

TRI COUNTY FINANCIAL CORP /MD/

Form 10-Q

May 11, 2007

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

(Mark One)

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

**For the Quarterly Period Ended March 31, 2007**

**OR**

**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 0-18279  
Tri-County Financial Corporation  
(Exact name of registrant as specified in its charter)**

Maryland  
(State of other jurisdiction of  
incorporation or organization)

52-1652138  
(I.R.S. Employer  
Identification No.)

3035 Leonardtown Road, Waldorf, Maryland  
(Address of principal executive offices)

20601  
(Zip Code)

(301) 843-0854  
(Registrant's telephone number, including area code)

Not applicable

(Former name, former address and former fiscal year, if changed since last report)

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.)

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

As of April 26, 2007 the registrant had 2,653,806 shares of common stock outstanding.

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FORM 10-Q**

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**Table of Contents****PART I FINANCIAL INFORMATION****ITEM I. FINANCIAL STATEMENTS****TRI-COUNTY FINANCIAL CORPORATION****CONSOLIDATED BALANCE SHEETS MARCH 31, 2007 AND DECEMBER 31, 2006 (UNAUDITED)**

|   | March 31, 2007        | December 31,<br>2006  |
|---|-----------------------|-----------------------|
| <b>ASSETS</b>   |                       |                       |
| Cash and due from banks   | \$ 2,545,692          | \$ 3,157,595          |
| Federal Funds sold  | 608,539               | 772,351               |
| Interest-bearing deposits with banks  | 11,453,211            | 14,260,560            |
| Securities available for sale   | 9,129,840             | 9,301,676             |
| Securities held to maturity at amortized cost   | 95,180,384            | 97,804,849            |
| Federal Home Loan Bank and Federal Reserve Bank stock at cost   | 5,400,900             | 6,100,400             |
| Loans receivable net of allowance for loan losses of \$3,984,655 and \$3,783,721, respectively                    | 436,331,951           | 422,479,799           |
| Premises and equipment, net   | 7,960,344             | 6,822,461             |
| Foreclosed real estate  | 460,884               | 460,884               |
| Accrued interest receivable   | 2,866,145             | 2,837,413             |
| Investment in bank owned life insurance   | 8,845,278             | 8,762,761             |
| Other assets  | 2,665,045             | 2,735,265             |
| <b>TOTAL ASSETS</b>   | <b>\$ 583,448,213</b> | <b>\$ 575,496,014</b> |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                       |                       |
| <b>LIABILITIES:</b>   |                       |                       |
| Noninterest-bearing deposits  | \$ 48,379,608         | \$ 43,723,436         |
| Interest-bearing deposits   | 393,148,950           | 374,289,966           |
| Total deposits  | 441,528,558           | 418,013,402           |
| Short-term borrowings   | 609,816               | 6,567,702             |
| Long-term debt  | 86,035,980            | 96,045,936            |
| Guaranteed preferred beneficial interest in junior subordinated debentures  | 12,000,000            | 12,000,000            |
| Accrued expenses and other liabilities  | 4,499,240             | 5,139,637             |
| Total liabilities   | 544,673,594           | 537,766,677           |
| <b>STOCKHOLDERS EQUITY:</b>   |                       |                       |
| Common stock par value \$.01; authorized - 15,000,000 shares; issued 2,647,003 and 2,642,288 shares, respectively | 26,470                | 26,423                |
| Additional paid in capital  | 9,538,076             | 9,499,946             |
| Retained earnings   | 29,349,523            | 28,353,792            |

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|  |                |                |
|--|----------------|----------------|
| Accumulated other comprehensive loss       | (42,448)       | (53,822)       |
| Unearned ESOP shares                       | (97,002)       | (97,002)       |
| <br>                                       |                |                |
| Total stockholders' equity                 | 38,774,619     | 37,729,337     |
| <br>                                       |                |                |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 583,448,213 | \$ 575,496,014 |

See notes to consolidated financial statements

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TRI-COUNTY FINANCIAL CORPORATION  
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)  
THREE MONTHS ENDED MARCH 31, 2007 AND 2006

|   | 2007         | 2006         |
|---|--------------|--------------|
| INTEREST INCOME:  |              |              |
| Interest and fees on loans                              | \$ 8,059,141 | \$ 6,663,527 |
| Taxable interest and dividends on investment securities | 1,428,541    | 1,591,302    |
| Interest on deposits with banks                         | 36,510       | 45,130       |
| Total interest income                                   | 9,524,192    | 8,299,959    |
| INTEREST EXPENSE:                                       |              |              |
| Interest on deposits                                    | 3,646,103    | 2,462,742    |
| Interest on short-term borrowings                       | 28,280       | 228,495      |
| Interest on long-term debt                              | 1,306,649    | 1,354,579    |
| Total interest expenses                                 | 4,981,032    | 4,045,816    |
| NET INTEREST INCOME                                     | 4,543,160    | 4,254,143    |
| PROVISION FOR LOAN LOSSES                               | 256,526      | 86,485       |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES     | 4,286,634    | 4,167,658    |

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TRI-COUNTY FINANCIAL CORPORATION  
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)  
THREE MONTHS ENDED MARCH 31, 2007 AND 2006

|   | 2007         | 2006       |
|---|--------------|------------|
| NONINTEREST INCOME:   |              |            |
| Loan appraisal, credit, and miscellaneous charges           | 63,588       | 98,617     |
| Net gain on the sale of foreclosed property                 | 66,428       |            |
| Income from bank owned life insurance                       | 82,517       | 70,772     |
| Gain on the sale of investment securities                   | 16,912       |            |
| Service charges   | 321,248      | 308,329    |
| Total noninterest income                                    | 550,693      | 477,718    |
| NONINTEREST EXPENSE:  |              |            |
| Salary and employee benefits                                | 1,883,486    | 1,661,371  |
| Occupancy   | 311,430      | 279,307    |
| Advertising   | 161,123      | 145,208    |
| Data processing   | 187,591      | 220,234    |
| Legal and professional fees                                 | 116,605      | 239,014    |
| Depreciation of furniture, fixtures, and equipment          | 119,258      | 112,496    |
| Telephone communications                                    | 22,911       | 22,721     |
| ATM expenses  | 67,017       | 57,322     |
| Office supplies   | 46,461       | 35,711     |
| Office equipment  | 11,210       | 12,793     |
| Other   | 334,058      | 344,378    |
| Total noninterest expenses                                  | 3,261,150    | 3,130,555  |
| INCOME BEFORE INCOME TAXES                                  | 1,576,177    | 1,514,821  |
| Income tax expense  | 566,558      | 541,684    |
| NET INCOME  | 1,009,619    | 973,137    |
| OTHER COMPREHENSIVE INCOME NET OF TAX                       |              |            |
| Net unrealized holding gains (losses) arising during period | 11,374       | (161,787)  |
| COMPREHENSIVE INCOME  | \$ 1,020,993 | \$ 811,350 |
| INCOME PER COMMON SHARE                                     |              |            |
| Basic   | \$ 0.38      | \$ 0.37    |
| Diluted   | 0.36         | 0.35       |
| See notes to consolidated financial statements              |              |            |

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**TRI-COUNTY FINANCIAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**  
**THREE MONTHS ENDED MARCH 31, 2007 AND 2006**

|  | <b>Three Months Ended</b> |              |
|--|---------------------------|--------------|
|  | <b>March 31,</b>          |              |
|  | <b>2007</b>               | <b>2006</b>  |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |                           |              |
| Net income   | \$ 1,009,619              | \$ 973,137   |
| Adjustments to reconcile net income to net cash provided (used) by operating activities:         |                           |              |
| Stock Based Compensation Expense   |                           | 60,000       |
| Provision for loan losses  | 256,526                   | 86,485       |
| Gain on sales of investment securities   | (16,912)                  |              |
| Depreciation and amortization  | 242,766                   | 213,856      |
| Net amortization of premium/discount on investment securities                                    | 6,758                     | (10,502)     |
| Increase in cash surrender of bank owned life insurance  | (82,517)                  | (70,772)     |
| Deferred income tax (benefit) expense  | (170,232)                 | 75,883       |
| Increase in accrued interest receivable  | (28,732)                  | (60,021)     |
| Increase (decrease) in deferred loan fees  | 43,633                    | (29,261)     |
| Increase (decrease) in accounts payable, accrued expenses, other liabilities                     | (706,825)                 | 24,228       |
| Decrease in other assets   | 234,592                   | 98,558       |
| <br>   |                           |              |
| Net cash provided by operating activities  | 788,676                   | 1,361,591    |
| <br>   |                           |              |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |                           |              |
| Purchase of investment securities available for sale   | (36,429)                  | (11,694)     |
| Proceeds from sale, redemption or principal payments of investment securities available for sale | 241,903                   | 163,379      |
| Purchase of investment securities held to maturity   |                           | (3,500,000)  |
| Proceeds from maturities or principal payments of investment securities held to maturity         | 2,618,216                 | 5,883,155    |
| Net redemption of FHLB and Federal Reserve stock   | 699,500                   | 121,100      |
| Loans originated or acquired   | (39,525,440)              | (36,968,947) |
| Principal collected on loans   | 25,373,129                | 26,803,170   |
| Purchase of Bank Owned Life Insurance  |                           | (2,000,000)  |
| Purchase of premises and equipment   | (1,380,648)               | (230,707)    |
| Proceeds from foreclosed real estate   | 66,428                    |              |
| <br>   |                           |              |
| Net cash used in investing activities  | (11,943,341)              | (9,740,544)  |



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**TRI-COUNTY FINANCIAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS(UNAUDITED)**  
**THREE MONTHS ENDED MARCH 31, 2007 AND 2006**

|   | <b>Three Months Ended</b> |               |
|---|---------------------------|---------------|
|   | <b>March 31,</b>          |               |
|   | <b>2007</b>               | <b>2006</b>   |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>              |                           |               |
| Net increase in deposits                                  | 23,515,156                | 8,744,990     |
| Proceeds from long-term borrowings                        |                           | 260,000       |
| Payments of long-term borrowings                          | (10,009,956)              | (8,546)       |
| Net decrease in short term borrowings                     | (5,957,886)               | (4,569,387)   |
| Exercise of stock options                                 | 38,183                    | 57,344        |
| Redemption of common stock                                | (13,896)                  | (144,710)     |
| <br>  |                           |               |
| Net cash provided by financing activities                 | 7,571,601                 | 4,339,691     |
| <br>  |                           |               |
| DECREASE IN CASH AND CASH EQUIVALENTS                     | (3,583,064)               | (4,039,262)   |
| <br>  |                           |               |
| CASH AND CASH EQUIVALENTS JANUARY 1                       | 18,190,506                | 22,575,240    |
| <br>  |                           |               |
| CASH AND CASH EQUIVALENTS MARCH 31                        | \$ 14,607,442             | \$ 18,535,978 |
| <br>  |                           |               |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b> |                           |               |
| Cash paid during the three months for:                    |                           |               |
| Interest  | \$ 5,018,941              | \$ 4,068,462  |
| Income taxes  | \$ 332,600                | \$ 613,000    |

See notes to consolidated financial statements

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**1. BASIS OF PRESENTATION**

*General* - The consolidated financial statements of Tri-County Financial Corporation (the Company ) and its wholly owned subsidiary, Community Bank of Tri-County (the Bank ) included herein are unaudited. However, they reflect all adjustments consisting only of normal recurring accruals that, in the opinion of management, are necessary to present fairly the Company s financial condition, results of operations, and cash flows for the periods presented. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. The Company believes that the disclosures are adequate to make the information presented not misleading. The balances as of December 31, 2006 have been derived from audited financial statements. There have been no significant changes to the Company s accounting policies as disclosed in the 2006 Annual Report. The results of operations for the three months ended March 31, 2007 are not necessarily indicative of the results of operations to be expected for the remainder of the year or any other period. Certain previously reported amounts have been restated to conform to the 2007 presentation.

It is suggested that these consolidated financial statements be read in conjunction with the consolidated financial statements and notes included in the Company s Annual Report for the year ended December 31, 2006.

**2. NATURE OF BUSINESS**

The Company, through its bank subsidiary, provides domestic financial services primarily in southern Maryland. The primary financial services include real estate, commercial and consumer lending, as well as traditional demand deposits and savings products.

**3. INCOME TAXES**

The Company uses the liability method of accounting for income taxes as required by SFAS No. 109, Accounting for Income Taxes. Under the liability method, deferred-tax assets and liabilities are determined based on differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities (i.e., temporary differences) and are measured at the enacted rates that will be in effect when these differences reverse. The Company also adopted FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN48 ) on January 1, 2007. FIN 48 is an interpretation of FASB Statement No. 109,

Accounting for Income Taxes, and seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. In addition, FIN 48 provides guidance on de-recognition, classification, interest and penalties, and accounting in interim periods and requires expanded disclosure with respect to the uncertainty in income taxes. There was no cumulative effect as a result of applying FIN 48. No adjustment was made to our opening balance of retained earnings.

**4. EARNINGS PER SHARE**

Earnings per common share are computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period, including any potential dilutive common shares outstanding, such as options and warrants. As of March 31, 2007, there were no shares excluded from the diluted net income per share computation because inclusion of these options would be anti-dilutive. Basic and diluted earnings per share, have been computed based on weighted-average

common and common equivalent shares outstanding as follows:

|         | <b>Three Months Ended</b> |             |
|---------|---------------------------|-------------|
|         | <b>March 31,</b>          |             |
|         | <b>2007</b>               | <b>2006</b> |
| Basic   | 2,643,950                 | 2,639,962   |
| Diluted | 2,829,778                 | 2,811,823   |

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Share and per share data have been adjusted to reflect the three for two common stock split effected in November 2006 as if it had occurred on January 1, 2006.

**5. STOCK-BASED COMPENSATION**

The Company has stock option and incentive plans to attract and retain key personnel in order to promote the success of the business. These plans are described in note 12 to the financial statements included in our Annual Report to Stockholders for the year ended December 31, 2006. No compensation related expense related to stock options has been recognized in the quarter ended March 31, 2007 and during 2006.

The Company and the Bank currently maintain incentive plans which provide for payments to be made in either cash or stock options. The Company has accrued the full amounts due under these plans, but currently it is not possible to identify the portion that will be paid out in the form of stock options.

A summary of the Company's stock option plans as of March 31, 2007 and changes during the three-month period then ended is presented below:

|                                  | Shares  | Weighted<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value | Weighted-Average<br>Contractual<br>Life<br>Remaining In<br>Years |
|----------------------------------|---------|--|---------------------------------|--|
| Outstanding at December 31, 2006 | 417,097 | \$ 13.86                                 |                                 |  |
| Granted                          |         |  |                                 |  |
| Exercised                        | (5,301) | 7.20                                     |                                 |  |
| Expired                          |         |  |                                 |  |
| Forfeited                        |         |  |                                 |  |
| Outstanding at March 31, 2007    | 411,796 | \$ 13.95                                 | \$ 5,272,812                    | 5.5  |
| Exercisable at March 31, 2007    | 411,796 | \$ 13.95                                 | \$ 5,272,812                    | 5.5  |

Share and per share data have been adjusted to reflect the three for two common stock split effected in November 2006 as if it had occurred on January 1, 2006.

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**6. GUARANTEED PREFERRED BENEFICIAL INTEREST IN JUNIOR SUBORDINATED DEBENTURES**

On June 15, 2005, Tri County Capital Trust II ( Capital Trust II ), a Delaware business trust formed, funded and wholly owned by the Company, issued \$5,000,000 of capital securities with an interest rate of 5.07% in a private pooled transaction. The rate is based on the 90-day LIBOR rate plus 1.70%. The Trust used the proceeds from this issuance to purchase \$5.2 million of the Company's junior subordinated debentures. The interest rate on the debentures and the trust preferred securities is variable and adjusts quarterly. The Company has, through various contractual arrangements, fully and unconditionally guaranteed all of Capital Trust II's obligations with respect to the capital securities. These capital securities qualify as Tier I capital and are presented in the Consolidated Balance Sheets as Guaranteed Preferred Beneficial Interests in Junior Subordinated Debentures. Both the capital securities of Capital Trust II and the junior subordinated debentures are scheduled to mature on June 15, 2035, unless called by the Company not earlier than June 15, 2010.

On July 22, 2004, Tri County Capital Trust I ( Capital Trust I ), a Delaware business trust formed, funded and wholly owned by the Company, issued \$7,000,000 of capital securities with an interest rate of 4.22% in a private pooled transaction. The rate is based on the 90-day LIBOR rate plus 2.60%. The Trust used the proceeds from this issuance to purchase \$7.2 million of the Company's junior subordinated debentures. The interest rate on the debentures and the trust preferred securities is variable and adjusts quarterly. The Company has, through various contractual arrangements, fully and unconditionally guaranteed all of Capital Trust I's obligations with respect to the capital securities. These capital securities qualify as Tier I capital and are presented in the Consolidated Balance Sheets as Guaranteed Preferred Beneficial Interests in Junior Subordinated Debentures. Both the capital securities of Capital Trust I and the junior subordinated debentures are scheduled to mature on July 22, 2034, unless called by the Company not earlier than July 22, 2009.

Costs associated with the issuance of the trust-preferred securities were less than \$10,000 and were expensed as period costs.

**7. NEW ACCOUNTING STANDARDS**

In September 2006, the Financial Accounting Standards Board, the ( FASB ) issued Statements of Financial Accounting Standards ( SFAS ) 157, Fair Value Measurements. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 applies to existing accounting pronouncements that require or permit fair value measurements in which FASB had previously concluded fair value is the most relevant measurement attribute. Accordingly, SFAS 157 does not require any new fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, with early adoption encouraged. The Company is currently evaluating the impact the adoption of this interpretation will have on its financial condition and results of operations.

SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115. SFAS 159 permits entities to choose to measure eligible items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. The fair value option (i) may be applied instrument by instrument, with certain exceptions, (ii) is irrevocable (unless a new election date occurs) and (iii) is applied only to entire instruments and not to portions of instruments. SFAS 159 is effective for the Corporation on January 1, 2008 and is not expected to have a significant impact on the Corporation's financial statements.

In September 2006, the FASB ratified the consensus reached by the EITF on Issue No. 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. EITF 06-4 requires the recognition of a liability and related compensation costs for endorsement split-dollar life insurance policies that provide a benefit to an employee that extends to postretirement periods as defined in SFAS No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions. The EITF reached a consensus that Bank Owned Life Insurance policies purchased for this purpose do not effectively settle the entity's obligation to the employee in this regard and, thus, the entity must record compensation costs and a related liability. Entities should recognize the effects of applying this Issue through either, (a) a change in

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accounting principle through a cumulative-effective adjustment to retained earnings or to other components of equity or net assets in the balance sheet as of the beginning of the year of adoption, or (b) a change in accounting principle through retrospective application to all prior periods. This Issue is effective for fiscal years beginning after December 15, 2007. Management is currently evaluating the impact of adopting this Issue on the Company's financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 is an interpretation of FASB Statement No. 109, Accounting for Income Taxes, and seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. In addition, FIN 48 provides guidance on de-recognition, classification, interest and penalties, and accounting in interim periods and requires expanded disclosure with respect to the uncertainty in income taxes. We adopted the provisions of FIN 48 on January 1, 2007. There was no cumulative effect as a result of applying FIN 48. No adjustment was made to our opening balance of retained earnings.

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**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

This document contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including discussions of Tri-County Financial Corporation's (the Company) goals, strategies and expected outcomes; estimates of risks and future costs; and reports of the Company's ability to achieve its financial and other goals. Forward-looking statements are generally preceded by terms such as expects, believes, anticipates, intends and similar expressions. These forward-looking statements are subject to significant known and unknown risks and uncertainties because they are based upon future economic conditions, particularly interest rates, competition within and without the banking industry, changes in laws and regulations applicable to the Company, change in accounting principles, and various other matters. Additional factors that may affect our results are discussed in the Company's Annual Report on Form 10-K (the Form 10-K) and this Quarterly Report on Form 10-Q under Item 1.A. Risk Factors. Because of these uncertainties, there can be no assurance that actual results, performance or achievements of the Company will not differ materially from any future results, performance or achievements expressed or implied by these forward-looking statements. The Company does not undertake and specifically disclaims any obligation to publicly release the result of any revisions that may be made to any forward-looking statement to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

**GENERAL**

The Company is a bank holding company organized in 1989 under the laws of the State of Maryland. It owns all the outstanding shares of capital stock of Community Bank of Tri-County (the Bank), a Maryland-chartered commercial bank. The Company engages in no significant activity other than holding the stock of the Bank, the payment of its subordinated debt, and directing the business of the Bank. Accordingly, the information set forth in this report, including financial statements and related data, relates primarily to the Bank and its subsidiaries.

The Bank serves the Southern Maryland area through its main office and eight branches located in Waldorf, Bryans Road, Dunkirk, Leonardtown, La Plata, Charlotte Hall, Prince Frederick and California, Maryland. The Bank is engaged in the commercial and retail banking business as authorized by the banking statutes of the State of Maryland and applicable Federal regulations. The Bank accepts demand and time deposits and uses these funds along with borrowings from the Federal Home Loan Bank (the FHLB), to fund loan originations to individuals, associations, partnerships and corporations. The Bank makes real estate loans including residential first and second mortgage loans, home equity lines of credit and commercial mortgage loans. The Bank also makes commercial loans including secured and unsecured loans. The Bank is a member of the Federal Reserve and FHLB Systems. The Federal Deposit Insurance Corporation provides deposit insurance coverage up to applicable limits.

Since its conversion to a state chartered commercial bank in 1997, the Bank has sought to increase its commercial, commercial real estate, construction, second mortgage, home equity, and consumer lending business as well as the level of transactional deposits to levels consistent with similarly sized commercial banks. As a result of this emphasis, the Bank's percentage of assets invested in residential first mortgage lending has declined since 1997. Conversely, targeted loan types have increased. The Bank has also seen an increase in transactional deposit accounts while the percentage of total liabilities represented by certificates of deposits has declined. Management believes that these changes will enhance the Bank's overall long-term financial performance.

Management recognizes that the shift in composition of the Bank's loan portfolio away from residential first mortgage lending will tend to increase its exposure to credit losses. The Bank continues to evaluate its allowance for loan losses and the associated provision to compensate for the increased risk. Any evaluation of the allowance for loan losses is inherently inexact and reflects management's expectations as to future economic conditions in the Southern Maryland area as well as individual borrower's circumstances. Management believes that its allowance for loan losses is adequate. For further information on the Bank's allowance for loan losses see the discussion in the sections captioned Financial Condition and Critical Accounting Policies as well as the relevant discussions in the Form 10-K and Annual Report for the year ended December 31, 2006.

After a series of increases in the Federal Funds rate, the Federal Reserve has not changed the Federal Funds rate since June 2006. The increases enacted up to June 2006 had the effect of pushing short-term rates higher while longer-term rates remained essentially unchanged. The difference between short- and long-term rates has decreased, creating a flat



yield curve. For the last several quarters, many market participants have signaled through price expectations that they

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expect a Federal Funds rate cut in response to their perceptions of a slowing economy and a deflation in housing prices. However, official Federal Reserve documents indicate that the Federal Reserve still believe that consumer price inflation remains a threat. As a result of these and other factors the Federal Reserve has decided to leave the Federal Funds rate unchanged.

## SELECTED FINANCIAL DATA

|                            | <b>Three Months Ended<br/>March 31,</b> |              |
|----------------------------|---|--------------|
|                            | <b>2007</b>                             | <b>2006</b>  |
| Condensed Income Statement |   |              |
| Interest Income            | \$ 9,524,192                            | \$ 8,299,959 |
| Interest Expense           | 4,981,032                               | 4,045,816    |
| Net Interest Income        | 4,543,160                               | 4,254,143    |
| Provision for Loan Losses  | 256,526                                 | 86,485       |
| Noninterest Income         | 550,693                                 | 477,718      |
| Noninterest Expense        | 3,261,150                               | 3,130,555    |
| Income Before Income Taxes | 1,576,177                               | 1,514,821    |
| Income Taxes               | 566,558                                 | 541,684      |
| Net Income                 | \$ 1,009,619                            | \$ 973,137   |

## Per Common Share

|                  |         |         |
|------------------|---------|---------|
| Basic Earnings   | \$ 0.38 | \$ 0.37 |
| Diluted Earnings | \$ 0.36 | \$ 0.35 |

Share and per share data have been adjusted to reflect the three for two common stock split effected in November 2006 as if it had occurred on January 1, 2006.

## RESULTS OF OPERATIONS

Net income for the three-month period ended March 31, 2007 totaled \$1,009,619 (\$0.38 basic and \$0.36 diluted earnings per share) compared to \$973,137 (\$0.37 basic and \$0.35 diluted earnings per share) for the same period in the prior year. This increase of \$36,482, or 3.75%, was caused by increases in net interest and noninterest income partially offset by increases in provision for loan losses and noninterest expenses.

For the three-month period ended March 31, 2007, interest income increased by \$1,224,233, or 14.75%, to \$9,524,192. The increase was due to higher average balances of earning assets and higher rates earned on these assets. The Bank continued to increase balances of loans which tend to have higher yields and decrease balances of cash and investment securities which tend to have lower yields. Interest expense increased to \$4,981,032 in the three-month period ended March 31, 2007 as compared to \$4,045,816 in the same period in the prior year, an increase of \$935,216 or 23.12%. The increase was the result of higher average balances and higher rates. Although overall rates paid on interest earning liabilities increased, the Bank's continued shifting from wholesale liabilities to retail deposits helped to control the overall amount of interest expense.

Provision for loan losses increased to \$256,526 for the three months ended March 31, 2007 from \$86,485 for the three-month period ended March 31, 2006. The increase in the provision was caused by the increases in the Bank's loan portfolio, especially in commercial loans, which tend to have a higher risk of default than one- to four family residential real estate loans. In addition, the Bank experienced \$57,325 of loan charge-offs in the current period compared to \$6,636 in the corresponding period in 2006. Higher charge-offs were caused by developments in certain individual loans and do not appear to indicate systemic weaknesses in our loan standards. While loan charge-offs have increased in the current period, total delinquency has decreased from December 31, 2006. Management will continue to periodically review its allowance for loan losses and the related provision and adjust as deemed necessary. This review will include a review of economic conditions nationally and locally, as well as a review of the performance of significant major loans and the overall portfolio.



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|   | Three Months Ended March<br>31, |                   |               | %<br>Change   |
|---|---------------------------------|-------------------|---------------|---------------|
|   | 2007                            | 2006              | \$ Change     |               |
| <b>NONINTEREST INCOME:</b>                        |                                 |                   |               |               |
| Loan appraisal, credit, and miscellaneous charges | \$ 63,588                       | \$ 98,617         | (35,029)      | (35.52)%      |
| Net gain on the sale of foreclosed property       | 66,428                          |                   | 66,428        | NA            |
| Income from bank owned life insurance             | 82,517                          | 70,772            | 11,745        | 16.60%        |
| Gain on sale of investment securities             | 16,912                          |                   | 16,912        | 100.00%       |
| Service charges                                   | 321,248                         | 308,329           | 12,919        | 4.19%         |
| <b>Total noninterest income</b>                   | <b>\$ 550,693</b>               | <b>\$ 477,718</b> | <b>72,975</b> | <b>15.28%</b> |

Loan appraisal, credit, and miscellaneous charges decreased based upon changes in market conditions which have made it harder to charge for certain fees. The increase in gain on the sale of foreclosed property reflects sale of property for \$66,428 in 2007 compared to no foreclosed property sold in the prior year. Income from bank-owned life insurance reflects a higher average balance of Bank owned life insurance in the current year. The change in gain on sale of investment securities reflects the sale of \$233,743 in investment securities in 2007 compared to no investment sales in 2006. The increase in service charges reflects higher transaction account balances as well as increased fees.

|  | Three Months Ended March<br>31, |                     |                   | %<br>Change  |
|--|---------------------------------|---------------------|-------------------|--------------|
|  | 2007                            | 2006                | \$ Change         |              |
| <b>NONINTEREST EXPENSE:</b>                        |                                 |                     |                   |              |
| Salary and employee benefits                       | \$ 1,883,486                    | \$ 1,661,371        | \$ 222,115        | 13.37%       |
| Occupancy  | 311,430                         | 279,307             | 32,123            | 11.50%       |
| Advertising  | 161,123                         | 145,208             | 15,915            | 10.96%       |
| Data processing                                    | 187,591                         | 220,234             | (32,643)          | (14.82)%     |
| Legal and professional fees                        | 116,605                         | 239,014             | (122,409)         | (51.21)%     |
| Depreciation of furniture, fixtures, and equipment | 119,258                         | 112,496             | 6,762             | 6.01%        |
| Telephone communications                           | 22,911                          | 22,721              | 190               | 0.84%        |
| ATM expenses                                       | 67,017                          | 57,322              | 9,695             | 16.91%       |
| Office supplies                                    | 46,461                          | 35,711              | 10,750            | 30.10%       |
| Office equipment                                   | 11,210                          | 12,793              | (1,583)           | (12.37)%     |
| Other  | 334,058                         | 344,378             | (10,320)          | (3.00)%      |
| <b>Total noninterest expenses</b>                  | <b>\$ 3,261,150</b>             | <b>\$ 3,130,555</b> | <b>\$ 130,595</b> | <b>4.17%</b> |

Salary and employee benefits costs increased because of increases in the number of personnel employed by the Bank and increased benefits costs. Employees were added to staff some administrative and sales positions. In addition, the Bank's average cost per employee has increased in the last year due to tight labor markets and the need to add highly skilled employees as the Bank grows in size and complexity. Occupancy expense increased as the Bank opened temporary space in connection with the rebuilding of a branch, as well as increases in land rentals on certain properties. Advertising expenses increased as the Bank has continued to focus on increasing market presence in southern Maryland. The drop in data processing expense reflects improved pricing in this area from certain vendors. The declines in legal and professional fees reflect the high level of Sarbanes-Oxley preparation activity in the prior

year compared to the current year. Depreciation expense includes increases due to a remodeled home office and additional branch equipment. ATM expenses reflect the replacement of older machines at some locations and additional usage of existing machines.

Income tax expense increased to \$566,558, or 35.95%, of pretax income, in the current year, from \$541,684, or 35.76%, of pretax income, in the prior year.

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## FINANCIAL CONDITION

## Assets

|   | March 31,<br>2007     | December 31,<br>2006  | \$ Change           | %<br>Change  |
|---|-----------------------|-----------------------|---------------------|--------------|
| Cash and due from banks   | \$ 2,545,692          | \$ 3,157,595          | \$ (611,903)        | (19.38)%     |
| Federal Funds sold  | 608,539               | 772,351               | (163,812)           | (21.21)%     |
| Interest-bearing deposits with banks  | 11,453,211            | 14,260,560            | (2,807,349)         | (19.69)%     |
| Securities available for sale   | 9,129,840             | 9,301,676             | (171,836)           | (1.85)%      |
| Securities held to maturity at amortized cost   | 95,180,384            | 97,804,849            | (2,624,465)         | (2.68)%      |
| Federal Home Loan Bank and Federal Reserve Bank stock at cost                                 | 5,400,900             | 6,100,400             | (699,500)           | (11.47)%     |
| Loans receivable net of allowance for loan losses of \$3,984,655 and \$3,783,721 respectively | 436,331,951           | 422,479,799           | 13,852,152          | 3.28%        |
| Premises and equipment, net   | 7,960,344             | 6,822,461             | 1,137,883           | 16.68%       |
| Foreclosed real estate  | 460,884               | 460,884               |                     | 0.00%        |
| Accrued interest receivable   | 2,866,145             | 2,837,413             | 28,732              | 1.01%        |
| Investment in bank owned life insurance   | 8,845,278             | 8,762,761             | 82,517              | 0.94%        |
| Other assets  | 2,665,045             | 2,735,265             | (70,220)            | (2.57)%      |
| <b>TOTAL ASSETS</b>   | <b>\$ 583,448,213</b> | <b>\$ 575,496,014</b> | <b>\$ 7,952,199</b> | <b>1.38%</b> |

Cash and due from banks, Federal Funds sold and interest-bearing deposits with banks decreased as the funds were used to fund growth in loans. Investment securities, including both the available for sale and held to maturity portfolios, decreased because the Bank has continued to use investment repayments, which have lower yields, as a source of funds to build its loan portfolio, which have higher yields and to pay down short-term borrowings. The Bank's holdings of Federal Reserve and Federal Home Loan Bank stock decreased because the Bank has decreased its borrowings from the Federal Home Loan Bank system, which decreased its stock ownership requirements. The loan portfolio increased as a result of increases in the Bank's portfolio of residential construction loans, commercial real estate loans, and commercial lines of credit due to continued marketing emphasis on these loan types.

Details of the Bank's loan portfolio are presented below:

|                             | March 31, 2007 |         | December 31, 2006 |         |
|-----------------------------|----------------|---------|-------------------|---------|
|                             | Amount         | %       | Amount            | %       |
| Real Estate Loans           |                |         |                   |         |
| Commercial                  | \$ 179,362,216 | 40.69%  | \$ 177,923,349    | 41.69%  |
| Residential first mortgages | 81,366,596     | 18.46%  | 80,781,271        | 18.93%  |
| Residential construction    | 54,311,102     | 12.32%  | 42,746,306        | 10.01%  |
| Second mortgage loans       | 24,202,421     | 5.49%   | 24,572,235        | 5.76%   |
| Commercial lines of credit  | 80,033,046     | 18.15%  | 79,629,910        | 18.66%  |
| Consumer loans              | 2,670,238      | 0.60%   | 2,812,945         | 0.66%   |
| Commercial equipment        | 18,904,955     | 4.29%   | 18,287,840        | 4.29%   |
|                             | 440,850,574    | 100.00% | 426,753,856       | 100.00% |

|                         |                |       |                |       |
|-------------------------|----------------|-------|----------------|-------|
| Less:                   |                |       |                |       |
| Deferred loan fees      | 533,968        | 0.12% | 490,335        | 0.11% |
| Allowance for loan loss | 3,984,655      | 0.90% | 3,783,721      | 0.89% |
|                         | 4,518,623      |       | 4,274,056      |       |
|                         | \$ 436,331,951 |       | \$ 422,479,800 |       |

At March 31, 2007, the Bank's allowance for loan losses totaled \$3,984,655 or 0.90% of loan balances as compared to \$3,783,721 or 0.89% of loan balances at December 31, 2006. Management's determination of the adequacy of the allowance is based on a periodic evaluation of the portfolio with consideration given to the overall loss experience; current economic conditions; volume, growth and composition of the loan portfolio; financial condition of the borrowers; and other relevant factors that, in management's judgment, warrant recognition in providing an adequate allowance. Management believes that the allowance is adequate. Additional loan information for prior years is presented in the Company's Form 10-K.

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The following table summarizes changes in the allowance for loan losses for the periods indicated.

|                                  | 3 Months<br>Ended<br>March 31, 2007 | 3 Months<br>Ended<br>March 31, 2006 |
|----------------------------------|-------------------------------------|-------------------------------------|
| Beginning Balance                | \$ 3,783,721                        | \$ 3,383,334                        |
| Charge Offs                      | 57,325                              | 6,636                               |
| Recoveries                       | 1,733                               |                                     |
| Net Charge Offs                  | 55,592                              | 6,636                               |
| Additions Charged to Operations  | 256,526                             | 86,485                              |
| Balance at the end of the Period | \$ 3,984,655                        | \$ 3,463,183                        |

The following table provides information with respect to our non-performing loans at the dates indicated.

|  | Balances as of<br>March 31,<br>2007 | Balances as of<br>December 31,<br>2006 |
|--|-------------------------------------|--|
| Accruing loans which are contractually past due 90 days or more: | \$                                  | \$                                     |
| Loans accounted for on a non-accrual basis                       | \$ 652,604                          | \$ 1,046,423                           |
| Total non-performing loans                                       | \$ 652,604                          | \$ 1,046,423                           |
| Non-performing loans to total loans                              | 0.15%                               | 0.25%                                  |
| Allowance for loan losses to non performing loans                | 610.58%                             | 361.59%                                |

No loans were considered impaired under SFAS 114.

**Liabilities**

|   | March 31,<br>2007 | December 31,<br>2006 | \$ Change    | %<br>Change |
|---|-------------------|----------------------|--------------|-------------|
| Noninterest-bearing deposits  | \$ 48,379,608     | \$ 43,723,436        | \$ 4,656,172 | 10.65%      |
| Interest-bearing deposits   | 393,148,950       | 374,289,966          | 18,858,984   | 5.04%       |
| Total deposits  | 441,528,558       | 418,013,402          | 23,515,156   | 5.63%       |
| Short-term borrowings   | 609,816           | 6,567,702            | (5,957,886)  | (90.71)%    |
| Long-term debt  | 86,035,980        | 96,045,936           | (10,009,956) | (10.42)%    |
| Guaranteed preferred beneficial interest<br>in junior subordinated debentures | 12,000,000        | 12,000,000           |              | 0.00%       |



|  |                |                |              |          |
|--|----------------|----------------|--------------|----------|
| Accrued expenses and other liabilities | 4,499,240      | 5,139,637      | (640,397)    | (12.46)% |
| Total liabilities                      | \$ 544,673,594 | \$ 537,766,677 | \$ 6,906,917 | 1.28%    |

Deposit balances increased due to the Bank's continuing efforts to increase its market share through advertising, branch improvements, and other marketing efforts. Non-interest bearing deposits increased during the three month period but many of these deposits are highly variable as to balances. The increases in deposits were used to reduce the balances of

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long-term debt and short-term borrowings. Accrued expenses and other liabilities declined due to the payment of incentives after year end and the payment of certain tax obligations.

## Stockholders Equity

|                                      | March 31,<br>2007 | December 31,<br>2006 | \$ Change    | %<br>Change |
|--------------------------------------|-------------------|----------------------|--------------|-------------|
| Common stock                         | \$ 26,470         | \$ 26,423            | \$ 47        | 0.18%       |
| Additional paid in capital           | 9,538,076         | 9,499,946            | 38,130       | 0.40%       |
| Retained earnings                    | 29,349,523        | 28,353,792           | 995,731      | 3.51%       |
| Accumulated other comprehensive loss | (42,448)          | (53,822)             | 11,374       | (21.13)%    |
| Unearned ESOP shares                 | (97,002)          | (97,002)             |              | 0.00%       |
| Total stockholders equity            | \$ 38,774,619     | \$ 37,729,337        | \$ 1,045,282 | 2.77%       |

Common stock and additional paid in capital increased due to the exercise of options. Retained earnings increased because of earnings, offset by the repurchase of 558 shares at a cost of \$13,890. Book value per share increased from \$14.28 per share to \$14.65 reflecting the total change in equity.

**LIQUIDITY AND CAPITAL RESOURCES**

The Company currently has no business other than holding the stock of the Bank and payment on its subordinated debentures. Its primary uses of funds are for the payment of dividends, the payment of interest and principal on debentures, and the repurchase of common shares. The Company's principal sources of liquidity are cash on hand and dividends received from the Bank. The Bank is subject to various regulatory restrictions on the payment of dividends. The Bank's principal sources of funds for investments and operations are net income, deposits from its primary market area, principal and interest payments on loans, interest received on investment securities and proceeds from sale and maturity of investment securities. Its principal funding commitments are for the origination or purchase of loans, the purchase of investment securities and the payment of maturing deposits. Deposits are considered a primary source of funds supporting the Bank's lending and investment activities. The Bank also uses various wholesale funding instruments including FHLB advances and reverse repurchase agreements. The Bank may borrow up to 40% of consolidated Bank assets on a line of credit available from the FHLB. As of March 31, 2007, the maximum available under this line was \$232 million, while outstanding advances totaled \$86 million. In order to draw on this line the Bank must have sufficient collateral. Qualifying collateral includes residential 1-4 family first mortgage loans, certain second mortgage loans, certain commercial real estate loans, and various investment securities. At March 31, 2007, the Bank had pledged collateral sufficient to draw \$201,862,880 under the line.

The Bank's most liquid assets are cash and cash equivalents, which are cash on hand, amounts due from financial institutions, Federal Funds sold, and money market mutual funds. The levels of such assets are dependent on the Bank's operating financing and investment activities at any given time. The variations in levels of cash and cash equivalents are influenced by deposit flows and anticipated future deposit flows.

Cash, cash equivalents, and interest-bearing deposits with banks as of March 31, 2007 totaled \$14,607,442, a decrease of \$3,583,064, or 19.70%, from the December 31, 2006 total of \$18,190,506. This decrease was due to the use of such funds to support the increase in loans and pay down short-term borrowings.

The Bank's principal sources of cash flows are its financing activities including deposits and borrowings. During the first quarter in 2007, all financing activities provided \$7,571,601 in cash compared to \$4,339,691 for the first quarter of 2006. The increase in cash flows from financing activities during the most recent period was principally due to increases in net deposits partially offset by net decreases in borrowing activities. Payments of long-term borrowings increased to \$10,009,956 in the first quarter of 2007 compared to \$8,546 in the same period of 2006. In addition, there was a net decrease in short-term borrowings in the current period of \$5,957,886 compared to a \$4,569,387 decrease in the same period in 2006. During the first quarter of 2007, net deposit growth was \$23,515,156 compared to \$8,744,990 in 2006. Operating activities provided cash of \$788,676 in the first quarter of 2007 compared to providing cash of \$1,361,591 in the first quarter of 2006. The change was caused primarily by a decrease of accounts payable

and other accrued expenses in 2007.

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The Bank's principal use of cash has been in investments in loans, investment securities and other assets. During the quarter ended March 31, 2007, the Bank invested a total of \$11,943,341 compared to \$9,740,544 in 2006. The principal reasons for the increase in cash used in investing activities was the purchase of premises and equipment and receipt of a lower amount of proceeds from maturing securities in 2007.

**REGULATORY MATTERS**

The Bank is subject to Federal Reserve Board capital requirements as well as statutory capital requirements imposed under Maryland law. At March 31, 2007, the Bank's tangible, leverage and risk-based capital ratios were 8.41%, 10.55% and 11.42%, respectively. These levels are in excess of the required 4.0%, 4.0% and 8.0% ratios required by the Federal Reserve Board as well as the 5.0%, 5.0%, and 10% ratios required to be considered well capitalized. At March 31, 2006, the Company's tangible, leverage and risk-based capital ratios were 8.79%, 11.03% and 11.90%, respectively. These levels are also in excess of the 4.0%, 4.0% and 8.0% ratios required by the Federal Reserve Board as well as the 5.0%, 5.0%, and 10% ratios required to be considered well capitalized.

**CRITICAL ACCOUNTING POLICIES**

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America and the general practices of the United States banking industry. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. The Company considers its determination of the allowance for loan losses and the valuation allowance on its foreclosed real estate to be critical accounting policies. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available. When these sources are not available, management makes estimates based upon what it considers to be the best available information.

The allowance for loan losses is an estimate of the losses that may be sustained in the loan portfolio. The allowance is based on two principles of accounting: (a) Statement on Financial Accounting Standards (SFAS) No. 5, Accounting for Contingencies, which requires that losses be accrued when they are probable of occurring and are estimable and (b) SFAS No. 114, Accounting by Creditors for Impairment of a Loan, which requires that losses be accrued when it is probable that the Company will not collect all principal and interest payments according to the contractual terms of the loan. The loss, if any, is determined by the difference between the loan balance and the value of collateral, the present value of expected future cash flows, or values observable in the secondary markets.

The loan loss allowance balance is an estimate based upon management's evaluation of the loan portfolio. Generally the allowance is comprised of a specific and a general component. The specific component consists of management's evaluation of certain loans and their underlying collateral. Loans are examined to determine the specific allowance based upon the borrower's payment history, economic conditions specific to the loan or borrower, or other factors that would impact the borrower's ability to repay the loan on its contractual basis. Management assesses the ability of the borrower to repay the loan based upon any information available. Depending on the assessment of the borrower's ability to pay the loan as well as the type, condition, and amount of collateral, management will establish an allowance amount specific to the loan.

In establishing the general component of the allowance, management analyzes non-classified and non-impaired loans in the portfolio including changes in the amount and type of loans. Management also examines the Bank's history of write-offs and recoveries within each loan category. The state of the local and national economy is also considered. Based upon these factors the Bank's loan portfolio is categorized and a loss factor is applied to each category. These

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factors may be higher or lower than the Bank's actual recent average losses in any particular loan category, particularly in loan categories where the Bank is rapidly increasing the size of its portfolio. Based upon these factors, the Bank will adjust the loan loss allowance by increasing or decreasing the provision for loan losses.

Management has significant discretion in making the judgments inherent in the determination of the provision and allowance for loan losses, including in connection with the valuation of collateral, a borrower's prospects of repayment, and in establishing allowance factors on the general component of the allowance. Changes in allowance factors will have a direct impact on the amount of the provision, and a corresponding effect on net income. Errors in management's perception and assessment of the global factors and their impact on the portfolio could result in the allowance not being adequate to cover losses in the portfolio, and may result in additional provisions or charge-offs. For additional information regarding the allowance for loan losses, refer to Notes 1 and 4 to the Consolidated Financial Statements as presented in the Company's annual report on Form 10-K.

In addition to the loan loss allowance, the Company also maintains a valuation allowance on its foreclosed real estate. As with the allowance for loan losses, the valuation allowance on foreclosed real estate is based on SFAS No. 5,

Accounting for Contingencies, as well as SFAS No. 144 Accounting for the Impairment or Disposal of Long-Lived Assets. These statements require that the Company establish a valuation allowance when it has determined that the carrying amount of a foreclosed asset exceeds its fair value. Fair value of a foreclosed asset is measured by the cash flows expected to be realized from its subsequent disposition. These cash flows should be reduced for the costs of selling or otherwise disposing of the asset.

In estimating the cash flows from the sale of foreclosed real estate, management must make significant assumptions regarding the timing and amount of cash flows. In cases where the real estate acquired is undeveloped land, management must gather the best available evidence regarding the market value of the property, including appraisals, cost estimates of development, and broker opinions. Due to the highly subjective nature of this evidence, as well as the limited market, long time periods involved, and substantial risks, cash flow estimates are highly subjective and subject to change. Errors regarding any aspect of the costs or proceeds of developing, selling, or otherwise disposing of foreclosed real estate could result in the allowance being inadequate to reduce carrying costs to fair value and may require an additional provision for valuation allowances.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK****Asset/Liability Risk Management**

Net interest income (NII), the primary component of the Company's net income, arises from the difference between the yield on interest-earning assets and the cost of interest-bearing liabilities and the relative amounts of such assets and liabilities. As interest rates change, the yield on interest-earning assets and the cost of interest bearing liabilities will also change. These changes can have a negative impact on net interest income as costs may rise faster than interest income. The variance in future financial performance caused by changes in interest rates can be broadly termed interest rate risk. Elements of interest rate risk include a mismatch between expected lives of current assets and liabilities (asset/liability mismatch), the ability of borrowers to prepay loans without penalty (prepayment risk), periodic and interest rate caps built into various loan types which limit upward interest rate adjustments, and adjustable rate liabilities and assets pricing being based upon different indices (basis risk).

The Company attempts to measure and control these risks through various tools including financial modeling of current and projected balance sheets. Financial modeling simulates the effects on the Company's financial position and net interest income of various interest rate scenarios. The Company uses several measures to gauge its interest rate risk including measuring the effect on NII of various interest rate scenarios, measuring the gap or mismatch in assets and liabilities repricing during a particular time period, and measuring the amount that the estimated market value of assets and liabilities would change given specific changes in interest rates. Modeling these calculations is inherently complex, as many important factors in these calculations are estimates of future consumer behavior based upon historical patterns. The Company uses a steady state balance sheet and parallel rate shifts in interest rates as the basis of many simulations. The Company also looks at results under non-parallel rate shifts.

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Presented below are the projected changes in NII given the parallel changes noted above:

**Projected Percentage change in Net Interest Income at March 31, 2007**

|              |              |           |              |              |
|--------------|--------------|-----------|--------------|--------------|
| +200         | +100         | No Change | -100         | -200         |
| Basis points | Basis points |           | Basis points | Basis points |
| 1.06%        | 1.00%        | 0.00%     | (1.93)%      | (7.07)%      |

The rate scenarios noted above show a slight positive change for the two higher interest rate scenarios. The down 100 basis point scenario shows a slight negative change while the down 200 basis point scenario shows a larger negative effect. The results shown above are slightly better in each interest rate scenario than those obtained as of December 31, 2006. These slight improvements reflect the maturity of certain financial instruments which had a negative effect on the results shown above.

Most of the declines in net interest income are small relative to the Company's net income and primarily result from the projected actions of customers and others taking advantage of the optionality built into the various financial instruments which make up the Company's assets and liabilities. The Company will continue to evaluate possible courses of action to control the risk of large interest rate declines on its operations.

Management will continue to analyze, simulate, and control interest rate risk as the Company grows. The Company may from time to time determine that the use of different financial instruments including interest rate caps, floors, swaps, long term borrowings, or other arrangements may be prudent. It is management's belief that the changes in the Company's balance sheet, including the increased emphasis on commercial lines of credit and certain other loans which tend to rapidly adjust to interest rate changes, and the declining importance of certain liabilities such as short term borrowings including reverse repurchase agreements and other short term liabilities will decrease the negative effects of changing interest rates on NII. However, these loans carry an increased risk of default, and increases in retail deposits will tend to increase non-interest expenses.

**ITEM 4. CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, management of the Company carried out an evaluation, under the supervision and with the participation of the Company's principal executive officer and principal financial officer, of the effectiveness of the Company's disclosure controls and procedures. Based on this evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934, as amended, (1) is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms and (2) is accumulated and communicated to the Company's management, including its principal and executive and financial officers as appropriate to allow timely decisions regarding required disclosure. It should be noted that the design of the Company's disclosure controls and procedures is based in part upon certain reasonable assumptions about the likelihood of future events, and there can be no reasonable assurance that any design of disclosure controls and procedures will succeed in achieving its stated goals under all potential future conditions, regardless of how remote, but the Company's principal executive and financial officers have concluded that the Company's disclosure controls and procedures are, in fact, effective at a reasonable assurance level.

In addition, there have been no changes in the Company's internal control over financial reporting (to the extent that elements of internal control over financial reporting are subsumed within disclosure controls and procedures) identified in connection with the evaluation described in the above paragraph that occurred during the Company's last fiscal quarter, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II OTHER INFORMATION**

Item 1 Legal Proceedings The Company is not involved in any pending legal proceedings. The Bank is not involved in any pending legal proceedings other than routine legal proceedings occurring in the ordinary course of business. Such routine legal proceedings, in the aggregate, are believed by management to be immaterial to the financial condition and results of operations of the company.





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**Item 1A Risk Factors** *A general housing price decline might have a negative impact on our operations* Recent developments in the housing market, including a dramatic rise in sub-prime mortgage foreclosure rates, have negatively impacted many financial institutions. Currently, the Bank has little direct exposure to these issues. In addition, the Bank has no direct exposure to exotic mortgage products such as option ARM s or interest only residential mortgage products. However, to the extent that the widespread availability of these products increased the demand and price of housing in our market area, the current higher foreclosure rates and the lack of available funding for certain prospective home buyers may lead to a general price decline in certain markets. A general housing price decline might have a negative impact on our operations leading to higher levels of loan losses and foreclosed assets. In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, **Item 1A. Risk Factors** in our Annual Report on Form 10-K for the year ended December 31, 2006, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks we face. Additional risks and uncertainties not currently known to us or that we have deemed to be immaterial also may materially adversely affect our business, financial condition, and/or operating results.

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

(a) Not applicable

(b) Not applicable

(c) The following table sets forth information regarding the Company s repurchases of its Common Stock during the quarter ended March 31, 2007.

| <b>Period</b> | <b>(a)<br/>Total<br/>Number<br/>of<br/>Shares<br/>Purchased</b> | <b>(b)<br/>Average<br/>Price<br/>Paid<br/>per<br/>Share</b> | <b>(c)<br/>Total<br/>Number<br/>of Shares<br/>Purchased<br/>as Part of<br/>Publicly<br/>Announced<br/>Plans<br/>or<br/>Programs</b> | <b>(d)<br/>Maximum<br/>Number of<br/>Shares<br/>that May Yet<br/>Be<br/>Purchased<br/>Under<br/>the Plans or<br/>Programs</b> |
|---------------|---|---|---|---|
|               |   |   |   |   |
| January 2007  |   |   |   | 63,737  |
| February 2007 |   |   |   | 63,737  |
| March 2007    | 558   | 24.90   | 558   | 63,179  |
| <b>Total</b>  | <b>558</b>  | <b>24.90</b>  | <b>558</b>  | <b>63,179</b>   |

On October 25, 2004, Tri-County Financial Corporation announced a repurchase program under which it would repurchase 127,500 shares of its common stock (as adjusted for the three for two stock splits declared in October 2004, December 2005, and October 2006). The program will continue until it is completed or terminated by the Board of Directors.

**Item 3 Default Upon Senior Securities** None

**Item 4 Submission of Matters to a Vote of Security Holders** None

Item 5 Other Information None

Item 6 Exhibits

Exhibit 10.1 Amended and Restated Employment Agreement by and among Community Bank of Tri-County,  
William J. Pasenelli and Tri-County Financial Corporation, as guarantor

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Exhibit 10.2 Amended and Restated Employment Agreement by and among Community Bank of Tri-County, C. Marie Brown, and Tri-County Financial Corporation, as guarantor

Exhibit 10.3 Amended and Restated Employment Agreement by and among Community Bank of Tri-County, Gregory C. Cockerham, and Tri-County Financial Corporation, as guarantor

Exhibit 31 Rule 13a-14(a) Certifications

Exhibit 32 Section 1350 Certifications

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**SIGNATURES**

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

**TRI-COUNTY FINANCIAL  
CORPORATION**

Date: May 10,  
2007

By: /s/ Michael L. Middleton

Michael L. Middleton, President, Chief  
Executive Officer and Chairman of the  
Board

Date: May 10,  
2007

By: /s/ William J. Pasenelli

William J. Pasenelli, Executive Vice  
President and Chief Financial Officer  
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