noninterest expense:				

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Salaries, wages and employee benefits	21,507	19,057	42,849	38,632
Furniture and equipment	4,089	4,014	8,066	8,001
Occupancy, net	3,194	3,620	6,637	6,931
Mortgage servicing rights amortization expense	1,036	1,189	1,979	2,360
Professional fees	614	668	1,395	1,292
Outsourced technology services	634	647	1,255	1,078
Core deposit intangible amortization expense	243	254	488	507
Other expenses	7,400	8,093	14,242	15,034
Total noninterest expense	38,717	37,542	76,911	73,835
Income before income taxes	24,728	19,704	49,516	37,965
Income tax expense	8,591	6,824	17,245	13,126
Net income	\$ 16,137	12,880	32,271	24,839
Basic earnings per common share	\$ 1.99	1.62	3.98	3.12
Diluted earnings per common share	\$ 1.95	1.59	3.90	3.06

See accompanying notes to unaudited consolidated financial statements.

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FIRST INTERSTATE BANCSYSTEM, INC. AND SUBSIDIARIES
Consolidated Statements of Stockholders Equity and Comprehensive Income
(Dollars in thousands, except share and per share data)
(Unaudited)

	Common shares outstanding	Common stock	Retained earnings	Unearned compensation- restricted stock	Accumulated other comprehensive income (loss)	Total stockholders equity
Balance at December 31, 2005	8,098,933	\$ 43,569	314,843	(330)	(8,235)	349,847
Comprehensive income:						
Net income			32,271			32,271
Unrealized losses on available-for-sale investment securities, net of income tax benefit of \$4,897					(7,547)	(7,547)
Less reclassification adjustment for losses included in net income, net of income tax benefit of \$2					2	2
Other comprehensive income						(7,545)
Total comprehensive income						24,726
Common stock transactions:						
Common shares retired	(68,099)	(4,861)				(4,861)
Common shares issued	6,045	414				414
Restricted shares issued	1,000					
Stock options exercised, net of 27,480 shares tendered in payment of option price and income tax withholding amounts	71,229	2,307				2,307
Stock option tax benefit		1,006				1,006
Stock-based compensation expense:		775				775

Stock-based compensation expense						
Reclassification of unearned compensation upon adoption of SFAS No. 123R		(330)		330		
Cash dividends declared: Common (\$1.08 per share)			(8,750)			(8,750)
Balance at June 30, 2006	8,109,108	\$ 42,880	338,364		(15,780)	365,464
Balance at December 31, 2004	7,980,300	\$ 36,803	275,172	(425)	(3,224)	308,326
Comprehensive income:						
Net income			24,839			24,839
Unrealized losses on available-for-sale investment securities, net of income tax benefit of \$132					(202)	(202)
Less reclassification adjustment for losses included in net income, net of income tax benefit of \$445					685	685
Other comprehensive income						483
Total comprehensive income						25,322
Common stock transactions:						
Common shares retired	(31,687)	(1,945)				(1,945)
Common shares issued	7,405	421				421
Restricted shares issued	1,000	56		(56)		
Stock options exercised, net of 10,424 shares tendered in payment of option price and income tax withholding amounts	23,592	784				784
Stock option tax benefit		267				267
		80		37		117

Restricted stock
remeasurement &
amortization

Cash dividends declared:

Common (\$0.90 per
share)

(7,172)

(7,172)

Balance at June 30, 2005

7,980,610

\$ 36,466

292,839

(444)

(2,741)

326,120

See accompanying notes to unaudited consolidated financial statements.

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FIRST INTERSTATE BANCSYSTEM, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(Dollars in thousands)
(Unaudited)

	For the six months ended June 30,	
	2006	2005
Cash flows from operating activities:		
Net income	\$ 32,271	24,839
Adjustments to reconcile net income to net cash provided by operating activities:		
Equity in undistributed earnings of joint ventures	(491)	(236)
Provision for loan losses	4,331	2,990
Depreciation	6,636	7,099
Amortization of core deposit intangibles	488	507
Amortization of mortgage servicing rights	1,979	2,360
Net premium amortization (discount accretion) on investment securities	(3,029)	466
Net loss on sale of investment securities	4	1,130
Net (gain) loss on sale of property and equipment	(15)	8
Net impairment reversals on mortgage servicing rights	(388)	(313)
Net increase in cash surrender value of company-owned life insurance	(1,032)	(828)
Write-down of property assets pending sale/disposal	46	16
Stock-based compensation expense related to stock options & restricted stock awards	775	117
Excess tax benefits from stock-based compensation	(1,006)	
Deferred income taxes	(2,335)	(1,307)
Changes in operating assets and liabilities:		
Increase in loans held for sale	(11,659)	(4,015)
Increase in interest receivable	(3,707)	(3,366)
Increase in other assets	(2,692)	(152)
Increase in accrued interest payable	476	1,218
Increase (decrease) in accounts payable and accrued expenses	(1,494)	5,582
Net cash provided by operating activities	19,158	36,115
Cash flows from investing activities:		
Purchases of investment securities:		
Held-to-maturity	(10,184)	(7,500)
Available-for-sale	(1,751,268)	(495,900)
Proceeds from maturities and paydowns of investment securities:		
Held-to-maturity	3,762	2,319
Available-for-sale	1,767,217	387,364
Proceeds from sales of available-for-sale investment securities	138	84,650
Net decrease in cash equivalent mutual funds classified as available-for-sale investment securities	5	124
Purchases and originations of mortgage servicing rights	(2,920)	(2,896)
Extensions of credit to customers, net of repayments	(213,553)	(151,504)
Recoveries of loans charged-off	1,341	1,027

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Proceeds from sales of other real estate	633	1,808
Net capital expenditures	(6,250)	(3,832)
Sale of banking office, net of cash	(2,547)	
Net cash used in investing activities	(213,626)	(184,340)
Cash flows from financing activities:		
Net decrease in deposits	(4,932)	(11,309)
Net increase in federal funds purchased	86,310	
Net increase in repurchase agreements	91,502	49,705
Net increase (decrease) in other borrowed funds	35,702	(427)
Borrowings of long-term debt	3,100	8,000
Repayments of long-term debt	(3,826)	(10,246)
Net decrease in debt issuance costs	19	20
Proceeds from issuance of common stock	2,721	1,205
Excess tax benefits from stock-based compensation	1,006	267
Payments to retire common stock	(4,861)	(1,945)
Dividends paid on common stock	(8,750)	(7,172)
Net cash provided by financing activities	197,991	28,098
Net increase (decrease) in cash and cash equivalents	3,523	(120,127)
Cash and cash equivalents at beginning of period	240,977	355,908
Cash and cash equivalents at end of period	\$ 244,500	235,781

See accompanying notes to unaudited consolidated financial statements.

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FIRST INTERSTATE BANCSYSTEM, INC. AND SUBSIDIARIES

Notes to Unaudited Consolidated Financial Statements

(Dollars in thousands, except share and per share data)

(1) Basis of Presentation

In the opinion of management, the accompanying unaudited consolidated financial statements of First Interstate BancSystem, Inc. (the Parent Company or FIBS) and subsidiaries (the Company) contain all adjustments (all of which are of a normal recurring nature) necessary to present fairly the financial position of the Company at June 30, 2006 and December 31, 2005 and the results of operations and cash flows for each of the three and six month periods ended June 30, 2006 and 2005, in conformity with U.S. generally accepted accounting principles. The balance sheet information at December 31, 2005 is derived from audited consolidated financial statements, however, certain reclassifications, none of which were material, have been made to conform to the June 30, 2006 presentation.

These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005. Operating results for the three and six months ended June 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

(2) Stock-Based Compensation

Effective January 1, 2006, the Company adopted the provisions of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard (SFAS) No. 123 (revised), Share-Based Payment (SFAS 123R) using a modified version of prospective application. Prior to the adoption of SFAS 123R, the Company accounted for share-based payments to employees using the intrinsic value method under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). Under the provisions of APB 25, restricted stock awards were accounted for using variable plan accounting whereby compensation expense or benefit was recorded each period from the date of grant to the measurement date based on the fair value of the Company s common stock at the end of each period. Stock option awards were accounted for using fixed plan accounting whereby the Company recognized no compensation expense for stock option awards because the exercise price of options granted was equal to the fair value of the common stock at the date of grant.

Under the modified prospective application, the provisions of SFAS 123R apply to new awards and to awards outstanding on January 1, 2006 and subsequently modified, repurchased or cancelled. Compensation expense recognized in 2006 includes compensation costs for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123, and compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. Prior periods were not restated to reflect the impact of adopting SFAS 123R.

As a result of adopting SFAS 123R on January 1, 2006, the Company s net income and basic and diluted earnings per share for the three and six months ended June 30, 2006, were lower by \$243 and \$357, respectively, and \$0.03 and \$0.01, respectively, than if the Company had continued to account for stock-based compensation under the provisions of APB 25.

Table of Contents**FIRST INTERSTATE BANCSYSTEM, INC. AND SUBSIDIARIES****Notes to Unaudited Consolidated Financial Statements***(Dollars in thousands, except share and per share data)*

The following table illustrates the effect on operating results and per share information had the Company accounted for stock-based compensation in accordance with SFAS 123R for the three and six months ended June 30, 2005:

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income as reported	\$ 12,880	24,839
Deduct: total stock-based employee compensation expense determined under a fair value method for all awards, net of taxes	(122)	(225)
Pro forma net income	\$ 12,758	24,614
Basic earnings per share	\$ 1.62	3.12
Pro forma basic earnings per share	\$ 1.60	3.09
Diluted earnings per share	\$ 1.59	3.06
Pro forma diluted earnings per share	\$ 1.57	3.04

In May 2006, the Company's Board of Directors adopted and shareholders approved the 2006 Equity Compensation Plan. The 2006 Equity Compensation Plan consolidates into one plan the benefits available under existing formal and informal equity compensation plans including the 2001 Stock Option Plan, the 2004 Restricted Stock Benefit Plan, the Officer Stock Benefit Plan and the Director Stock Compensation Plan. Subsequent to April 2006, the Company ceased awarding benefits under all pre-existing share-based benefit plans. All share-based payment awards after April 2006 will be made pursuant to the 2006 Equity Compensation Plan.

At June 30, 2006, the Company had \$1,304 of unrecognized compensation cost related to share-based payment awards which is expected to be recognized over a weighted-average period of 0.8 years. The Company recorded compensation expense associated with share-based payments of \$525 and \$108 for the three month periods ended June 30, 2006 and 2005, respectively; and, \$775 and \$164 for the six months ended June 30, 2006 and 2005, respectively. The total weighted average fair value of stock options and restricted stock awards vested during the six months ended June 30, 2006 and 2005 was \$429 and \$443, respectively.

Stock Options

All options granted under the 2006 Equity Compensation Plan and 2001 Stock Option Plan have an exercise price equal to fair value at the date of grant, may be subject to vesting as determined by the Company's Board of Directors or Compensation Committee and can be exercised for periods of up to ten years from the date of grant. Stock issued upon exercise of options is subject to a shareholder agreement prohibiting transfer of the stock for a period of six months following the exercise. In addition, the shareholder agreement grants the Company a right of first refusal to repurchase the stock and provides the Company a right to call some or all of the stock under certain conditions. The Company uses the Black-Scholes option pricing model to estimate the fair value of share-based payment awards. Weighted-average assumptions used in the option pricing model for the periods indicated are presented in the following table.

Three months ended June 30,	Six months ended June 30,
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	2006	2005	2006	2005
Dividend yield	3.01%	3.05%	3.01%	3.05%
Expected volatility	5.60%	8.40%	5.88%	8.40%
Risk-free interest rate	5.01%	4.27%	4.51%	4.19%
Expected life of options (in years)	6.20	8.50	6.20	8.50
Weighted-average grant date fair value	\$7.21	\$6.96	\$7.69	\$6.06

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The assumptions above are based on historical exercise and post-vesting employment termination behaviors and expected future exercising patterns of employees; and, historical volatility of the Company's common stock calculated using the quarterly appraised value of a minority interest over the expected life of options in 2006 and the contractual option term in 2005. Risk-free interest rates are based on U.S. treasury constant maturity yields in effect as of each grant date for treasury securities with maturities approximating the expected life of options granted.

The following table represents stock option activity for the six months ended June 30, 2006:

	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contract Life
Outstanding options, beginning of period	837,145	\$ 45.95	
Granted	140,751	68.25	
Exercised	(98,709)	42.83	
Forfeited	(7,362)	59.05	
Outstanding options, end of period	871,825	\$ 49.80	6.34 years
Outstanding options exercisable, end of period	689,889	\$ 46.78	5.66 years

At June 30, 2006, the Company had 738,404 shares available for future stock option grants to employees and directors under the 2006 Equity Compensation Plan. The aggregate intrinsic value of options outstanding and options exercisable were \$21,536 and \$19,127, respectively, as of June 30, 2006 and \$15,694 and \$13,505, respectively, as of June 30, 2005. The total intrinsic value of stock options exercised was \$2,630 and \$703 during the six months ended June 30, 2006 and 2005, respectively.

Net cash proceeds from the exercise of stock options were \$2,307 and \$784 for the six months ended June 30, 2006 and 2005, respectively. The Company receives a tax deduction generally equal to the excess of the fair value of common stock received pursuant to an option exercise over the exercise price of the option. Under SFAS 123R, tax benefits from the exercise of stock options are reported as financing cash flows in the consolidated statements of cash flows rather than as operating cash flows as was required under APB 25. For the six months ended June 30, 2006 and 2005, the Company recorded financing cash flows of \$1,006 and \$267, respectively, related to tax benefits from the exercise of stock options.

The following table summarizes the Company's nonvested stock option activity for the six months ended June 30, 2006:

	Number of Shares	Weighted-Average Grant-Date Fair Value
Nonvested stock options, beginning of period	186,141	\$ 5.50
Granted	97,616	5.93
Vested	(94,459)	5.32
Forfeited	(7,362)	5.63

Nonvested stock options, end of period	181,936	\$	5.75
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Compensation expense related to stock options awards of \$460 and \$647 was included in salaries, wages and benefits expense on the Company's consolidated income statements for the three and six month periods ended June 30, 2006, respectively, and \$47 and \$47 for the three and six month periods ended June 30, 2005, respectively.

Table of Contents**FIRST INTERSTATE BANCSYSTEM, INC. AND SUBSIDIARIES****Notes to Unaudited Consolidated Financial Statements***(Dollars in thousands, except share and per share data)**Restricted Stock*

Common stock issued under the 2006 Equity Compensation Plan and the 2004 Restricted Stock Plan may not be sold or otherwise transferred until restrictions have lapsed or performance objectives have been obtained. During the vesting period, participants have voting rights and receive dividends on the restricted shares. Upon termination of employment, common shares upon which restrictions have not lapsed must be returned to the Company. The unearned stock-based compensation related to these awards is amortized to compensation expense over the period the restrictions lapse (generally three years). As of June 30, 2006, unearned stock-based compensation of \$277 associated with these awards was included in common stock on the Company's consolidated financial statements. Compensation expense related to restricted stock awards of \$65 and \$128 was included in salaries, wages and benefits expense on the Company's consolidated income statements for the three and six month periods ended June 30, 2006 and \$61 and \$117 for the three and six month period ended June 30, 2005, respectively.

The following table represents the shares that were granted and outstanding as of June 30, 2006 and December 31, 2005:

	June 30, 2006	December 31, 2005
Restricted stock, beginning of period	10,500	11,000
Granted during the period ended	1,000	500
Forfeited during the period ended		(1,000)
Outstanding, end of period	11,500	10,500

(3) Computation of Earnings per Share

Basic earnings per common share (EPS) is calculated by dividing net income by the weighted average number of common shares outstanding during the period presented. Diluted earnings per common share is calculated by dividing net income by the weighted average number of common shares and potential common shares outstanding during the period.

The following table sets forth the computation of basic and diluted earnings per share for the three and six month periods ended June 30, 2006 and 2005:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net income basic and diluted	\$ 16,137	12,880	32,271	24,839
Average outstanding shares-basic	8,104,670	7,964,416	8,106,570	7,967,125
Add: effect of dilutive stock options	173,020	150,987	175,282	138,593

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Average outstanding shares-diluted	8,277,690	8,115,403	8,281,852	8,105,718
Basic earnings per share	\$ 1.99	1.62	3.98	3.12
Diluted earnings per share	\$ 1.95	1.59	3.90	3.06

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The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the commitment contract. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. At June 30, 2006, commitments to extend credit to existing and new borrowers approximated \$918,495, which includes \$183,890 on unused credit card lines and \$294,531 with commitment maturities beyond one year.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. At June 30, 2006, the Company had outstanding standby letters of credit of \$99,374. The estimated fair value of the obligation undertaken by the Company in issuing the standby letters of credit is included in other liabilities in the Company's consolidated balance sheet.

(5) Segment Reporting

The Company has two operating segments, Community Banking and Technology Services. Community Banking encompasses commercial and consumer banking services offered to individuals, businesses and municipalities. Technology Services encompasses technology services provided to affiliated and non-affiliated financial institutions.

The Other category includes the net funding cost and other expenses of the Parent Company, the operational results of non-bank subsidiaries (except the Company's technology services subsidiary) and intercompany eliminations.

Selected segment information for the three and six month periods ended June 30, 2006 and 2005 follows:

	Three Months Ended June 30, 2006			Total
	Community Banking	Technology Services	Other	
Net interest income (expense)	\$46,901	40	(977)	45,964
Provision for loan losses	2,578			2,578
Net interest income (expense) after provision	44,323	40	(977)	43,386
Noninterest income:				
External sources	16,162	3,905	(8)	20,059
Internal sources		3,375	(3,375)	
Total noninterest income	16,162	7,280	(3,383)	20,059
Noninterest expense	34,757	5,564	(1,604)	38,717
Income (loss) before income taxes	25,728	1,756	(2,756)	24,728

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Income tax expense (benefit)	9,024	695	(1,128)	8,591
Net income (loss)	\$16,704	1,061	(1,628)	16,137
Depreciation and core deposit intangibles amortization	\$ 3,517		61	3,578

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Table of Contents**FIRST INTERSTATE BANCSYSTEM, INC. AND SUBSIDIARIES****Notes to Unaudited Consolidated Financial Statements***(Dollars in thousands, except share and per share data)*

	Three Months Ended June 30, 2005			Total
	Community Banking	Technology Services	Other	
Net interest income (expense)	\$41,772	23	(923)	40,872
Provision for loan losses	1,365			1,365
Net interest income (expense) after provision	40,407	23	(923)	39,507
Noninterest income:				
External sources	14,333	3,288	118	17,739
Internal sources		3,489	(3,489)	
Total noninterest income	14,333	6,777	(3,371)	17,739
Noninterest expense	34,124	4,940	(1,522)	37,542
Income (loss) before income taxes	20,616	1,860	(2,772)	19,704
Income tax expense (benefit)	7,231	738	(1,145)	6,824
Net income (loss)	\$13,385	1,122	(1,627)	12,880
Depreciation and core deposit intangibles amortization	\$ 3,765		61	3,826
	Six Months Ended June 30, 2006			Total
	Community Banking	Technology Services	Other	
Net interest income (expense)	\$93,387	71	(1,879)	91,579
Provision for loan losses	4,331			4,331
Net interest income (expense) after provision	89,056	71	(1,879)	87,248
Noninterest income:				
External sources	31,363	7,533	283	39,179
Internal sources		6,912	(6,912)	
Total noninterest income	31,363	14,445	(6,629)	39,179
Noninterest expense	69,412	10,751	(3,252)	76,911
Income (loss) before income taxes	51,007	3,765	(5,256)	49,516
Income tax expense (benefit)	17,920	1,488	(2,163)	17,245

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Net income (loss)	\$33,087	2,277	(3,093)	32,271
Depreciation and core deposit intangibles amortization	\$ 7,002		122	7,124
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Table of Contents**FIRST INTERSTATE BANCSYSTEM, INC. AND SUBSIDIARIES****Notes to Unaudited Consolidated Financial Statements***(Dollars in thousands, except share and per share data)*

	Six Months Ended June 30, 2005			Total
	Community Banking	Technology Services	Other	
Net interest income (expense)	\$ 81,922	40	(1,757)	80,205
Provision for loan losses	2,990			2,990
Net interest income (expense) after provision	78,932	40	(1,757)	77,215
Noninterest income:				
External sources	27,646	6,630	309	34,585
Internal sources	1	6,894	(6,895)	
Total noninterest income	27,647	13,524	(6,586)	34,585
Noninterest expense	67,134	9,802	(3,101)	73,835
Income (loss) before income taxes	39,445	3,762	(5,242)	37,965
Income tax expense (benefit)	13,814	1,491	(2,179)	13,126
Net income (loss)	\$ 25,631	2,271	(3,063)	24,839
Depreciation and core deposit intangibles amortization	\$ 7,484		122	7,606

(6) Supplemental Disclosures to Consolidated Statement of Cash Flows

The Company paid cash of \$46,484 and \$26,088 for interest during the six months ended June 30, 2006 and 2005, respectively. The Company paid cash for income taxes of \$20,169 and \$11,534 during the six months ended June 30, 2006 and 2005, respectively.

(7) Recent Accounting Pronouncements

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (an interpretation of SFAS No. 109) (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 requires the Company to recognize in the financial statements the impact of a tax position if that position is more likely than not of being sustained on audit based on the technical merits of the position. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure. The provisions of FIN 48 are effective for the Company on January 1, 2007 with earlier adoption encouraged. The Company is currently evaluating the financial statement impact of adoption of FIN 48.

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Item 2.

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

The following discussion should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2005, including the audited financial statements contained therein, filed with the Securities and Exchange Commission.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Rule 175 promulgated thereunder, and Section 21E of the Securities Exchange Act of 1934, as amended, and Rule 3b-6 promulgated thereunder, that involve inherent risks and uncertainties. Any statements about the Company's plans, objectives, expectations, strategies, beliefs, or future performance or events constitute forward-looking statements. Such statements are identified as those that include words or phrases such as believes, expects, anticipates, plans, trend, objective, continue or similar expressions or future or conditional verbs such as would, should, could, might, may or similar expressions. Forward-looking statements involve known and unknown risks, uncertainties, assumptions, estimates and other important factors that could cause actual results to differ materially from any results, performance or events expressed or implied by such forward-looking statements. All forward-looking statements are qualified in their entirety by reference to risk factors discussed in Item 1A of the Company's Annual Report of Form 10-K for the year ended December 31, 2005, including, among others: (i) credit risk; (ii) credit concentration and economic conditions in Montana and Wyoming; (iii) declines in real estate values; (iv) changes in interest rates; (v) inability to meet liquidity requirements; (vi) availability of capital; (vii) competition; (viii) dependence on technology; (ix) ineffective internal operational controls; (x) difficulties in execution of business strategy; (xi) disruption of vital infrastructure; (xii) changes in or noncompliance with governmental regulations; (xiii) restrictions on dividends and stock redemptions; (xiv) capital required to support the Company's bank subsidiary (the Bank); and (xv) investment risks affecting holders of common stock. Because the foregoing factors could cause actual results or outcomes to differ materially from those expressed or implied in any forward-looking statements, undue reliance should not be placed on any forward-looking statements. Further, any forward-looking statement speaks only as of the date on which it is made, and the Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of future events or developments.

CRITICAL ACCOUNTING ESTIMATES AND SIGNIFICANT ACCOUNTING POLICIES

The Company's consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles and follow general practices within the industries in which it operates. Application of these principles requires management to make estimates, assumptions and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ significantly from those estimates.

The Company's accounting policies are fundamental to understanding Management's Discussion and Analysis of Financial Condition and Results of Operations. The most significant accounting policies followed by the Company are presented in Note 1 of the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

The Company's critical accounting estimates are summarized below. Management considers an accounting estimate to be critical if: (1) the accounting estimate requires management to make particularly difficult, subjective and/or complex judgments about matters that are inherently uncertain, and (2) changes in the estimate that are reasonably likely to occur from period to period, or the use of different estimates that management could have reasonably used in the current period, would have a material impact on the Company's consolidated financial statements, results of operations or liquidity.

Allowance for Loan Losses

The allowance for loan losses represents management's estimate of probable credit losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of subjective measurements, including management's assessment of the

internal risk classifications of loans, changes in the nature of the loan portfolio, industry concentrations and the impact of current local, regional and national economic factors on the quality of the loan portfolio. The allowance for loan losses is maintained at an amount the Company believes is sufficient to provide for estimated losses inherent in its loan portfolio at each balance sheet date. Management believes the process for determining the allowance for loan losses takes into account all of the significant potential factors that could result in credit losses. However, the process includes judgmental and quantitative elements that may be subject to significant change. To the extent actual outcomes differ from the Company's estimates, additional provision for loan losses could be required, which could adversely affect earnings or financial performance in future periods. Note 1 of the Notes to Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2005 describes the methodology used to determine the allowance for loan losses. A discussion of the factors driving changes in the amount of the allowance for loan losses is included herein under the heading "Asset Quality, Provision/Allowance for Loan Losses."

Table of Contents*Valuation of Mortgage Servicing Rights*

The Company recognizes as assets the rights to service mortgage loans for others, whether acquired or internally originated. Mortgage servicing rights are initially recorded at fair value and are amortized over the period of estimated servicing income. Mortgage servicing rights are carried on the consolidated balance sheet at the lower of amortized cost or fair value. The Company utilizes the expertise of a third-party consultant to estimate the fair value of its mortgage servicing rights quarterly. In evaluating the mortgage servicing rights, the consultant uses discounted cash flow modeling techniques, which require estimates regarding the amount and timing of expected future cash flows, including assumptions about loan repayment rates, costs to service, as well as interest rate assumptions that contemplate the risk involved. Management believes the valuation techniques and assumptions used by the consultant are reasonable.

Determining the fair value of mortgage servicing rights is considered a critical accounting estimate because of the assets' sensitivity to changes in estimates and assumptions used, particularly loan prepayment speeds and discount rates. Imprecision in estimating these factors can impact the amount of revenue or loss recorded in the Company's financial statements. Notes 1 and 7 of the Notes to Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2005 describe the methodology used to determine fair value of mortgage servicing rights.

EXECUTIVE OVERVIEW

During the first half of 2006, the Company remained focused on improving operating efficiency and identifying new opportunities to generate additional noninterest income. This strategy resulted in increased earnings during the three and six months ended June 30, 2006. Net income increased \$3.3 million, or 25.3%, to \$16.1 million, or \$1.95 per diluted share, for the quarter ended June 30, 2006 as compared to \$12.9 million, or \$1.59 per diluted share, for the same period in 2005. During the six months ended June 30, 2006, net income increased \$7.4 million, or 29.9%, to \$32.3 million, or \$3.90 per diluted share, as compared to \$24.8 million, or \$3.06 per diluted share, for the same period in the prior year. Quarter-to-date and year-to-date net interest income, on a fully taxable-equivalent basis, increased 12.5% and 14.2%, respectively, as compared to the same periods in 2005 partly due to growth in average earning assets. Average earning assets grew 12.3% and 11.6% and comprised a larger percentage of total assets during the three and six months ended June 30, 2006, respectively, as compared to the same periods in 2005. In addition, noninterest-bearing deposits and common equity comprised a larger share of the funding base during the first and second quarters of 2006, as compared to the same periods in 2005, allowing the Company to be less reliant on higher costing funding sources, such as time deposits, in the current year. Net income during the first and second quarters of 2006 was also positively impacted by lower expenses associated with discontinuation of operations at Wal-Mart in-store banking offices as described below; decreases in losses on sales of investment securities; increases in fee income resulting from debit card transaction volumes; and, increases in revenues from technology and financial services. Partially offsetting these improvements in net income were increases in provisions for loan losses and salaries, wages and employee benefit expenses.

On January 1, 2006, the Company adopted SFAS No. 123R, *Share-Based Payments*, which requires all share-based payments to be recognized in the financial statements based on the fair value of the award at the date of grant. Adoption of SFAS No. 123R resulted in the recognition of compensation expense related to stock option and restricted stock awards, net of related income tax benefits, of \$324 thousand and \$479 thousand during the three and six months ended June 30, 2006, respectively.

In January 2005, the Company made a strategic decision to discontinue the operation of nine banking offices located inside Wal-Mart stores. During 2005, operations at five of the nine Wal-Mart in-store banking offices were discontinued and customer loan and deposit accounts were transferred to existing banking offices located in the same communities. During January 2006, operations were discontinued and customers' accounts were transferred at three of the four remaining Wal-Mart in-store banking offices and the final Wal-Mart in-store banking office was sold. The Company recorded expenses directly related to the discontinuation of operations of \$23 thousand and \$897 thousand during the six months ended June 30, 2006 and 2005, respectively.

The Company has held a minority equity interest in an unconsolidated joint venture entity since 2001. In 2005, the entity engaged a financial advisor to explore strategic alternatives to maximize its equity value and a non-binding

acquisition proposal was received. Although the 2005 acquisition proposal was never consummated, it could have resulted in an estimated gain to the Company of approximately \$5.0 to \$10.0 million. The entity has recently renewed its efforts to explore an acquisition transaction. Company management currently anticipates that the acquisition of the entity, should it occur, could result in a gain to the Company that may be substantially more than estimated in 2005. There can be no assurance, however, that the entity will receive an acceptable proposal or that an acquisition or similar transaction will be effected.

On July 27, 2006, the Company's Board of Directors passed a resolution to increase quarterly dividends to common shareholders to \$0.61 per common share until further notice. Previously, dividends to common shareholders were \$0.58 per common share each calendar quarter.

Table of Contents**RESULTS OF OPERATIONS**

Net Interest Income. Net interest income, the Company's largest source of operating income, is derived from interest, dividends and fees received on interest earning assets, less interest expense incurred on interest bearing liabilities. The most significant impact on the Company's net interest income between periods is derived from the interaction of changes in the volume of and rates earned or paid on interest earning assets and interest bearing liabilities (spread). The volume of loans, investment securities and other interest earning assets, compared to the volume of interest bearing deposits and indebtedness, combined with the spread, produces changes in the net interest income between periods. Noninterest-bearing sources of funds, such as demand deposits and stockholders' equity, also support earning assets. The impact of free funding sources is captured in the net interest margin, which is calculated as net interest income divided by average earning assets. Given the interest free nature of free funding sources, the net interest margin is generally higher than the spread.

The following tables present, for the periods indicated, condensed average balance sheet information for the Company, together with interest income and yields earned on average interest earning assets and interest expense and rates paid on average interest bearing liabilities.

Average Balance Sheets, Yields and Rates

(Dollars in thousands)

	Three Months Ended June 30,					
	2006			2005		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Interest earning assets:						
Loans (1)	\$ 3,190,310	60,191	7.57%	\$ 2,830,362	46,865	6.64%
Investment securities (1)	1,029,513	11,840	4.61	864,639	8,811	4.09
Federal funds sold	31,393	414	5.29	76,704	568	2.97
Interest bearing deposits in banks	6,987	75	4.31	20,287	139	2.75
Total interest earning assets	4,258,203	72,520	6.83%	3,791,992	56,383	5.96%
Noninterest earning assets	442,759			458,597		
Total assets	\$ 4,700,962			\$ 4,250,589		